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EU Proposes Regulation of OTC Derivatives Market

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TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 29-10
ETF ADVISORY COMMITTEE No. 44-10
EQUITY MARKETS ADVISORY COMMITTEE No. 38-10
FIXED-INCOME ADVISORY COMMITTEE No. 20-10
INTERNATIONAL MEMBERS No. 22-10
SEC RULES MEMBERS No. 101-10 RE: EU PROPOSES REGULATION OF OTC DERIVATIVES MARKET

On September 15, 2010, the European Commission published a proposal for regulating the over-the-counter ("OTC") derivatives markets in an internationally consistent and non-discriminatory way. [1] The proposed regulation ("Regulation") is summarized below.

Title I (Subject matter, scope and definition)

The scope of the Regulation would include financial counterparties, non-financial counterparties (exceeding certain thresholds) and all categories of OTC derivatives contracts. As proposed, "financial counterparties" would include investment firms, credit institutions, insurance undertakings, assurance undertakings, undertakings for collective investments in transferable securities (UCITS), institutions for occupational retirement provision, and alternative investment funds managers. "Non-financial counterparties" would include all other counterparties. The types of OTC derivatives contracts that would be subject to the Regulation are listed in Annex 1, Section C, of the Markets in Financial Instruments Directive (MiFID); [2] certain derivatives (e.g., spot FX transactions forwards) ultimately may be excluded.

Title II (Clearing, reporting and risk mitigation of OTC derivatives)

The Regulation would require clearing of all "standardized" OTC derivatives – i.e., contracts that are eligible for clearing by central counterparties ("CCPs"). The eligibility requirement would be imposed to reduce risk in the financial system by forcing a CCP to clear contracts

that it is unable to risk-manage. The Regulation would introduce two approaches to determine which contracts would be cleared: (1) a "bottom-up" approach and (2) a "top-down" approach. Under the "bottom-up" approach, once a CCP decides to clear certain contracts and its competent authority approves the clearing, the European Securities Markets Authority ("ESMA") would determine whether a clearing obligation should apply to all of those contracts in the European Union. Under the "top-down" approach, ESMA, together with the European Systematic Risk Board ("ESRB"), would determine which contracts would be subject to the clearing obligations. The Regulation also would require CCPs to accept clearing of eligible contracts on a non-discriminatory basis regardless of the venue of execution.

Non-financial counterparties would be subject to the Regulation if their OTC derivatives positions cross an "information threshold" and a "clearing threshold" and are considered to be systematically important. The details of these thresholds would be specified by the European Commission on the basis of draft regulatory standards proposed by ESMA, in consultation with the ESRB. The information threshold would allow financial authorities to identify non-financial counterparties that have accumulated significant positions in OTC derivatives. Once the non-finanical counterparty exceeds the information threshold, it would be required to notify the competent authority of this fact, be subject to the proposed reporting obligation and provide justification for taking those significant derivatives positions.

The clearing threshold, on the other hand, would be used to establish whether a non-financial counterparty would become subject to the proposed clearing obligation. If some of the contracts in an OTC derivatives position are not eligible for CCP clearing, the non-financial counterparty would be subject to capital or collateral requirements. In calculating the positions for the clearing threshold, the Regulation would provide that a contract would not be taken into account if it is entered to cover the risks arising from an objectively measurable commercial activity. Furthermore, financial counterparties and non-financial counterparties above the clearing threshold would be required to report to a registered trade repository the details of any derivative contracts they have entered. The European Commission would need to be empowered to determine the details, type, format and frequency of the reports for the different classes of derivatives.

Title III (Authorization and supervision of CCPs)

The proposed authorization and supervision requirements for CCPs would apply irrespective of the type of financial instruments to be cleared by CCPs. The authorization of CCPs would be premised on CCPs' access to adequate liquidity, resulting from either capital requirements or access to central bank or to creditworthy and reliable commercial bank liquidity. The Regulation would provide that capital, together with retained earnings and reserves of a CCP, should be proportionate to the size and activity of the CCP at all times to ensure that the CCP is adequately capitalized against operational or residual risks and that it is able to conduct an orderly winding down or restructuring of its operations if necessary. Competent authorities would retain the responsibility for authorizing and supervising CCPs. ESMA, however, would play a central role in the authorization process because of the systemic importance of CCPs and the cross-border nature of their activities.

With regards to CCPs from third countries, ESMA would have direct responsibility for recognizing such CCPs if certain conditions are met. For example, the European Commission would have to ascertain the legal and supervisory framework of that third

country as equivalent to that of the European Union. The CCP also would need to be authorized and subject to effective supervision in that third country and ESMA would need to have cooperation arrangements with the third country competent authorities.

Title IV (Requirements for CCPs)

Organizational Requirements

To ensure robust governance arrangements of CCPs, the Regulation would introduce measures designed to address any potential conflicts of interest between owners, management, clearing members and indirect participants, which could limit CCPs' capacity to clear. The role of independent board members and the risk committee would be clearly defined and the CCPs' governance arrangements would be publicly disclosed.

Prudential Requirements

The Regulation would mitigate counterparty credit risk exposure arising out of the use of CCPs though a number of mechanisms, including stringent but non-discriminatory participation requirements, financial resources, and other guarantees. For instance, CCP authorization would be conditioned upon satisfying minimum capital requirements and a CCP would be required to have a default fund which members of the CCP would have to contribute to in case of insolvency. A CCP also would have to establish rules that each clearing member distinguish and segregate the assets and positions of its own from those of its clients. In addition, a CCP would be required to ensure that it could transfer assets and positions from one clearing member to another on the occurrence of a pre-defined trigger. These provisions would prevail over national insolvency law to ensure the orderly transfer of trades on the occurrence of the insolvency of a clearing member.

Title V (Interoperability)

Under the Regulation, an "interoperability arrangement" would be an arrangement between two or more CCPs that involves a cross-system execution of transactions. CCPs would have to satisfy the competent authorities regarding the soundness of their systems and procedures to manage the extra risk that interoperability entails. Given the early stage of the development of CCP clearing for OTC derivatives, the Regulation provides that it would not be appropriate at this time to extend this part of the proposal to instruments other than cash securities such as transferable securities or money-market instruments.

Title VI (Registration and surveillance of trade repositories)

The Regulation would include a reporting requirement to increase the transparency of the OTC derivatives market. The Regulation would give ESMA the powers to register trade repositories, withdraw their registration and perform surveillance.

Title VII (Requirements for trade repositories)

The Regulation would subject trade repositories to organizational and operational requirements to ensure appropriate safeguarding and transparency of data. To be registered, trade repositories would be required to be established in the European Union unless they are deemed subject to equivalent rules and appropriate surveillance in a third

country. The Regulation calls for an international agreement to ensure that there are no legal obstacles that would inhibit an effective exchange of information and unfettered access to data maintained in a trade repository.

If you have any questions or need additional information, please contact Heather Traeger at (202) 326-5920 or Jared Lee at (202) 326-5835.

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endnotes

[1] "Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, European Commission" (2010); available at http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm. The proposal follows earlier European initiatives to ensure efficient, safe and sound derivatives markets. See, e.g., "Public consultation on derivatives and market infrastructures" (2010); available at http://ec.europa.eu/internal_market/consultations/docs/2010/derivatives/100614_derivatives.pdf and "Declaration on strengthening the financial system" available at http://www.londonsummit.gov.uk/resources/en/PDF/annex-strengthening-fin-sysm.

[2] "Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments" (2004); available at http://eur-lex.europa.eu/LexUriServ/site/en/consleg/2004/L/02004L0039-20060428-en.pdf.