News Bulletin

September 20, 2010

Draft EU Regulation on OTC Derivatives, Central Counterparties and Trade Repositories

On 15 September 2010, the European Commission ("EU Commission") tabled its legislative proposal (the "Proposal") for a Regulation on OTC derivatives, central counterparties and trade repositories (the "Regulation").[1]

The draft regulation, aimed at improving the transparency and safety of the over-the-counter ("OTC") derivatives market, is very much in line with the Commission's previous consultation papers.[2]

It is also intended to be aligned with the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") on key issues (e.g., partial exemption for non-financial counterparties), with the aim of ensuring a level playing field between the European Union ("EU") and U.S. and to reduce opportunities for regulatory arbitrage.

As with the Dodd-Frank Act, however, there still remain many details to be filled in by future regulation.

We summarise below the key provisions contained in the draft Regulation.

Title I: Subject Matter, Scope and Definition

The proposed scope of the Regulation is broad and covers all trades of financial derivatives which are made in the OTC market, as listed in Annex I, Section C, paragraphs (4)-(10) of the Markets in Financial Instruments Directive ("MiFID").[3] Title I lays down the uniform requirements covering financial parties and non-financial counterparties (e.g., manufacturing, agricultural or energy companies) where they exceed either the clearing or information thresholds. Prudential provisions apply to central counterparties ("CCPs") in relation to the clearing obligation (not only for derivatives but also any other financial instruments) and trade repositories in relation to transaction reporting.

Members of the European System of Central Banks ("ESCB"), other national bodies managing public debt and multilateral development banks are excepted from the scope of the Regulation, so that they may exercise their powers to intervene to stabilise the market unfettered.

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[1] European Commission Proposal for a Regulation on OTC derivatives, central counterparties and trade repositories (15 September 2010), http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf. *See also* European Commission Press Release: Making derivatives markets in Europe safer and more transparent (15 September 2010), http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1125&format=HTML&aged=0&language=EN&guiLanguage=en.

[2] *See* Morrison & Foerster client alert: Structured Thoughts: Clearing the way for reform: European Commission consultation on derivatives and market infrastructures (29 June 2010), http://www.mofo.com/files/Uploads/Images/100629StructuredThoughts.pdf.

[3] Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments, http://eur-lex.europa.eu/LexUriServ/site/en/consleg/2004/L/02004L0039-20060428-en.pdf.

Title II: Clearing, Reporting and Risk Mitigation of OTC Derivatives

Eligibility for the clearing obligation

As agreed at the G20 leaders' summit in September 2009, financial counterparties will come under an obligation to clear all their standardised (i.e., "eligible" according to the regulatory criteria) OTC derivative contracts through CCPs which are listed in a register maintained by the European Securities and Markets Authority ("ESMA").[4] Non-financial counterparties exceeding a "clearing threshold" (yet to be determined) will also be subject to such clearing requirement.

In order to ensure that as many OTC contracts as possible will be cleared through CCPs whilst actually reducing, rather than compounding, the risks in the financial system, a contract's "eligibility for the clearing obligation" will be determined through a dual process, as follows:

1) A *"bottom-up"* approach, whereby once a CCP is authorised by its competent authority to clear a class of derivative contracts, the competent authority must inform ESMA, which will then determine whether a clearing obligation should apply to all such contracts in the EU. This decision will be based on the following objective criteria:

- reduction of systemic risk in the financial system;
- the liquidity of contracts;
- availability of pricing information;
- ability of the CCP to handle the volume of contracts; and
- level of client protection provided by the CCP.

Before making its decision, ESMA must conduct a public consultation and where appropriate also consult with competent authorities in third countries.

2) A *"top-down"* approach, whereby ESMA, together with the European Systemic Risk Board ("ESRB"), will determine which contracts (which are not as yet being cleared by a CCP) should potentially be subject to the clearing obligation.

A CCP that has been authorised to clear eligible derivative contracts must accept clearing of such contracts on a non-discriminatory basis, regardless of the execution venue where they are concluded.

Counterparties which do not meet the participation requirements, or which are not interested in becoming clearing members, must enter into the necessary arrangements with clearing members to access the CCP as clients.

Non-clearing-eligible derivatives

In relation to OTC derivatives which are not considered to be eligible for central clearing, the relevant counterparties (i.e., financial counterparties or non-financial counterparties exceeding the clearing threshold) will be required, as a means of mitigating operational and credit risks, to use or implement the following:

- electronic means of ensuring timely confirmation of the contract terms;

[4] *See* Morrison & Foerster client alert: The New EU Financial Regulatory Framework (16 September 2010), http://www.mofo.com/files/Uploads/Images/100916-EU-Regulatory-Framework.pdf. ESRB is a new macro-prudential authority to oversee financial stability in the EU, and ESMA is a new European Supervisory Authority which will replace the current Committee of European Securities Regulators (CESR), both from 1 January 2011.

- robust, resilient and auditable processes to reconcile portfolios, manage risks and monitor the value of outstanding contracts;
- timely, accurate and appropriately segregated exchange of collateral;[5] and
- an appropriate and proportionate holding of (additional) capital.

Reporting obligation

Financial counterparties will be subject to an obligation to report to a trade repository (i.e., a central data bank) registered with ESMA the details of any OTC derivative contract they have entered into and any modifications (including any novation or termination) no later than one working day after the execution, clearing or modification. The reporting obligation will also apply to non-financial counterparties exceeding an "information threshold" (yet to be determined).

The information held by trade repositories will be made available to ESMA and other regulatory authorities, and trade repositories will be required to publish aggregate positions by class of derivatives on the contracts reported to them.

The EU Commission will determine the details, type, format and frequency of the reports for different classes of derivative contracts, in accordance with technical standards to be developed by ESMA. The reports must contain at least:

- the parties to the contract and, where different, the beneficiaries of the rights and obligations under it; and
- the main characteristics of the contract, including the type, underlying, maturity and notional value.

Should a trade repository be incapable of recording the details of a particular OTC derivatives contract, this information should be provided directly to the relevant competent authority.

Member states will be responsible for laying down penalty rules for failure to comply with the obligations under Title II and must notify the rules to the EU Commission by 30 June 2012 (and any subsequent amendments).

Partial exemption for non-financial counterparties

A partial exemption is granted to non-financial counterparties, such that (i) the clearing obligation will only apply if they exceed a clearing threshold and (ii) the reporting obligation will only apply if they exceed an information threshold.

Thus, corporates will only be subject to a clearing or reporting obligation if they are active participants in the OTC derivatives market the value of whose OTC derivatives positions meet the relevant threshold and are considered to be systemically important. In determining this threshold, derivatives entered into for the purpose of commercial activity (i.e., hedging), will not be taken into account. This represents an important change from the previous proposals by the EU Commission which did not include such a carve-out.

Such non-financial counterparties will be subject to the same regulatory requirements as financial counterparties, and the clearing obligation will apply to all its OTC derivative contracts (not just those above the threshold).

[5] It is unclear whether the reference to segregated collateral indicates an intention to require segregation of collateral for non-centrally-cleared OTC Derivatives, and currently in the majority of OTC derivatives trades, collateral posted is not required to be segregated by the recipient. EBA, ESMA and EIOPA will be jointly producing draft regulatory technical standards, *inter alia*, by 30 June 2012 for adoption by the European Commission.

The relevant thresholds have yet to be specified by the EU Commission. The draft Regulation provides that the thresholds will be based on the draft technical standards to be proposed by ESMA, taking into account the "systemic relevance" of the sum of net positions and exposures by counterparty per class of derivatives and in consultation with ESRB and other relevant authorities (e.g., in case of energy markets, the Agency for the Cooperation of Energy Regulators).

The revised proposals relating to non-financial entities are therefore likely to allay some of the concerns raised by the non-financial industry which had undertaken significant lobbying to seek to exempt non-financial entities from the clearing requirement. The draft Regulation provides a wider exemption for non-financial entities than the Dodd-Frank Act which only exempts non-financials from a clearing obligation in respect of their hedging activities subject to certain conditions. However, there remain uncertainties in the draft Regulation which will be closely watched by the non-financial sector. It is not yet clear how high the clearing and information thresholds will be set. In addition, little guidance is given in the draft Regulation as to what constitutes a derivative entered into for the purpose of commercial activity. It appears this will be wider than a strict hedging position, but it is likely that the EU Commission will want to prevent the provision being interpreted too widely. It is likely ESMA will need to publish further guidance on this question in due course.

Title III: Authorisation and Supervision of CCPs

CCPs established in the EU must apply for authorisation by a competent authority, which will require them to have access to adequate liquidity (through the central bank and/or a creditworthy and reliable commercial bank).

In order to be authorised a CCP must have an initial minimum capital of at least €5 million. A CCP must have sufficient capital, together with retained earnings and reserves, to protect against operational and residual risks. The EU Commission will adopt regulatory technical standards relating to capital, retained earnings and reserves, following submission of draft standards formulated by ESMA, in consultation with EBA, by 30 June 2012.

National competent authorities will remain responsible for the authorisation and supervision of CCPs in their jurisdiction. However, in light of the systemic importance of CCPs and the cross-border nature of their activities, ESMA will also be given a central role in the authorisation process by being charged with responsibilities:

- to ensure common and objective application of the Regulation;
- to develop a number of draft technical standards in critical areas for correct application of the Regulation; and
- to facilitate the adoption of a joint opinion by the college of supervisors.

The Regulation also includes provisions for dealing with "emergency situations" (not defined), given that CCPs are systemically important institutions. The relevant competent authorities must define procedures and contingency plans to address emergency situations. The EU Commission must also develop specific policies and measures in its future initiative on crisis management and resolution.

In addition, ESMA will also have the direct responsibility of recognising CCPs from "equivalent" third (i.e., non-EU) countries to perform activities and services in the EU, i.e., where:

- the EU Commission has determined that the legal and supervisory framework of that country is equivalent to that of the EU;
- the CCP is authorised and subject to effective supervision in that third country; and
- ESMA has established co-operation arrangements with the third country's competent authorities.

Title IV: Requirements for CCPs

Organisational requirements

A CCP must have in place robust governance arrangements, which must be publicly disclosed, including, *inter alia*:

- the establishment of an independent risk committee, composed of representatives of its clearing members and independent members of the board;
- the implementation of adequate internal systems, operational and administrative procedures (including recordkeeping), subject to independent audits; and
- effective written arrangements to identify and manage any potential conflicts of interest.

It must notify the competent authority of any changes to its management and provide it with all the information necessary to assess whether the board members are of good repute and sufficiently experienced.

Where any parties propose to acquire (directly or indirectly), or dispose of, a "qualifying holding" (defined as 10% or more of the capital or voting rights) in a CCP, they must first notify the competent authorities of the CCP in writing, indicating the size of the intended holding. Such written notification will be required if as a result of the proposed acquisition the proportion of the capital or voting rights held would reach or exceed 10%, 20%, 30% or 50%, or the CCP would become its subsidiary. Likewise, prior written notification of a proposed disposal will be required if as a result of the proposed disposal the capital or the voting rights held would fall below 10%, 20%, 30% or 50%, or the CCP would cease to be its subsidiary.

Upon receipt of such notification, the competent authority will make an assessment within a period of 60 working days and may oppose the proposed acquisition[6] of a qualifying holding in the CCP. In order to ensure the sound and prudent management of the CCP which is proposed to be acquired, the competent authority will appraise the suitability of the proposed acquirer and the financial soundness of the proposed acquisition against the following criteria:

- the reputation and financial soundness of the proposed acquirer;
- the reputation and experience of any person who will direct the business of the CCP upon the proposed acquisition;
- whether the CCP will be able to comply, and continue to comply, with the provisions of the Regulation; and
- whether there are reasonable grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing is being committed, or that the proposed acquisition could increase the risk thereof.

Outsourcing will only be allowed if it does not impact on proper operation of the CCP and its ability to manage risks. CCPs will remain fully liable where any of its operational functions are outsourced.

Conduct of business requirements

CCPs will be subject to conduct of business requirements including an overriding requirement that when providing services to its clearing members or their clients, a CCP must act fairly and professionally in their best interests and sound risk management.

[6] Interestingly, the proposed Regulation makes no mention of the relevant competent authority being able to oppose a proposed disposal of a qualifying holding.

A CCP will be required to establish the categories of admissible clearing members and non-discriminatory, transparent and objective criteria for the participation. In particular, a CCP will be required to ensure that clearing members which clear transactions on behalf of their clients have the necessary financial resources and operational capacity.

CCPs will need to publicly disclose the fees and prices for their services and must disclose to clearing members and clients the risks associated with the services provided.

Prudential requirements

In view of the systemic importance that CCPs will have, the Regulation sets out prudential requirements for CCPs.

Critically, CCPs must mitigate their counterparty credit risk exposure through a number of risk control mechanisms, which include:

- measuring its liquidity and credit exposures to clearing members and any other CCPs with whom it has concluded an interoperability arrangement on a near to real time basis;
- setting margin requirements which capture the risk characteristics of the products cleared and the interval between margin collections, market liquidity and possible changes over the term of the transaction;
- calling and collecting margins to limit its credit exposures to clearing members at a level sufficient to cover losses that result from at least 99% of the exposure movements over an appropriate time horizon;
- segregating the margins posted by each clearing member and, where relevant, other CCPs with which it has an interoperability arrangement;
- establishing and maintaining a mutualised default fund to which its clearing members must contribute, to be applied in priority to other financial resources in covering losses which arise from any default by its clearing members;
- maintaining sufficient other financial resources (e.g., a clearing fund or an insurance or loss-sharing arrangement) to cover potential losses in excess of the default fund and the margins;
- developing "scenarios of extreme but plausible market conditions" to ensure that default fund and other financial resources will enable the CCP to withstand the default of its two largest clearing members or sudden sales of financial resources and rapid reductions in market liquidity; and
- having default procedures in place to deal with a clearing member's failure to comply with the participation requirements.

A CCP will be required to only accept highly liquid collateral with minimal credit and market risk to cover its exposure to clearing members, applying adequate haircuts to asset values that reflect the potential for declines in value. The EU Commission is empowered to adopt regulatory technical standards specifying the type of collateral that can be considered highly liquid and the appropriate haircuts.

A CCP will only be permitted to invest its financial resources in highly liquid financial instruments with minimal market risk and credit risk, within acceptable concentration limits.

A CCP must, where available, use central bank money to settle its transactions; where central bank money is not accessible, steps must be taken to strictly limit credit and liquidity risks.

Title V: Interoperability

Article 2 defines an "interoperability arrangement" as "an arrangement between two or more CCPs that involves a cross-system execution of transactions." Interoperability is regarded as an essential tool to achieve an effective integration of the post-trading market in the EU, but could expose CCPs to additional risks. Therefore, regulatory approval will be required before CCPs may enter into an interoperability arrangement.

CCPs entering into an interoperability arrangement must put in place adequate risk management systems to effectively identify, monitor and manage the additional risks involved.

In view of the additional complexity involved, the scope of interoperability arrangements will be restricted to "cash securities" (i.e., transferable securities and money-market instruments) at this stage. ESMA is to report to the EU Commission by 30 September 2014 on whether other financial instruments should also be permitted.

The EU Commission has stated it believes interoperability will be important in achieving effective integration in the European markets. Its proposals are, however, likely to be subject to considerable comment and debate, including discussions on whether the safeguards and limitations imposed in relation to such activities will in practice make effective interoperability between different CCPs difficult to achieve in a meaningful way.

Title VI: Registration and Surveillance of Trade Repositories

ESMA will be the regulatory authority empowered to authorise or withdraw the registration of trade repositories and will be responsible for monitoring their compliance with the registration requirements. The registration of a trade repository will be effective throughout the EU.

In order to be registered, trade repositories must be established in the EU (and meet the applicable requirements under Title VII). However, a trade repository established in a third country may be recognised by ESMA, if it meets the requirements to establish that such trade repository is subject to equivalent supervisory rules and appropriate surveillance in that third country, i.e.:

- the trade repository is authorised and subject to effective surveillance in that third country;
- the EU Commission has decided that the legal and supervisory arrangements of that third country is equivalent to those of the EU;
- ESMA has established co-operation arrangements with the third country's competent authorities for immediate and continuous access to all the necessary information; and
- additionally, the EU has entered into an international agreement with that country on mutual access to and exchange of data maintained in trade repositories.

At ESMA's request, the EU Commission may impose a fine on a trade repository which intentionally or negligently breaches its obligations under Title VI. The EU Commission is also empowered to adopt regulatory technical standards on (i) detailed criteria for establishing the amount of such fine; and (ii) appropriate procedures for enquiries, decisions, rights of defence and the quantification and collection of the fines.

Title VII: Requirements for Trade Repositories

The Regulation will also impose a set of standards for registered trade repositories to meet, ranging from governance, compliance, operational systems and safeguarding the integrity of the information received.

So as to give all market participants and relevant regulators a clear view of the OTC derivatives market, trade repositories must also:

- publish aggregate positions by class of derivatives on the contracts reported to them; and
- make available the necessary information to ESMA and relevant competent authorities and central banks.

Title VIII: Transitional and Final Provisions

By 31 December 2013, the EU Commission must review and report to the EU Parliament and Council on the institutional and supervisory arrangements under Title III (authorisation and supervision of CCPs) and the role of ESMA in particular.

Also by 31 December 2013, the Commission must, in coordination with ESMA and the relevant sectoral authorities, assess the systemic importance of the transactions of non-financial counterparties in OTC derivatives.

By 30 September 2014, ESMA must submit reports to the EU Commission on the application of the clearing obligation under Title II (Clearing, reporting and risk mitigation of OTC derivatives) and on the extension of the scope of interoperability arrangements under Title V (Interoperability arrangements) to other transactions in classes of financial instruments than transferable securities and money-market instruments.

In addition, the EU Commission will, in cooperation with the member states and ESMA, and after requesting the assessment of ESCB, provide an annual report to EU Parliament and EU Council assessing the systemic risk and cost implications of interoperability arrangements, together with appropriate proposals.

Next Steps

The Proposal will next be passed to the EU Parliament for further negotiations with the EU member state governments in the coming months, which may lead to possible amendments. It is likely to be adopted in the course of next year, and once adopted the new Regulation will apply from the end of 2012.

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