MAYER • BROWN

Article

This article first appeared in a slightly different form in *Derivatives Week*, 28 December 2009

REGULATING DERIVATIVES: WHAT'S IN STORE FOR EUROPE AND THE US IN 2010?

By Edmund Parker and Devora Kirk

On 20th October, the European Commission (the "Commission") published "Ensuring efficient, safe and sound derivatives markets: future policy actions". This was the parting communication of the "Barroso Commission" - the European Commission in place since 2004. The communication set out the future planned policy actions for regulating derivatives, which the new Commission, will implement in 2010.

The Commission's proposals centre on reducing counterparty credit risk and operation risk; increasing market transparency; and enhancing market integrity and oversight. The new Commission will start the process of drafting "ambitious legislation to regulate derivatives in 2010"; and if the planned changes come to fruition, they will be momentous.

Across the pond, momentous changes in derivatives regulation are being implemented. Legislation has navigated through Congress, with compulsorily clearing and exchange trading for standardised products, and greater regulation of market participants – now enshrined in a bill making its way to Senate.

The European Proposals

The Commission's proposals cover four areas: reducing counterparty credit risk; reducing operation risk; increasing transparency; and enhancing market integrity and oversight:

Reducing counterparty credit risk

The Commission concluded that the crisis demonstrated that market participants had failed to price counterparty credit risk correctly, and that clearing through a central clearing counterparty (CCP) would have mitigated this. The Commission has already encouraged the establishment of CCPs for credit derivatives. We now have several in Europe. The Commission will now propose legislation to regulate the conduct of business and governance of CCPs, in particular to address conflicts of interest, access, transparency of risk, business procedures and continuity.

Legislation will cover the same range of derivative financial instruments as MiFID. The legislation will provide rules to ensure that CCPs do not employ low risk management standards. It will also provide greater legal protection for collateral provided to CCPs. Although supervision of CCPs will be provided by a home member state, authorisations granted under this proposal would allow CCPs to provide their services in all Member States.

Central clearing for certain standardised derivatives contracts will become mandatory. However, the communication recognises that central clearing is not suitable for all derivative

Edmund Parker *is a partner and head of the derivatives practice at Mayer Brown International LLP, and* **Devora Kirk** *is a trainee at Mayer Brown International LLP.*

products. One of the most keenly debated regulatory points of 2009! However, the Commission believes though that derivative contracts have been under collateralised in the past, and so will propose legislation requiring financial firms to post initial margin and variation margin (to reflect changes in mark to market value). This is also intended to act as an incentive to central clearing. Non-financial firms will be regulated less and will not face these requirements.

New rules will apply heftier capital charges to non-centrally cleared derivatives contracts, than those that are centrally cleared. The Commission believes that a strong differential will also encourage central clearing. We expect a heated debate as to just how hefty these capital charges will be.

Reducing operational risk.

The Commission intends to reduce operational risk through mandatory use of data repositories as well as encouraging standardisation of legal terms of contracts and enhancing the speed of contract processing. The market though has already made its own efforts here, with the standardisation of coupons under the small bang protocol being a good example.

Increasing transparency.

The Commission will propose legislation to force market participants to record non-centrally cleared transactions and positions in trade repositories. Further legislation will regulate these trade repositories. These changes are proposed for mid-2010. Legislation will also bring about trading of standardised derivatives on exchanges and other trading platforms. A review of MiFID in 2010 will revisit the transparency of derivatives traded on exchanges or other organised venues.

Enhancing market integrity and oversight.

A review of the Market Abuse Directive (MAD) in 2010 will clarify and extend the scope of its market manipulation provisions in relation to derivatives and give regulators the possibility to set position limits to counter excessive price movements or concentration of speculative positions.

ISDA's Response

ISDA responded to the communication immediately. The response was cautious, asking that "any new policies or regulations preserve and enhance the critical ability of market participants to manage their risk exposures", and stating that "ISDA thinks the benefits, as well as the drawbacks, of exchange trading now need to be carefully weighed" counselling that "mandated exchange trading could limit the flexibility of derivatives users to hedge their risk exposure" and that "some forms of price disclosure and inappropriate forms of standardisation will harm liquidity by disincentivising participation in derivative markets."

Although ISDA was supportive of the Commission's calls for transparency, and stated its commitment to the increased use of CCPs, it was critical of increasing collateral requirements on non-financial institutions.

The US Perspective

Proposed OTC derivatives regulation in the United States has been gathering momentum in 2009. The hysteria has lapsed: credit derivatives won't be banned. The path of the legislation which is likely to become law started in May 2009 when the US Treasury released proposals to reform the regulation of the OTC derivatives market. It is unusual for an administration to release a bill, but that's just what the Obama Administration did when it released the "Over-the-Counter Derivatives

Markets Act of 2009" in August. This is popularly known as the Obama Proposal; and it built on the Treasury proposals.

Barney Frank, the House Financial Services Committee Chairman, took the Obama Proposal and together his committee, released on 2nd October a bill amending and enhancing the Obama Proposal. This amendment to the "Over-the-Counter Derivatives Markets Act of 2009" is known as the Frank Bill. The proposed regulation provided for split regulatory oversight by the Commodities and Futures Trading Commission ("**CFTC**") and the Securities Exchange Commission ("**SEC**") of clearing houses and swap participants; with detailed rule-making to follow. It outlined a push to compulsory clearing and exchange trading of many derivatives contracts, with margin requirements for those not cleared; and certain protections for collateral provided. Tight requirements for trading performed through exchanges and clearing houses; and reporting of information to trade repositories are also set out.

The Agricultural Committee, led by Collin Peterson, then performed a mark-up of the Frank Bill calling it "Derivatives Markets Transparency and Accountability Act of 2009" which it released on 21st October. This mark-up is known as the Peterson Bill. It introduced an end users exemption from the regulatory radar and gave regulators the power to impose position limits to limit speculation in commodity derivative underlying assets such as oil. A combined bill, was passed by Congress on 11 December. Broadly in the shape of the Peterson bill, it contained some further amendments, such as limiting bank ownership of clearing houses. The bill now goes to the Senate, before going back to the President.

There is many a slip between cup and lip, and ample opportunity for these proposals to be wrecked by administrative delay or amendment in the Senate.

We believe that the reforms will come, but their extent (and the range of exemptions provided, particularly in relation to extra-territorial reach) are still open to debate. 2010 will be very interesting indeed.