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EU DERIVATIVES REFORM

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It is an often-quoted truism that when America sneezes Europe catches a cold. The United States sneezed with the Dodd-Frank Act in July 2010 and, on 15 September (the second anniversary of Lehman's bankruptcy), the European Commission responded with the publication of its much-anticipated draft legislation for overhauling the OTC derivatives market. Europe, at least for the moment, appears to be in rude health.

Shape of Legislation

The Commission's proposed legislation, in contrast to previous financial markets harmonisation initiatives, takes the form of a regulation (rather than a directive). So, unlike predecessor landmark reforms such as the Prospectus Directive and the Markets in Financial Intermediation Directive (MiFID), once it clears the legislative hurdles, the regulation will have direct effect throughout the EU without requiring any separate implementing legislation by individual member states. Furthermore, member states will not be permitted to "gold-plate" the regulation with additional restrictions.

The scope of the regulation extends to all OTC derivative contracts conducted by both financial and non-financial institutions domiciled in the European Union. The regulation would introduce a framework of central clearing for the majority of standardised derivative contracts, heavily regulate central counterparties (CCPs) and impose strict reporting requirements to trade repositories.

All of this would be implemented and supervised by new pan-European regulatory body, the European Securities and Markets Authority (ESMA).

Central Clearing

Central clearing of derivatives contracts has been a central theme of the EU's proposed reforms since the Commission's original communication on the derivatives markets in July 2009. This was supported by the G-20 agreement in September 2009 that, by the end of 2012, all standardised OTC derivatives contracts must be centrally cleared.

The regulation would implement this aim, and sets out two complementary approaches for determining which derivatives contracts would be made subject to mandatory central clearing. The "top-down" approach gives ESMA, in cooperation with the European Systemic Risk Board, discretion to require CCP clearing of categories of derivative contracts that are not already centrally cleared. Conversely, the "bottom-up" approach allows ESMA to consider which contracts are already centrally cleared by CCPs and to make a determination as to whether clearing of these contracts should be made mandatory.

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This bifurcated approach recognises the efforts that the derivatives industry is already making in moving towards central clearing of certain standardised contracts, but gives the regulator power to influence this process to protect the integrity and security of the market.

In setting out the clearing requirement, the regulation makes a distinction between financial and non-financial counterparties. Financial counterparties will be required to centrally clear all categories of derivative transactions that have been designated by ESMA. However, non-financial counterparties will be exempt from central clearing and/or notification to ESMA, unless they are transacting in volumes that exceed certain thresholds (to be determined at a later date by the Commission). Any transactions that are entered into by these non-financial counterparties to manage their commercial risks shall be excluded when determining whether such thresholds would be met.

Risk Management Requirements

In respect of those derivatives transactions not subject to mandatory clearing, strict risk management requirements would be introduced. The regulation tasks ESMA with developing these standards in areas such as electronic trading, portfolio reconciliation, dispute resolution, collateral segregation and capital requirements. ESMA, in coordination with other pan-European regulators, has a deadline of 30 June 2012 to submit these draft regulatory standards to the Commission.

Central Counterparties

Central clearing of standardised derivative contracts is a central tenet of the regulation. However, the Commission is justifiably fearful that CCPs could themselves contribute to systemic risk in the market and seeks to address this concern in the regulation. While individual member states will authorise and supervise CCPs, there will be a requirement for close co-operation with a "college" of other regulators comprising ESMA and those national regulators with a close connection to the relevant CCP or its clearing members. ESMA will be required to develop technical standards and to resolve disputes among the members of the relevant college. ESMA will also be responsible for determining which CCPs located outside the European Union will be recognised.

CCPs will be subject to robust governance arrangements, as well as being compelled to introduce strong internal systems and procedures. They will also be scrutinised by independent audits. They will be obligated to mitigate the credit risk that they will face from their external counterparties by tough entry requirements on who may use their services and ongoing margin obligations.

Margin must be segregated by the CCP to ensure that both it and its clearing members are protected against a counterparty's default. The threshold limits and fine detail of how this will be done are subject to later disclosure by the Commission.

Where a clearing member does default, its posted margin will be applied first to cover the CCP's losses (broadly speaking the cost of it entering into a replacement contract). If this is insufficient, the CCP will also have recourse to a default fund sourced from the other clearing members in proportion to their exposure. After that the CCP may look to its own capital, as well as to other credit support arrangements that it has put in place.

The regulation stresses the importance of interoperability of CCPs, i.e. the ability of counterparties to trade across separate CCP platforms. However, interoperability agreements are subject to risk management arrangements and the approval of relevant national regulators.

Trade Repositories

Regulators want to know what is going on. To achieve this, the regulation requires the establishment of trade repositories. ESMA

(and not individual member states) will regulate and monitor these to ensure consistent application of reporting standards across the European Union.

Financial counterparties will have to notify the relevant trade repository of any new transaction no later than one business day after it is entered into or modified. If no such repository existed at the time the relevant trade was executed then the reporting requirement will be deferred until a suitable trade repository has been established.

ESMA will use the information to increase market transparency and to identify and quickly address any systemic risks.

The regulation makes it possible for ESMA to recognise trade repositories established outside the European Union, so long as equivalent requirements are met.

What's in Store?

The regulation is in proposed form. Technically only the Council of Ministers and the European Parliament need to pass it for it to become law across the whole European Union. Practically though, further lobbying by the derivatives industry may lead to modifications, and the work involved in properly establishing ESMA and other proposed pan-European regulators, together with the detailed rule-making provisions they must implement, may draw the process out.

US regulation will likely take effect first, perhaps by more than a year: the US Dodd Frank Act was enacted in July, with its detailed rule-making provisions for derivatives to be concluded by July next year.

With many of the politically charged aspects of the Dodd-Frank Act (such as pushing out financial institutions' derivative desks to new entities, restrictions on proprietary trading, and the potential introduction of derivative position limits) absent from the regulation though, the European side of the derivative industry may be counting itself lucky not to have caught that cold.

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