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E.U. DERIVATIVES REFORM: THE SHAPE OF THINGS TO COME

By Edmund Parker

On Sept. 15th, the second anniversary of Lehman Brothers' bankruptcy no less, the European Commission published draft legislation overhauling the regulation of Europe's OTC derivatives market.

The proposed legislation (a directly effective regulation), covers all OTC derivative contracts entered into by European Union domiciled financial and non-financial institutions. It contains a framework for centrally clearing most standardised derivative contracts, and scrutinising and controlling those which are not; beefy regulation of central counterparties (CCPs) and trade repositories; and strict reporting requirements to those newly created trade repositories.

A new pan-European regulatory body, the European Securities and Markets Authority (ESMA) will oversee implementation and will, in coordination with other pan-European regulators, write detailed rules to flesh out the regulation's broad principles by the middle of next year. They will have its work cut out – similar detailed rules in corresponding United States legislation are likely to run to thousands of pages!

Central Clearing

OTC derivatives central clearing is the poster child of derivatives regulation, both in Europe and the US. The regulation has two

approaches to deciding which derivatives contracts must be centrally cleared. A “top-down” approach will give ESMA, (with help from the European Systemic Risk Board) power to require central clearing of selected derivative categories not already centrally cleared. And a “bottom-up” approach will allow these regulators to demand mandatory central clearing of categories of derivatives already to some extent centrally cleared.

The regulation draws a distinction between those who use OTC derivatives, distinguishing between financial and non-financial counterparties. Financial institutions will have to centrally clear all OTC derivatives categories which ESMA designates. Non-financial counterparties though will be exempt from central clearing and/or notification to ESMA, unless that is their non-hedging transaction volumes exceed certain, yet to be determined, thresholds.

Quis custodiet ipsos custodes?

Regulators hope that central clearing will guard the financial system against the woes it alleges derivatives to have caused in the financial crisis. But who will watch over the central counterparties, so that they in turn do not create systemic risk, or institutions deemed to be big to fail?

Individual member states will regulate their CCPs, but must co-operate with a



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“college” of national regulators. The CCP’s will have rigorous internal systems and procedures, open themselves up to internal audits, call for and segregate margin from their members, and be restrictive as to whom they admit as members.

The regulation also deals with what happens when a clearing member defaults. First it provides that posted margin will be applied to cover the CCP’s losses (i.e. the cost of a replacement contract). If this is insufficient, the CCP will look to a default fund funded by other clearing members. Finally, it will look to its own capital and resources.

Risk Management Requirements

The regulation promises that ESMA will develop strict risk management requirements for non-centrally cleared trades, in particular in relation to electronic trading, portfolio reconciliation, dispute resolution, collateral segregation and capital requirements

Trade Repositories

To keep regulators in the know, the regulation will establish trade repositories, which will also be ESMA regulated.

Financial counterparties will then notify the relevant trade repository of new derivative transactions. ESMA will use the information to increase market transparency and to identify and quickly address any systemic risks.

The EU proposed legislation is broadly similar to the OTC derivatives legislation introduced by the Dodd-Frank Act in the U.S. To the relief of many though, certain of the more contentious areas are absent: such as pushing out financial institutions’ derivative desks to new entities, restrictions on proprietary trading, and the potential introduction of derivative position limits.