



FINANCIAL MARKET NEWS

THE REGULATION OF OTC DERIVATIVES IN EUROPE

This memorandum covers the forthcoming regulation of OTC derivatives in Europe.

Context and Background

The draft regulation on OTC derivatives, central counterparties and trade repositories (“the Regulation”) was published on Friday 17 September 2010. The opening paragraph of the Explanatory Memorandum to the Regulation refers to the near collapse of Bear Stearns in March 2008, the default of Lehman Brothers on 15 September 2008, and the bail out of AIG the following day. In contrast, when looking at cleared derivatives markets, there has never been a call on certain clearing systems such as LCH Clearnet, which has survived a number of market crashes and world wars unscathed. Regulators have been examining the particular role of Credit Default Swaps (“CDS”) in the crisis and produced a number of documents:

- 4 March 2009 “Driving European Recovery” COM (2009) 114, a commitment to deliver transparency and financial stability
- 3 July 2009 “Ensuring efficient, safe and sound derivatives markets” COM (2009) 332
- September 2009 G20 “All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end 2012 at the latest. OTC trades should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements”
- 20 October 2009 “ensuring efficient, safe and sound derivatives markets: Future policy actions” COM (2009) 563 (“the Langen Report”)
- June 2010 G20 “improve transparency and regulatory oversight of over the counter derivatives in an internationally consistent and non-discriminatory way”

In summary the regulation:

- Requires the clearing of certain OTC derivatives (list to be decided)
- Requires the reporting of OTC derivatives
- Requires capital and collateral to be put aside in respect of OTC derivatives which are not centrally, but bilaterally cleared (i.e. those not on the list)
- Upgrades the regulatory framework for Central Counterparties (“CCPs”)
- Puts in place a regulatory framework for trade repositories (ESMA will be responsible for their registration and surveillance)

The New European Financial Regulatory Landscape



There has long been a desire at European level, not necessarily shared by the Member States, for a European wide regulator of the financial sector. At the last round of consideration of this issue, a number of committees were established. These committees are now to metamorphose into nascent regulatory bodies with increased powers from January 2011, the intention being to introduce a single European rulebook:

Committee	Regulator
CEBS Committee of Banking Supervisors	EBA European Banking Authority
CESR Committee of European Securities Regulators	ESMA European Securities Markets Authority
CEIOPS Committee of European Insurance and Occupational Pensions Supervisors	EIOPA European Insurance and Occupational Pensions Authority

A further development of interest is the European Investigation Order, which will enable cross border investigation by one Member State police force into another Member State. The requested state will be duty bound to assist the requesting state, and this is predicted to create certain difficulties since various police forces have differing targets and approaches as to what are serious offences.

The New UK Financial Regulatory Landscape

The financial crisis, allied to the change to a Coalition government, has prompted a change in approach to financial market regulation. The Financial Services Authority is to be abolished and many of its functions are to be transferred to a new prudential regulatory authority, the Prudential Regulatory Authority. The operational regulatory functions are to be transferred to a new Consumer Protection and Markets Authority (CPMA). FSA has already been testing whether there will be any gaps. Despite the changes, FSA has indicated that it intends to carry on as normal.

Since Big Bang, the UK regulatory landscape has changed from one of specialist sectoral regulators with a considerable amount of self regulation, to one of a single market regulator, based on the Scandinavian model, with no self regulation. The last time the UK regulatory structure was addressed, the “twin peaks” model was rejected as second best, so it will be interesting to see whether it will succeed this time. It is likely to heal some of the difficulties, but by no means all. See our forthcoming detailed article on the subject. The immediate difficulties are likely to include:

- Too great a focus on banks
- No real simplification of an over complex and overly verbose approach to financial market regulation
- Increasing political interference, both at national and European level
- Higher capital requirements, thus making capital harder to access
- Continuing and regrettable absence of the element of self regulation



- Patchy and incoherent regulatory enforcement
- No coherent comprehensive regulatory model

The Regulation

The European Commission and ESMA will identify the class of eligible OTC derivatives that must be centrally cleared. CCPs will be subject to rigorous organisational, conduct of business and prudential requirements and ESMA will have a central role in their authorisation, being responsible for authorisation of non-EU CCPs. Trade repositories will be regulated at EU level.

The Regulation adopts two approaches to determine which OTC derivatives will be cleared, the objective being to make this list as broad as possible so as to reduce overall systemic risk:

- Bottom up – where a CCP decides to clear certain OTC derivatives and is authorised to do so by its competent authority, which is then to inform ESMA. ESMA will then decide on the basis of objective criteria whether a clearing obligation should apply to all of those contracts in the EU
- Top down – where ESMA together with ESRB determines which contracts should potentially be subject to the clearing obligation. This is seen as important to identify and capture those contracts that are not yet being cleared

Counterparties that are subject to the clearing obligation cannot avoid the requirement by deciding not to participate in a CCP. If the counterparty does not meet the participation requirements or is not interested in doing so, it must enter into an arrangement with a clearing member in order to access the CCP, similar to the arrangement of Clearing Members and Non Clearing Members of exchanges in the exchange traded derivatives world.

CCPs authorised to clear OTC derivatives are required to clear regardless of execution venue. Non FICs are assumed to be hedging commercial risk and thus exempt, provided their positions in OTC derivatives do not reach a systemically important level. This level is based on two thresholds (commercially hedged contracts will not be taken into account, only speculative ones, and then only on a net basis):

- An information threshold – allowing the identification of non FICs that have a significant position in an instrument, which then triggers an automatic requirement on the non FIC to report and justify its positions
- A clearing threshold – to assess whether the non FIC should become subject to clearing of all its contracts, or if they are not subject to central clearing, then capital and collateral requirements will be applied

OTC derivatives that are not centrally cleared will continue to be managed on a bilateral basis. Here, requirements come into play for use of electronic means, and risk management procedures with timely, accurate and appropriately segregated collateral, and appropriate capital.



FICs and non FICs over the threshold must report details of any OTC derivative to a registered trade repository, or if the TR cannot take the details, they must be reported to the relevant regulator direct. The Commission will determine the details, type, format and frequency of reports.

CCPs will need to have access to liquidity whether from central or commercial banks. Authorisation will be by national regulators but with ESMA involvement and ESMA will authorise CCPs of third countries. This will include focus on contingency plans. As regards third country CCPs, their legislative and regulatory framework must be equivalent to the EU, the CCP must be authorised and supervised effectively, and ESMA must have a co-operation agreement with the relevant regulator. CCPs must have robust governance arrangements covering conflicts of interest and independence of board members and the risk management function and be publicly disclosed. They must also have adequate internal systems, operational and administrative procedures, and be independently audited. They must also have stringent participation requirements, financial resources and other guarantees. Outsourcing by CCPs will only be allowed if it does not impact on the CCP's operation and its ability to manage risk. CCPs will have to hold a minimum level of capital and have a mutualised default fund.

The Regulation also has important rules on segregation and portability of positions and collateral. Interoperability is restricted to cash securities for the present, though may be extended with regulatory approval.

ESMA will be responsible for the authorisation and supervision of trade repositories and ensure unfettered access to the data they hold. TRs will be subject to organisational and operational requirements and ensure appropriate safeguarding and transparency of data. ESMA can also authorise third country TRs if certain requirements are met, including unfettered access to data, which in effect will require a treaty.

Review of the Markets in Financial Instruments Directive (“MiFID”)

The MiFID Review is addressing aspects of general regulation which will impact the world of OTC derivatives in this respect. See our separate memorandum on this subject.

What is “Europe”?

“Europe” for these purposes means the Member States of the European Union, it does not mean the whole of the European continent. It does not include the various micro states, such as Andorra, nor does it include the smaller states of the Balkans, for example, which have not yet joined the EU. See our separate Memorandum on Europe and its expansion.

Differences to the US approach



The approaches are remarkably similar, reflecting the overall objective of the G20. The US equivalent legislation is contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act. In both the US and the EU there will be a certain amount of implementing regulation putting flesh on the bones of the legislation.

There are certain key differences:

- there is no EU equivalent to the US concept of “push out” , restricting banks’ derivatives trading
- there is no EU equivalent to the US Volcker rule which restricts the proprietary trading activities of banks
- there is no EU equivalent to the US provisions allowing regulators to restrict bank ownership of CCPs
- in the EU, certain more general aspects are being dealt with separately under the MiFID review, whereas in the US regulation occurs within the Dodd Frank Act
- In the EU the clearing obligation has a de minimis limit, so clearing only applies to financial institution counterparties (“FICs”) when dealing with other FICs and non FICs when positions (excluding certain hedges) exceed a certain amount. In the US, the clearing obligation falls on all those trading certain contracts, with a narrow exclusion for when non FICs enter into certain hedging transactions
- In the EU, FICs and non FICs will have to have procedures requiring segregation of collateral or a proportionate holding of capital for uncleared OTC derivatives. In the US, margin requirements will be imposed on FICs and “major swap participants” (“MSPs”) (a broadly similar group to non FICs) entering into uncleared transactions
- In the EU, only limited rules will apply to non FICs (e.g. margin and capital). In the US, MSPs will be subjected to registration and conduct of business rules as well as margin and capital requirements
- In the EU, recognition of non-EU trade repositories will be conditional on conclusion of a treaty. In the US, recognition of non-US trade repositories depends on full compliance with US requirements
- In the EU, any amendments to the regime will take longer than in the US, and be more complex, hence the importance of lobbying in the EU sooner rather than later
- Differences may arise in definition of OTC derivatives to be subject to the clearing obligation
- For certain products therefore, it may turn out to be more advantageous to operate in the EU, and in others the US

Naturally, there are other markets in the world where it is possible to trade OTC derivatives, but no mention is made of these in the European regulation.

Alphabet Soup

Here is a short summary guide to the relevant financial markets abbreviations:



ACER	Agency for the Co-operation of Energy Regulators
AMF	Autorite des Marches Financiers
BaFIN	Bundesanstalt für Finanzdienstleistungsaufsicht
CCP	Central Counterparty
CDS	Credit Default Swap
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CEPS	Centre for European Policy Studies
CESR	Committee of European Securities Regulators
CFTC	Commodity Futures Trading Commission (US)
CPSS	Committee on Payment and Settlement Systems
DCM	Designated Contract Market (US term)
DG MARKT	Financial Markets Directorate of the European Commission (formerly DG XV)
DWG	Derivatives Working Group
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
ESCB	European System of Central Banks
ESMA	European Securities Market Authority
ESRB	European Systemic Risk Board
EU	European Union
FSA	Financial Services Authority
FSB	Financial Stability Board
G20	Group of Twenty
IOSCO	International Organisation of Securities Commissions
MSP	Major Swap Participant (US term)
OTC	Over The Counter
SEC	Securities and Exchange Commission (US)
SEF	Swap Execution Facility (US term)
TFEU	Treaty on the Functioning of the European Union
TR	Trade Repository
US	United States

This publication is intended for general purposes only and not as legal advice in relation to any specific scenario. For further information, please contact:

Financial Markets Law International
 Netherley House
 18 Watford Road
 St. Albans
 Herts AL1 2AJ
 United Kingdom

Tel: +44 1727 845897
 Fax: +44 1727 855838
 Mob: +44 7798 838125
 Email: rp@fmli.co.uk
 Web: www.fmli.co.uk