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Update on OTC Derivative Reform in Europe and the US

Author: Jacqui Hatfield, Partner, London
Author: Andrew P. Cross, Partner, Pittsburgh
Author: Rhianydd Griffith, Associate, London

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Introduction

The perceived opaque market structure and comparatively unmitigated risks existing in over the counter ("**OTC**") derivatives trading have generated much discussion amongst regulators in the last twelve months. The lack of public information available on the valuation of underlying assets (particularly in the context of certain bespoke credit derivative transactions), the price formulation of contracts and the potential domino effect that can result from the lack of a central counterparty in such transactions, arguably perpetuated the financial crisis and led to the G20 leaders' agreement in September 2009 that:

— *"all standardised OTC derivatives contracts should be traded on exchanges...and cleared through a central counterparty by the end of 2012 at the latest;*
— *OTC derivative contracts should be reported to trade repositories; and*
— *Non-centrally cleared contracts should be subject to higher capital requirements."*

Following a period of consultation ending on 10 July 2010, the European Commission (the "**EC**") has published a proposal for a Regulation on OTC derivatives, central counterparties and trade repositories (COM(2010) 484/5) (the "**Regulation**"). The provisions of the Regulation largely effect the G20 policy aims of improving the transparency, integrity and regulatory oversight of the OTC derivatives market and reducing counterparty and operational risk in trading.

If approved by the European Parliament ("**EP**"), the Regulation will be directly effective in all EU member states, which will prevent any member states having any margin of discretion when implementing the new regime. It is intended that the Regulation will come into force by the end of 2012.

Due to the global nature of derivatives trading, the Regulation has been drafted with the express intention of aligning its requirements with the similar reforms proposed in the US, under the Dodd-Frank Act. This client alert therefore not only outlines the content and potential implications of the proposed reforms within the EU (to the extent currently possible), but also provides a brief comparison between the US and EU regulatory positions.

Summary of the Regulation

The Regulation makes the use of a central clearing party ("**CCP**") compulsory for certain OTC derivative contracts, and attempts to improve risk and collateral management in those contracts where a CCP is not required. It also imposes an obligation on certain counterparties to report all OTC derivatives (whether or not cleared) to a registered *"trade repository"*, which will, in turn, be under a duty to make information available to the relevant member state regulators. Further provisions deal with the management and governance of the CCP's and trade repositories which will necessarily be established for the purpose of compliance with the Regulation.

Compulsory clearing

The Regulation provides that a CCP must be used for each OTC derivative contract where the contract in question is eligible for clearing and where the parties involved are subject to the clearing provisions.

Where the clearing obligation applies, the relevant counterparty will need to become a clearing member of a CCP or a client of a clearing member in order to comply.

Contracts eligible for clearing

As agreed by the G20, the clearing obligation will only apply to what are considered "standardised" contracts. The Regulation does not specify which particular types of contract will be considered standardised, but provides that the EC will take an ongoing, two-pronged approach to determine which contracts must be cleared:

- **The "bottom up" approach:** This will be market driven by allowing CCPs to decide which contracts they should clear. Once a CCP has been authorised to clear such contracts by its home regulator (in the case of the UK, the FSA) the regulator must notify

the newly formed European Securities Markets Association ("ESMA"). ESMA will then have the power to decide whether a blanket clearing obligation should apply to that type of contract across the EU.

- **The "top down" approach:** This will involve ESMA working in conjunction with a second authority?- the European Systemic Risk Board ("ESRB")?- to identify any contracts which are not already being cleared by CCP's, but should (in their view) be subject to the clearing obligation.
- When exercising its decision making power under this top down approach, ESMA is obliged by the Regulation to take account of certain criteria, including the need to reduce systemic risk in the financial system, the liquidity of contracts, the availability of pricing information, the ability of a CCP to handle the volume of a particular type of contract, and the level of client protection provided by the CCP. ESMA will conduct a public consultation before making any decision.

Where ESMA decides a type of contract is eligible for clearing under either approach, it will be listed in an up to date public register which will contain details of all eligible OTC derivatives contracts.

Counterparties subject to the clearing obligation

Financial counterparties (e.g. investment firms, banks, insurance undertakings, pension funds, UCITS and alternative investment fund managers) ("FCs") will be subject to the clearing obligation in respect of all eligible contracts which they enter into with:

- another FC;
- any non EU entity; and?
- any non-financial counterparty (defined as any party which is not an FC) which meets the *"clearing threshold"* (see below).?

Non-financial counterparties ("**NFCs**") will be subject to the same clearing obligation if their OTC derivatives positions meet the "clearing threshold". The clearing threshold is to be determined by draft technical standards to be issued by the EC, in conjunction with ESMA, the ESRB and any

relevant industry specific authorities by approximately 30 June 2012 - around six months before the Regulation should come into effect.

It is unclear, at this stage, precisely how the clearing threshold will be calculated. The EC states that in setting the threshold it will take into account the *"systemic relevance of the sum of net positions by counterparty per class of derivatives"* and it is envisaged that the clearing thresholds will be different for different asset classes, and possibly even within an asset class.

It is expressly stated that any OTC derivative contracts which are *"objectively measurable"* as being directly linked to the NFC's commercial activities will not be considered when measuring whether an NFC has exceeded the threshold. As such, an NFC using derivatives solely for commercial hedging activities i.e. to hedge the risk arising from its usual business activities (such as the supply of energy, agri or metals products, exports and air travel) should not generally be subject to the clearing obligation. This, of course, depends on how broadly this exception is construed in practice. No equivalent exemption applies to FCs.

If an NFC?meets the clearing threshold, it will be subject to the clearing obligation in respect of its eligible transactions (including otherwise exempt commercial hedges).

Risk management/margin requirements for non-cleared contracts

Where a contract is not eligible for clearing, the Regulation nonetheless imposes an obligation on both FCs and NFCs (which exceed the clearing threshold), to ensure that appropriate procedures and arrangements are in place to measure, monitor and mitigate credit and operational risk, arising from the trade. Such measures must include:

- electronic confirmations of the terms of a contract (where possible); and
- robust, resilient and auditable processes to monitor the value of outstanding contracts on a daily marked-to-market basis and to manage risk, including timely and appropriately segregated exchange of collateral or appropriate and proportionate holding of capital.

The EC (in collaboration with relevant supervisory authorities such as the European Banking Authority, the European Insurance and Occupational Pensions Authority and ESMA) is due to

draw up technical standards regarding the arrangements and levels of collateral and capital which will be required for compliance with the Regulation by 30 June 2012.

Whilst not contained in the Regulation, it is likely that non-cleared OTC contracts will be subject to higher capital resource requirements by regulators - providing an incentive for financial institutions to push OTC contracts onto CCP's. This is likely to provide the momentum for the "bottom up" approach detailed above to capture OTC derivatives.

Reporting Requirements

The Regulation provides that FCs must report details of any OTC derivative contract they have entered into (including any modification or termination of such a contract) to a registered trade repository no later than the working day after the execution, clearing, or modification of the contract. There is no eligibility criteria limiting the types of derivative contract which must be reported by an FC, so even OTC derivatives which do not have to be centrally cleared will still need to be reported.

The EC is to produce technical standards outlining the format, type and details of the reports which will be required for each class of derivative by 30 June 2012.

OTC derivative contracts which do not fall into a category which a trade repository will accept, must be reported to a relevant competent authority. Both counterparties to a transaction need not report it to the repository or authority, provided that one counterparty has complied.

NFCs which take positions in OTC derivatives which exceed an information threshold (to be set by the EC in conjunction with ESMA) will be obliged to notify the relevant competent authority (which, in the UK's case, would be the FSA) of that fact and to provide justification for its taking those positions. The NFC will then be subject to the same reporting requirements as are imposed on FCs (described above). Commercial hedging activities will count toward the information threshold.

The information threshold is intended to allow financial authorities to identify NFCs that have accumulated significant positions in OTC derivatives, and to subject them to the supervision of the authorities in a way they have not been previously. Again, in setting and reviewing the

information threshold, the EC is to take into consideration the "*systemic relevance of the sum of net positions and exposures by counterparty per class of derivatives."* It is to be seen what level of NFC exposure the EC will deem reportable.?

The trade repository in turn will be obliged to record the information it receives, and to make aggregate figures (calculated by class of derivative) available to regulators. The information recorded may also be made available to the counterparties to the transaction for the purposes of reference or correction, but will otherwise remain confidential.

Requirements for CCPs and Trade Repositories

The Regulation also sets out the procedure for the authorisation and supervision of CCPs and trade repositories. Such matters will be managed by the national regulatory authorities (e.g. the FSA in the UK) which will implement the requirements listed in the Regulation.

The significant requirements on CCPs include maintaining a minimum capital requirement of EUR 5 million, and the obligation to:

- have an independent risk committee;
- call and collect margins to cover credit exposures;?
- maintain a default fund to protect against the insolvency of one or more members; and
- accept only *"highly liquid collateral with minimal credit and market risk"*.

Such measures, in particular the margin requirement, may have an impact on the cost to market participants trading OTC, particularly where no such down payments have previously been necessary (for example under ISDA agreements with no supporting CSA).

Trade repositories will be subject to registration with ESMA, then to ongoing confidentiality, governance and non discriminatory access requirements, among others.

Penalties for non-compliance

National regulators will be tasked with making *"effective, proportionate and dissuasive"* rules regarding the penalties which will be imposed for non compliance with the provisions of the Regulation. The penalties must include *"at least"* administrative fines.

Comparison with the US regulatory position

As stated above, it was the express intention of the EC to make the Regulation consistent with the provisions on OTC derivatives in the Dodd-Frank Act (as far as is possible). In the main, this objective has been successful; however there remain certain significant differences between the two regimes. It will be interesting to see whether the differences are extended when the technical elements of the regimes are formalised - for example, global banks may find maintaining their compliance difficult if the lists of *"standardised"* contracts in the EU and US do not align.

In addition, there is a risk of financial institutions being able to take advantage of regulatory arbitrage if the systems are not kept broadly in line.

Who is subject to clearing?

The Dodd-Frank Act imposes a clearing obligation on all parties who trade a clearable contract, save for a very narrow exemption for non-financial entities which enter transactions to hedge or mitigate commercial risks. The Regulation appears to be more lenient than the Dodd-Frank Act, in that non-financial entities only become subject to the clearing obligation if their positions exceed a clearing threshold. In addition, under the Regulation financial entities trading with non-financial entities (who do not exceed the clearing threshold), will not be subject to the central clearing obligation. The Dodd-Frank Act does not contain an exemption from clearing or analogous concept as the "clearing threshold" provisions of the Regulation.

What is subject to clearing?

The Regulation applies to *"derivative contracts...that are traded over-the-counter"*.

The Dodd-Frank Act applies to any agreement, contract or transaction that is, or in the future becomes known to the trade as a *"swap,"* a broadly defined term that encompasses virtually every type of OTC derivative currently traded in the markets. The Dodd-Frank Act does however exclude from the definition of a swap any sale of a non-financial commodity for deferred shipment or delivery, so long as the parties intend to physically settle the transaction (the so-called, "forward contract exclusion").

Spot foreign exchange transactions remain outside the scope of regulation, but while the EU definition also excludes commercial forward foreign exchange transactions, the US definition is broader as it merely permits the Treasury Secretary to exempt foreign exchange swaps and forwards from the clearing obligation at some point in the future (and not from the reporting and other business conduct obligations).

In both the EU and the US, the details of the derivative contracts eligible for clearing are still to be determined by each regulator. However, there are differences in the frames of reference in each jurisdiction, as the US evaluation criteria are more detailed and also take into account clearing costs and the effect of a decision on competition, which is beyond the remit of the eligibility decision to be made by ESMA.

Other differences

The Dodd-Frank Act prohibits federal assistance to any swap dealer or major swap participant. However, insured banks are exempt from this prohibition if they keep their derivatives activities within certain limits, including hedging and dealing in interest rate swap and foreign exchange transactions. There is no equivalent provision in the Regulation. In addition, the Dodd-Frank Act contains the un-mirrored restriction on proprietary trading by banks *(the "Volcker Rule")* in order to limit the perceived volatility caused by banks speculating with their own profits.

The Dodd-Frank Act addresses issues related to trading and transparency which are not addressed by the Regulation, but will be dealt with under the upcoming review of the EU Markets in Financial Instruments Directive.

Finally, the Dodd-Frank Act mandates that all centrally cleared transactions trade through an exchange or a "swap execution facility," the latter constituting a trading platform that will be defined through the rulemaking process in the US over the next several months. The primary goal of this front-end execution mandate is to increase pre-trade price transparency and efficiency of the derivatives markets.

Comment

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Issues such as how the insolvency of a CCP will be handled have yet to be addressed - whilst this is meant to be very unlikely, it is difficult to see how this would have less of a domino effect than a large market participant under the pre-Regulation system collapsing.

Several outstanding issues remain with respect to the technical implementation and scope of the Regulation. As mentioned above, the types of contract eligible for clearing, the clearing and information thresholds for NFC's, the extent of the exemption for commercial hedging activities and the levels of collateral and capital required for non cleared contracts are still yet to be determined by EC technical standards.

Until the thresholds have been set, the full impact of the Regulation on the market will remain unknown. However, the Regulation needs to be viewed as one aspect of an increasing push towards transparency and disclosure in financial markets that have previously been operated without direct regulatory oversight.?In?particular, it may be formative in bringing OTC markets under the market abuse regime for the first time.

Interested participants should be looking at focusing their lobbying attempts at ensuring these thresholds are set at appropriate levels.

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