

Draft EU Regulation on OTC Derivatives

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8 February 2011

Outline

- Key issues in relation to regulation of OTC derivatives
- Summary of EU draft European Market Infrastructure Regulation (“EMIR”) re regulation of OTC derivatives
- Comparison with Dodd-Frank provisions in the U.S.

Overview

- Following the financial crisis, the regulation of OTC derivatives has been in sharp focus
 - initial impetus was in relation to CDS
 - the OTC market generally now faces much greater regulation
- There have been recent detailed regulatory proposals in the US and the EU and other jurisdictions (e.g. Japan)

Overview (cont.)

- September 2009: G-20 Agreement
- Regulatory proposals are focused on four key areas:
 - reducing counterparty risk including strengthening clearing requirements
 - reducing operational risk including greater standardisation and electronic processing
 - increasing transparency including through trade repositories
 - improving market integrity

EU Proposed Regulation of OTC Derivatives - History

- EU Commission Communication July 2009
- June 2010 - EU Commission further public consultation published
- Draft Regulation on OTC derivatives, central counterparties and trade repositories - 15 September 2010
- Belgian Presidency compromise proposals – 17 November 2010 and 7 December 2010
- Hungarian Presidency compromise proposal – 5 January 2011
- Draft Regulation is intended to be aligned with Dodd-Frank legislation on key issues

EU Proposed Regulation of OTC Derivatives - Overview

- An obligation on all financial counterparties to clear all eligible derivative contracts with CCPs
- An obligation on participants to report all OTC derivative contracts to trade repositories
- Obligations in respect of reporting, reconciliation, collateralisation and holding of capital in relation to non-clearing eligible OTC derivatives
- Rules relating to the authorisation and supervision of CCPs
- Organisational, conduct of business and prudential requirements for CCPs
- Rules on interoperability of CCPs
- Provisions for the registration and surveillance of trade repositories

EU Proposed Regulation of Derivatives – The Clearing Obligation

- All financial counterparties must clear all eligible derivative contracts through a CCP
- There is a dual process for determining whether a contract is eligible for clearing:
 - bottom-up approach
 - top-down approach
- CCP must accept the clearing of eligible contracts it is authorised to clear on a non-discriminatory basis regardless of the execution venue

EU Proposed Regulation of OTC Derivatives – Non Financial Counterparties

- A non-financial counterparty is exempt from the clearing obligation unless its position in OTC derivatives exceeds a “clearing threshold”
 - it is not clear where the clearing threshold will be set
 - if the counterparty’s position exceeds the clearing threshold, it will be subject to a clearing obligation for all its eligible derivative contracts
 - in calculating its positions the counterparty can disregard any derivative that is objectively measurable as reducing risks directly linked to the commercial activities of the counterparty

EU Proposed Regulation of OTC Derivatives – Non-Clearing Eligible Derivatives

- In relation to OTC derivatives entered into by financial counterparties (or non-financial counterparties subject to the clearing obligation) not considered eligible for central clearing, appropriate procedures and arrangements to monitor and mitigate operational and credit risk must be put in place including:
 - electronic means to confirm the contract terms
 - robust, resilient and auditable processes to reconcile portfolios, manage risks and monitor the value of outstanding contracts
 - timely, accurate and appropriately segregated exchange of collateral
 - appropriate and proportionate holding of (additional) capital

EU Proposed Regulation of OTC Derivatives – Reporting Obligation

- Financial counterparties will be under an obligation to report to a trade repository the details of any OTC derivative contract they have entered into
- Non-financial counterparties will also be under such an obligation (previous proposals to set a reporting threshold appear to have been dropped)
- EU Commission and ESMA to develop technical reporting rules

EU Proposed Regulation of OTC Derivatives – Authorisation and Supervision of CCPs

- CCPs established in the EU must apply for authorisation by a competent authority
- Certain minimum capital and liquidity requirements must be complied with
- National competent authorities will be responsible for authorisation and supervision of CCPs in their jurisdiction.
- ESMA will however also have an important role including:
 - ensuring common and objective application of the Regulation
 - developing draft technical standards
 - recognising and supervising CCPs from “equivalent” third countries
- CCPs will also be subject to organisational and conduct of business requirements.

EU Proposed Regulation of OTC Derivatives – Margin and Segregation

- A CCP must keep records and accounts enabling:
 - the distinction of the assets and positions of a clearing member from those of the CCP and any other clearing member
 - each clearing member to distinguish its assets and positions from those of its clients
 - each clearing member to distinguish the assets and positions held for the account of a client from those held for the account of other clients (“full segregation”)
- Clearing members must offer full segregation to their clients
- Clients that have selected full segregation may treat their exposures as exposures to a CCP giving a current exposure of zero for regulatory capital purposes under the CRD

EU Proposed Regulation of OTC Derivatives – Prudential Requirements

- CCPs are required to measure liquidity and credit exposures to clearing members and other CCPs on a near to real time basis
- Margin requirements
- Establishment of a default fund
- Liquidity risk controls
- Collateral requirements

EU Proposed Regulation of OTC Derivatives – Other Requirements

- Interoperability:
 - an arrangement between CCPs including cross-execution of transactions
 - regulatory approval needed from competent authorities
 - adequate risk management policies to be in place
 - arrangements to be restricted to cash securities (transferable securities and money market instruments)
- Regulation of trade repositories
 - ESMA to authorise trade repositories in the EU
 - ESMA may recognise trade repositories established outside the EU subject to conditions
 - ongoing governance, compliance, operational and other requirements

Comparison Between Proposed EU Regulation and Dodd-Frank Act

- Scope
 - both include very wide definitions including most derivatives
 - in the US, FX swaps and forwards may be exempted by regulation
- Regulatory responsibility
 - in the EU derivative trading continues to be regulated by relevant national regulators
 - CCPs in the EU will also be regulated by national regulators
 - ESMA will have an important role including development of technical standards and overseeing non-EU CCPs
 - Dodd-Frank establishes a bifurcated approach between the CFTC (swaps) and the SEC (security based swaps)

Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Non-financial entities:
 - under Dodd-Frank, exemption for non-financial entities which use a swap to hedge or mitigate commercial risk
 - EU rules permit non-financials to exclude derivatives which can be objectively viewed as reducing risks directly linked to their commercial activities
 - EU also provides a clearing threshold for non-financials in respect of derivatives not excluded from the clearing obligation

Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Clearing requirements:
 - both EU and US require impetus from clearing entities and regulators on which derivatives will be subject to clearing obligation
 - non-discriminatory acceptance for clearing from approved class in both cases
 - EU regulation does not currently require exchange trading for cleared derivatives
- Reporting requirements:
 - reporting requirements to trade repositories are similar
 - in US and EU, non-financials must report all swap transactions to repository even if exempt from clearing
 - unlike the US, EMIR does not provide for real time public reporting of derivative transactions although the recent MiFID review in the EU does now include this.

Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Trade repositories:
 - similar registration system in US and EU
 - US provisions do not specifically provide for recognition of non-US repositories
 - EU rules do envisage recognition of foreign repositories subject to conditions
 - similar provisions re risk control, disclosure, governance, etc.
- Regulation of CCPs:
 - more detailed cob, organisational and prudential rules in EU. US regulators to produce standards
 - grandfathering of existing CCPs in EU and US
 - both EU and US provide for recognition of foreign clearing systems subject to conditions
 - both provide for minimum capital requirements – currently US proposals are less detailed
 - US regulators may impose shareholding limits
 - no ownership cap in the EU but disclosure of shareholdings and changes in shareholdings required at specified thresholds

Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Segregation of collateral requirements
 - both US and EU contain rules requiring segregation of margin
 - in the US, in relation to non cleared swaps, counterparties can require segregation of initial margin
 - in the EU, in relation to non cleared swaps, counterparties can require segregation of margin. Ongoing debate as to whether this requirement should apply only to initial margin
 - in relation to cleared swaps, EU rules enable clients of clearing members to require their collateral to be segregated from that of other clients within the CCP
 - EU rules set out a default waterfall for CCPs. Margins posted by clearing members may not be used to cover losses resulting from the default of another clearing member
 - in relation to cleared swaps, the CFTC is consulting on four alternative approaches to collateral

Comparison Between Proposed EU Regulation and Dodd-Frank Act (cont.)

- Timing:
 - EU regulation intended to be in force by 2012
 - EU technical standards due to be completed by ESMA by end June 2012
 - most provisions of Dodd-Frank and relevant rules to be effective by July 2011
- Other provisions
 - EU rules contain no equivalent of the Volcker rule or swaps push-out rule
 - Dodd-Frank rules enable CFTC to impose position limits
 - EMIR contains contain no specific rules on position limits – CCPs may however impose these under their risk management obligations. The MiFID review also contemplates that regulators may require position limits for certain transactions
 - no specific provisions relating to interoperability of CCPs under Dodd-Frank

Issues for Cross-border Institutions

- Dodd-Frank will not apply to activities outside the US unless:
 - they have a direct and significant connection with activities in, or effect on, commerce of the U.S. or
 - they contravene such rules or regulations as may be prescribed under the Act necessary or appropriate to prevent the evasion of the relevant provisions of the Act
- Dodd-Frank envisages that swaps may be cleared through foreign clearing houses
- EU draft Regulation:
 - applies to entities with an establishment in the EU
 - envisages CCPs outside the EU subject to specified criteria