MEMO# 26562

October 9, 2012

European Securities and Markets Authority Issues Final Report on the Draft Technical Standard for Regulation of OTC Derivatives

[26562]

October 9, 2012

TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 63-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 54-12
ICI GLOBAL MEMBERS
INTERNATIONAL MEMBERS No. 42-12
INVESTMENT ADVISER MEMBERS No. 35-12
SEC RULES MEMBERS No. 90-12 RE: EUROPEAN SECURITIES AND MARKETS AUTHORITY ISSUES FINAL REPORT ON THE DRAFT TECHNICAL STANDARD FOR REGULATION OF OTC DERIVATIVES

On September 27, 2012, the European Securities and Markets Authority ("ESMA") issued its final report ("Final Report") setting forth specific standards on how the European regulation on OTC derivatives – European Market Infrastructures Regulation ("EMIR") – would be implemented. [1] ESMA issued the Final Report after two rounds of consultations and a public hearing. [2] The Final Report was submitted to the European Commission by September 30, and the Commission has three months to decide whether to endorse ESMA's draft technical standards.

The Final Report covers OTC derivatives, including indirect clearing arrangements, the clearing obligation, access to trading venues, non-financial counterparties, risk mitigation techniques for contracts not cleared by a central counterparty ("CCP"), and intergroup exemptions. The report also discusses CCP requirements, standards for trade repositories, and the information to be reported to trade repositories. A few of the significant issues for funds are discussed below.

Indirect Clearing Arrangements

In the Final Report, ESMA no longer imposes a mandatory requirement for clearing members ("CMs") to facilitate indirect clearing services although CMs that do provide indirect clearing services must do so on reasonable commercial terms. ESMA also no longer requires CMs to manage the positions of indirect clients for at least 30 days following the failure of a direct client. Moreover, the Final Report does not specify whether indirect clients will be able to request individually segregated accounts at the CCP level where indirect clearing services are available. ESMA, however, states that to effectuate its mandate to provide indirect clients equivalent protection as direct clients for the purposes of segregation and portability, ESMA recommends that CMs establish arrangements for the transfer of indirect clients' assets and positions to alternative providers of indirect clearing services on request and, where porting is not possible, put in place robust procedures to liquidate indirect clients' assets and positions.

Risk Mitigation for Uncleared Derivatives

For OTC derivative contracts that are not subject to the clearing obligation, counterparties are required to mitigate risks by using different techniques to be specified by ESMA in the technical standards.

Timely Confirmations

In the Final Report, ESMA would require financial counterparties to enter into confirmations on the business day following execution. Recognizing that this confirmation timeframe will entail a significant change to market practice, ESMA proposes a transition period. For credit default swaps and interest rate swaps concluded by February 28, 2014, financial counterparties would be required to confirm by the end of the second business day following execution. For equity swaps, foreign exchange swaps, commodity swaps and all other derivatives concluded by August 31, 2013, financial counterparties would be required to confirm by the end of the third business day and, for those derivatives concluded by August 31, 2014, by the end of the second business day following execution.

Portfolio Reconciliation and Portfolio Compression

The Final Report modifies the frequency with which portfolio reconciliation must be undertaken. Portfolio reconciliation must still be undertaken each business day when counterparties have 500 or more OTC derivative contracts outstanding with each other, weekly where counterparties have between 51 and 499 contracts outstanding, and quarterly where 50 or fewer contracts are outstanding. The provision on portfolio compression has remained largely unchanged. To give counterparties time to adapt their systems and procedures, the provisions on portfolio reconciliation and compression will apply six months after the technical standards enter into force.

Marking-to-Model

The Final Report continues to require independent monitoring and validation of marking-to-model (in situations where market conditions would prevent marking-to-market) to be undertaken by "another division than the division taking the risk." ESMA, however, clarifies in the recitals that the board may delegate the approval of the model for marking-to-model to a committee (although the ultimate responsibility for the model will remain with the board). ESMA also clarifies in the recitals that models may be developed externally rather than internally (although responsibility for the models will remain with the board).

Central Counterparties

Governance Arrangements

Although ESMA notes that the buy-side commenters requested stronger representation in risk committees and on the boards of CCPs, the Final Report states that ESMA had no mandate to further specify board or risk committee composition because the compositions of the risk committee and the board were already specified in EMIR.

Eligible Assets for Collateral and Valuation and Haircuts

The Final Report increases CCPs' level of discretion with respect to the valuation of collateral and applicable haircuts. CCPs are no longer able to rely wholly on external opinions in assessing the creditworthiness of financial instruments being used as collateral and with respect to the appropriate levels of haircuts. Although the Final Report adds "information regarding eligible collateral and applicable haircuts" to the list of information that CCPs are required to disclose publicly, EMSA does not mention any requirement to publish in advance changes that CCPs may make to their policy on accepting cash or financial instruments denominated in the relevant currency as collateral.

Trade Repositories

ESMA adopted a phase-in approach to reporting by asset class with interest rate and credit derivatives being reported first and the other asset classes six months later. Moreover, another six months is provided for the industry to develop or adapt systems required to report data on collateral. If there is no trade repository registered for a particular derivative class by a certain date, the draft technical standards give counterparties 90 days after which a trade repository has been registered before reporting must begin. If no trade repository is registered for a particular derivative by July 2015, the reports must be sent to ESMA.

Jennifer S. Choi
Senior Associate Counsel – Securities Regulation

endnotes

[1] The Final Report is available at http://www.esma.europa.eu/system/files/2012-600_0.pdf.

[2] ICI and ICI Global submitted a comment letter in response to the second consultation paper. For a summary of the comment letter, see ICI Memorandum No. 26368 (August 6, 2012), available at http://www.ici.org/iciglobal/myglobal/memos/memo26368.