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Alert Memo

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

On September 15, the EU Commission published a draft regulation on OTC Derivatives, Central Counterparties and Trade Repositories (the "OTC Derivatives Regulation").[1] The OTC Derivatives Regulation will require financial counterparties and non-financial counterparties over certain transaction volume thresholds to clear standardized OTC derivatives through registered central counterparties ("CCPs"). Financial counterparties will also have to report their derivatives contracts to registered trade repositories. The OTC Derivatives Regulation will set out requirements both for CCPs and for trade repositories. The OTC Derivatives Regulation provides that draft implementing rules and standards should be submitted to the Commission by the end of June 2012, and it is expected that the final provisions will apply to market participants from the end of that year.

The OTC Derivatives Regulation reflects the policies laid out by the Commission in its communication of October 2009 and subsequent communications on reform of the derivatives markets,[2] and also the final declaration of the Pittsburgh G-20 leaders' summit in September 2009.[3] The regulatory approach taken in the OTC Derivatives Regulation is generally consistent with that of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[4] There are significant differences between the OTC Derivatives Regulation and Dodd-Frank, however, including the absence of an EU requirement to trade standardized derivatives contracts on exchange, the EU's imposition of interoperability requirements on CCPs for cash markets, and the details of the protections that CCPs will be required to adopt to protect against member defaults. In addition to the OTC Derivatives Regulation, the Commission is planning

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1 See proposal for a regulation at http://tinyurl.com/OTCRegulation

2 COM(2009) 563 – http://tinyurl.com/OctoberCommunication, and the Commission's June 2010 Public Consultation on Derivatives Markets Infrastructures – http://tinyurl.com/DerivativesConsultation

3 http://tinyurl.com/G20June2010

4 See the CGS&H Alert Memorandum "Dodd-Frank Wall Street reform and Consumer Protection Act Poised to Usher in Sweeping Reform of U.S. Financial Services regulation", July 9, 2010 for further details. http://www.cgsh.com/summary_of_the_dodd-frank_wall_street_reform_and_consumer_protection_act/

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other regulatory reforms to enhance the transparency and stability of the derivatives markets.[5]

I. BACKGROUND

In its communications on reform of the derivatives markets, the EU Commission has identified four main policy objectives: to (i) increase standardization of derivatives contracts, (ii) increase the use of trade repositories, (iii) mandate the use of CCPs for standardized OTC derivatives, and (iv) increase the use of organized trading venues. These reforms seek to reduce counterparty and operational risk, increase transparency, and enhance market integrity and oversight.

The Commission's initiatives in the area of derivatives regulation form part of a broader regulatory reform program notably including the establishment of four new European-level supervisory authorities, including the European Securities and Markets Authority ("ESMA") and the European Systemic Risk Board ("ESRB").[6] ESMA and ESRB will play important roles in the implementation of the OTC Derivatives Regulation.

This memorandum considers the key elements of the OTC Derivatives Regulation:

- Rules on OTC Derivatives entered into by financial and non-financial counterparties;
- Regulation of CCPs; and
- Regulation of trade repositories.

This memorandum also discusses similarities and differences between the OTC Derivatives Regulation and the related provisions of Dodd-Frank.

II. RULES ON OTC DERIVATIVES

A. SCOPE

The OTC Derivatives Regulation will apply to financial counterparties, non-financial counterparties that enter into OTC derivatives over certain thresholds, CCPs and trade repositories. "Financial counterparties" are defined to include EU investment firms, credit institutions, insurance, assurance and reinsurance companies, EU mutual funds ("UCITS") and alternative investment fund managers. "Non-financial

[5] See the CGS&H Alert Memorandum "Developments in EU Regulation of Derivatives", July 5, 2010 for further details. http://www.cgsh.com/eu_commission_consultation_on_derivatives_and_market_infrastructure/

[6] On September 2, 2010, the EU Council of Ministers and the European Parliament reached agreement in principle on the new EU supervisory framework. The agreement was approved by the Council on September 7 and is expected to be approved by the European Parliament in the week of September 20. The new supervisory bodies are intended to be established by January 2011.

counterparties" include all other entities established in an EU Member State. The provisions relating to CCPs and trade repositories are discussed below. The OTC Derivatives Regulation will not apply to national central banks and multilateral development banks.

B. CLEARING REQUIREMENTS

Under the OTC Derivatives Regulation, eligible OTC derivatives contracts between financial counterparties will have to be cleared through an EU-registered CCP, with each financial counterparty acting as a clearing member or client of the CCP.[7] The clearing obligation also applies to eligible OTC derivatives contracts entered into with non-EU entities, whether or not they are financial counterparties.

Non-financial counterparties that take positions in OTC derivatives exceeding clearing thresholds to be determined by the Commission (based on draft regulatory standards developed by ESMA and ESRB) will also be subject to the clearing obligation in respect of all of their relevant OTC derivatives contracts. In calculating the thresholds for non-financial counterparties, those OTC derivatives contracts that are directly linked to the commercial activity of that counterparty will be excluded. In the U.S., non-dealer market participants (whether or not engaged primarily in a financial business) who have a "substantial position" in swaps (excluding certain hedging positions) or whose swaps create "substantial counterparty exposure" will be regulated in a substantially identical manner to dealers and therefore come within the clearing obligation notwithstanding the limited exemption for non-financial entities.[8] The Commission believes a similar approach to those being proposed internationally is important to avoid the possibility of regulatory arbitrage by market participants.

The OTC Derivatives Regulation establishes a framework within which OTC contracts subject to mandatory clearing will be identified. To determine which OTC derivatives contracts are "eligible," the Commission proposes a dual approach: a "bottom up" approach under which a CCP who wishes to clear a particular class of contract can apply to ESMA for authorization; and a "top down" approach under which ESMA and the ESRB can specify eligible contracts that are not yet subject to clearing by any CCP. When a CCP applies for authorization to clear a particular class of contract, ESMA will consider a series of factors: (i) reduction of systemic risk in the financial

[7] The EU proposals do not got as far as the U.S. regime however, which may require foreign financial counterparties to register with the CFTC or SEC as swap dealers or major swap participants on the current drafting of the legislation, resulting in significant capital and disclosure obligations – for more details, see our Alert Memorandum referred to in note 4, above.

[8] Under the Dodd-Frank provisions, there is a limited exception to the mandatory clearing requirement for a defined category of end users. Specifically, this exception will be available to a person (and under specified conditions, an affiliate of a person) who (a) is not a "financial entity" (defined broadly, but excluding certain captive consumer financing entities), (b) is using swaps to hedge or mitigate commercial risk and (c) notifies the CFTC or SEC, as applicable, "how it generally meets its financial obligations associated with entering into non-cleared swaps".

system, (ii) the liquidity of the contracts, (iii) the availability of pricing information, (iv) the ability of a CCP to handle the volume of contracts, and (v) the level of client protection. It remains to be seen how the "top-down" approach will work in practice, as any specification by ESMA could operate in effect as an outright ban if no CCP had sought authorization to clear the relevant class of derivative.

The OTC Derivatives Regulation would not require CCPs to clear all eligible OTC derivatives. The Commission's Explanatory Memorandum notes that "forcing a CCP to clear OTC contracts that it is unable to risk-manage may have adverse repercussions on the stability of the system." Instead, the Commission is relying on European CCPs taking the commercial initiative to clear all relevant contracts. Where a CCP does decide to clear relevant OTC contracts and is authorized to do so, however, it must do so on a non-discriminatory basis, regardless of the "venue of execution", which would appear to include multilateral trading and other facilities not regulated as markets under the Markets in Financial Instruments Directive ("MiFID") as well as pure OTC contracts. Unlike the U.S. position, however, where certain standardized derivatives are required to be traded on eligible trading venues, the OTC Derivatives Regulation does not include any obligation for identified classes of contract to be centrally traded on a regulated market, multilateral trading facility, or otherwise.

C. REPORTING REQUIREMENTS

Financial counterparties and non-financial counterparties whose activities exceed certain information thresholds to be determined by the Commission (based on draft regulatory standards developed by ESMA and ESRB) will be required to report details of all their OTC derivatives contracts (including those entered into with non-financial counterparties) to a registered trade repository within one day, or, where the repository is not able to record that information, to the relevant competent authority. The Commission will adopt regulatory standards for such reports based on drafts to be published by ESMA. This is a more lenient requirement than the U.S. position under Dodd-Frank, where all OTC Derivative contracts, including bilateral bespoke deals, need to be publically reported on a "real time" basis, as soon as technologically practicable, subject to certain limited exceptions for block trades.

D. RISK-MITIGATION REQUIREMENTS

Financial counterparties or non-financial counterparties that exceed the clearing threshold will be required to put in place procedures to measure, monitor and mitigate operational and credit risk. These procedures will include employing electronic means to ensure the timely confirmation of the terms of their OTC derivative contracts and putting in place robust, resilient and auditable processes to monitor the value of outstanding contracts, reconcile portfolios, manage risk and identify disputes. The value of outstanding contracts will be required to be marked to market on a daily basis. Traders will be obliged to put in place risk management procedures that include timely, accurate

and appropriately segregated exchanges of collateral and will themselves be required to have appropriate and proportionate capital resources. Further details will not become clear until implementing measures are agreed. As such, it is too early to say, for example, whether the EU rules will require segregated collateral to be held with independent third party custodians, as required in the U.S. under Dodd-Frank.

III. REGULATION OF CCPS

A. EU CCPS

An EU CCP's home country regulators will have the primary responsibility for authorizing and supervising the CCP. Once authorized, CCPs will have the right to operate throughout the EU. Those existing EU CCPs that are already permitted to carry out clearing services will be required apply for authorization under the OTC Derivative Regulation regime within two years of it coming into force.

ESMA will also play a key role in the regulation of CCPs, as the OTC Derivatives Regulation gives ESMA responsibility for ensuring common application of the OTC Derivatives Regulation and competence to develop technical standards in key areas related to CCP regulation. ESMA is also a member of the "college of regulators" (composed of regulators and other participants related to a CCP's jurisdiction and proposed areas of operation), which will be consulted, amongst other matters, on the CCP's application for authorization.

The OTC Derivatives Regulation would not require CCPs to be "credit institutions" under MiFID, as is the case in a number of European jurisdictions. The Commission had initially supported this requirement, since it would give CCPs access to central bank liquidity. However, this requirement would have constituted a significant departure from current practice in, for example, the United Kingdom, where CCPs benefit from "exempt status" under the Financial Services and Markets Act 2000[9] and are subject to a bespoke regulatory regime, administered by the Financial Services Authority.[10] However, access to adequate liquidity remains a condition of authorization, and the regulation provides that this requirement could be met either by authorization as a credit institution or from other "appropriate arrangements."

B. THIRD-COUNTRY CCPS

CCPs from countries outside of the EU will only be permitted to operate in the EU to the extent that they have been recognized by ESMA. For a non-EU CCP to be recognized, the Commission must first confirm that the legal and supervisory framework of the relevant country is equivalent to the EU's, and the CCP is authorized and subject

[9] Section 285 of the Financial Services and Markets Act 2000 sets out the scope of a recognised clearing house's exemption from the authorisation requirements of the Act.

[10] The recognition regime is set out in the Financial Services Authority's REC sourcebook.

to supervision in that third country. Additionally, ESMA must have established cooperation arrangements with the relevant third-country regulatory authority. If ESMA recognizes a non-EU CCP, then EU counterparties may satisfy the clearing requirement by clearing through that CCP.[11]

C. CCP OPERATING REQUIREMENTS

A number of organizational and prudential requirements for CCPs, which seek to harmonize key areas of CCP regulation throughout the EU, are set out in the OTC Derivatives Regulation. The Commission explains in its Explanatory Memorandum that these requirements have been introduced to ensure that CCPs have robust governance arrangements, including a clear organizational structure with well-defined, transparent and consistent lines of responsibility, as well as effective processes to identify, manage, monitor and report risks. These aims are reflected in high-level obligations on CCPs to put in place appropriate procedures, systems and resources. In particular, CCPs will be required to separate reporting lines between risk management and other operations and to put in place a remuneration policy that does not incentivize risk taking.

1. Conflicts of Interest and Independence

The OTC Derivatives Regulation would impose new rules to avoid conflicts of interest with owners, management, clearing members and indirect participants. The OTC Derivatives Regulation emphasizes the role to be played by independent board members and requires CCP risk committees to be staffed only by independent directors and representatives of clearing members – a provision that is likely to be particularly controversial in relation to those CCPs owned by an exchange or other trading venue (*i.e.*, a so-called “vertical silo”). Governance arrangements within a CCP must be publicly disclosed and subject to independent audits. The OTC Derivatives Regulation would also impose requirements relating to the composition of CCP boards and record keeping. In practice, many of these requirements replicate national provisions or best practices already followed by many EU CCPs. The Explanatory Memorandum states that the Commission believes that it is appropriate to require these measures, irrespective of a CCP’s ownership structure.

The OTC Derivatives Regulation would impose obligations to determine that shareholders and persons with “qualifying holdings” of 10% in the CCP are “suitable”. Similarly, where close links exist between a CCP and other persons, the authority may only grant authorization where those links do not prevent effective supervision. Finally,

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[11] In the U.S., Dodd-Frank similarly permits the clearing requirement to be satisfied by clearing through a foreign clearinghouse deemed comparably regulated. In practice, however, a separate requirement that a firm clearing swaps be registered with the U.S. Commodity Futures Trading Commission as a futures commission merchant could, absent exercise of agency exemptive authority, make this alternative illusory.

the competent authority would have to approve significant acquisitions and disposals of interests in CCPs. Any such decisions must be based on an assessment of the reputation, experience and financial soundness of the acquirer, as well as the CCP's ability to continue to comply with its regulatory obligations. These requirements mirror similar obligations that apply to all EU credit institutions, investment firms, and other financial services providers.

2. Outsourcing

In line with other recent EU financial services rules, outsourcing will only be allowed where it does not impact the proper functioning of a CCP and its ability to manage risks. As the Commission notes in its Explanatory Memorandum, this means that "in practical terms, no risk management functions will be allowed to be outsourced." This will be a concern to those CCPs who currently outsource a broad range of functions to external providers and may require the renegotiation or termination of existing outsourcing contracts to ensure appropriate control remains with the CCP.

3. Capital Requirements and Default Protections

The Commission's proposed harmonization of prudential requirements aimed at reducing counterparty credit risk exposure goes to the heart of CCP structures and protection models. The OTC Derivatives Regulation would require CCPs to have stringent but non-discriminatory participation requirements and to disclose fully the prices and fees charged for the services it provides. The former is likely to be of concern to captive CCPs operating in a vertical silo, who would be required to accept clearing members not otherwise trading on their related exchanges.

The OTC Derivatives Regulation will establish a framework that will govern the series of complementary protection mechanisms that a CCP must put in place. CCPs must have minimum capital of €5 million, and a mutualised default fund. The regulations create a framework for establishing minimum margin levels and harmonizing permitted collateral for margin requirement and requires intra-day margining of clearing members when certain thresholds have been crossed. It also aims to reduce settlement risk by requiring CCPs, as a condition to authorization, to have access to adequate liquidity. This includes the use of central bank money where available, or to creditworthy and reliable commercial bank liquidity. A CCP's capital, together with retained earnings and reserves, must be sufficient to ensure an orderly winding-down or restructuring of the activities of the CCP over an appropriate time span, and should ensure that the CCP is adequately protected against operations and residual risks.

In addition to these measures, the OTC Derivatives Regulation provides for CCPs to maintain other "sufficient available financial resources" to cover potential losses that exceed losses covered by margin requirements and their default funds. Examples include "any other clearing fund provided by clearing members or other parties, loss sharing

arrangements, insurance arrangements, the own funds of the CCP, parental guarantees or similar provisions." In practice, however, none of these options are likely to be a particularly attractive (or realistic) for CCPs, and this requirement appears to go significantly further than the protections presently provided by European CCPs.

Notably, the OTC Derivatives Regulation provides that a CCP must segregate the margin posted by each clearing member and, where relevant, by CCPs with which it has interoperability arrangements, and is required to ensure that these margins are protected from any losses that the CCP itself may suffer and against the default of other members. The regulation also gives clients of clearing members the right to require that their positions be "portable" to another clearing member, or to be segregated (along with related margin) from positions of clearing members and other clients.

The Commission believes that the proposed changes will help to reduce counterparty credit risk and will meet certain concerns highlighted by Lehman's demise. However, segregation of client positions and the resulting additional margin requirements effectively reduce collateral efficiency and may therefore increase the cost of clearing. These developments may not be attractive to market participants who clear on a number of exchanges and currently benefit from significant collateral efficiencies through netting and/or cross-margining. All of these provisions are likely to involve operational changes at CCPs, where margin today is often co-mingled and where, in the extreme situation of a CCP default, clearing member cash margin would often form part of the estate of the insolvent CCP.

4. Interoperability

Increasing interoperability between post-trade infrastructure providers is a key policy goal of the Commission. However, interoperability increases the links between systemically important institutions and therefore needs to be carefully regulated to avoid creating additional risk. The effect of the interoperability provisions in the OTC Derivatives Regulation when read alongside the existing European Code of Conduct for Clearing and Settlement is to require CCPs in cash markets to enable cross-system execution and settlement of transactions by entering into arrangement with other CCPs, subject only to risk-based restrictions.

The OTC Derivatives Regulation provides that, when establishing an interoperability arrangement with another CCP to provide services to a particular trading venue, the CCP shall have non-discriminatory access to data from that trading venue and to the relevant settlement system. Furthermore, a CCP may only reject or limit another party's request to enter into an interoperability arrangement or to provide data feed or settlement system access to avoid risks. This is in notable contrast to U.S. rules under Dodd-Frank, which entitle a derivatives clearing organization to decline to enter into any inter-clearinghouse arrangements involving mutual offset, cross-margining,

interoperability or similar arrangements that would expose it to the credit risk of another clearing organization.

Under the OTC Derivatives Regulation, approval will be required before entering into an interoperability arrangement, and CCPs will be required to satisfy their competent authorities that their systems and procedures are sufficient to address any extra risks incurred by the new arrangements. The Commission does not currently intend to extend the compulsory interoperability provisions beyond cash markets, but by September 30, 2014, ESMA should report on whether an extension to other financial instruments would be appropriate. An extension of compulsory interoperability to derivatives markets would be controversial amongst CCPs. Derivative contracts remain registered for significantly longer settlement periods than cash securities, and CCPs regard control over the liquidity represented by this "open interest" as critical to the success of their businesses.

IV. REGULATION OF TRADE REPOSITORIES

As discussed above, the OTC Derivatives Regulation requires market participants to report OTC derivative transactions to authorized trade repositories that will collect and maintain records of OTC derivatives to aid transparency for regulators. The OTC Derivatives Regulation requires repositories to be authorized and supervised by ESMA and sets out a framework of harmonized standards to ensure that information is reliable and secure. Trade repositories must be established in the EU, but overseas repositories may be recognized by ESMA if the relevant overseas jurisdiction provides appropriate supervision and international information-sharing agreements are in place.

V. CONCLUSION

In conclusion, the OTC Derivatives Regulation represents a significant change to the status quo. The clearing and reporting requirements will fundamentally change the way that OTC derivatives are traded and settled, decreasing counterparty risk and adding transparency to a market that has traditionally been opaque. Furthermore, when coupled with the new prudential and operational requirements for CCPs, the changes are likely to have a practical impact on the method and cost of doing business, further emphasizing the importance of liquid collateral and focusing the attention of the market on the efficiencies that can be gained through interoperability and cross-margining. However, much of the detail remains to be set by implementing measures.

While the headline changes brought about by the regulation would decrease counterparty credit risk by bringing more transactions into the clearing net and increasing transparency, it is likely that the market will focus further on the potential risks of CCP structures themselves. Moves away from a bilateral trading model toward a centrally cleared hub-and-spoke model provide significant benefits and protections for members in the context of most counterparty defaults, but in extreme circumstances rely

on the CCP being too big to fail. To address this, the new requirements on CCPs impose for the first time a harmonized European set of minimum requirements governing capital, authorization and default protections, much of which will require changes to long-established practices. Furthermore, structural goals such as interoperability, client margin segregation and portability – whilst conceptually beneficial to clearing members and their clients – may require significant investment in infrastructure at the CCP operational levels and may have a high administrative cost. Ultimately, any increased costs to CCPs will be borne by the market.

Finally, it is valuable to compare the EU approach to that of the U.S. As the Commission notes in its explanatory memorandum to the OTC Derivatives Regulation, "given the global nature of the OTC derivatives market an internationally coordinated approach is crucial… to avoid the risk of regulatory arbitrage." The Commission it considers the regulation to be consistent with Dodd-Frank, noting that "it contains similar provisions requiring the reporting of OTC derivative contracts and the clearing of eligible contracts… [and] puts in place strict capital and collateral requirements for OTC derivatives that remain bilaterally cleared. Finally, it puts in place a regulatory framework for trade repositories and upgrades the existing regulatory framework for CCPs."

However, there are significant differences between the two regimes, and further differences may arise as the implementing measures are developed. The EU almost certainly will not adopt anything similar to the so-called derivatives "push-out" provision in Dodd-Frank and, as noted above, the OTC Derivatives Regulation does not include mandatory exchange trading requirements. Unlike Dodd-Frank, the EU regime does not require real-time public disclosure of qualifying OTC derivatives trades, merely reporting to a repository. In addition, the U.S. regime could end up being more restrictive in areas such as ownership and governance of CCPs and other market facilities, and on business conduct requirements applicable to dealers and other major market participants, although this will depend on the final implementing rules. Finally, whether and how authorities in the U.S. and EU will adopt a workable approach to cross-regional transactions (cleared and non-cleared) remains an area of uncertainty.

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For additional information, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under derivatives, banking and finance in the "Practices" section of our website (www.clearygottlieb.com) if you have any questions.

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