

Developments in EU Regulation of Derivatives

The European Commission has recently launched several consultations clarifying its plans for regulation of the EU derivatives markets. The Commission underscored its commitment to reform in this area in its June 2, 2010 Communication on its financial regulatory reform program.¹ The Commission proposes a “paradigm shift” in the regulation of derivatives markets, from a “light-touch model,” under which derivatives are treated as financial instruments for professional use that do not require close monitoring and regulation, to the creation of a more centralized and transparent clearing and trading process. The proposals underlying the consultations are consistent with the provisions relating to derivatives markets contained in the final declaration of the Toronto G-20 leaders' summit of June 26 and 27, 2010.²

In its consultations, the Commission seeks comments in three broad areas: the extension of the Market Abuse Directive (the “MAD”) to cover derivatives (the “MAD Consultation”),³ derivatives market infrastructure (the “Derivatives Consultation”) ⁴ and regulation of short selling and credit default swaps (the “Short Selling/CDS Consultation”).⁵ In a related development, on June 15, 2010, the European Parliament adopted a resolution, based on the 2010 “Langen Report”⁶ supporting the Commission’s prior proposals and calling for further regulation of the derivatives markets.

Following the consultations, the Commission intends to present formal legislative proposals in September 2010. Parliament’s approval of the Langen Report indicates that the Commission’s proposals are likely to receive broad support in the Parliament.

¹ The Communication can be viewed at <http://tinyurl.com/2010Communication>. Please also see CGS&H Alert Memorandum on “European Commission Update on the EU’s Financial Regulatory Reform Program”, June 11, 2010, <http://tinyurl.com/CGSHAlertJune2010>

² <http://tinyurl.com/G20June10>

³ <http://tinyurl.com/MarketAbuseConsultation>

⁴ <http://tinyurl.com/DerivativesConsultation>

⁵ <http://tinyurl.com/ShortSellingConsultation>

⁶ <http://tinyurl.com/textsadopted>, as based on the European Parliament’s 2010 “Langen Report” <http://tinyurl.com/LangenReport2010>

This Memorandum outlines the Commission's proposals as set out in the current consultations and concludes by comparing the Commission's proposals and U.S. efforts to regulate derivatives markets.

I. BACKGROUND

In its communication of March 4, 2009, the Commission identified derivatives market reform as an important component of its broader financial regulatory reform program.⁷ The Commission elaborated on its proposals in two Communications: "*Ensuring efficient, safe and sound derivatives markets*"⁸ and "*Ensuring efficient, safe and sound derivatives markets: future policy actions.*"⁹

- In the first communication, the Commission identified four complementary policy actions to reduce the negative impact of OTC derivatives markets on financial stability: (i) increase standardization of derivatives contracts; (ii) increase the use of trade repositories; (iii) strengthen the use of central counterparty clearing houses ("CCPs"); and (iv) increase the use of organized trading venues.
- In the second, the Commission outlined a series of proposed reforms governing both OTC derivatives and those traded on organized trading venues, with the aim of: (i) reducing counterparty risk; (ii) reducing operational risk; (iii) increasing transparency; and (iv) enhancing market integrity and oversight.

The Parliament's Committee on Economic and Monetary Affairs (ECON) launched a study of the Commission's proposals. The resulting Langen Report welcomes the Commission's initiative for better derivatives regulation and calls for clear and robust

⁷ Please see the CGS&H Alert Memorandum "Expanding EU Role in European Financial Regulation", March 27, 2009 for further details. <http://tinyurl.com/CGSHAlertMarch2009>.

⁸ <http://tinyurl.com/JulyCommunication>. Please see the CGS&H Alert Memorandum, "EC proposals for increased transparency and risk mitigation in derivatives markets", July 24, 2009, for further details <http://tinyurl.com/CGSHDerivatives>. On September 21, 2009, the Committee of European Securities Regulators ("CESR") published a response <http://www.cesr.eu/popup2.php?id=6053> to the Commission Communication on ensuring safe and sound derivatives markets, outlining a number of elements that CESR believes should guide any regulatory developments in this field and providing its general views on the use of central data repositories, CCPs and trading transparency.

⁹ <http://tinyurl.com/OctoberCommunication>

legislative reform proposals to deal with a wide range of issues relating to derivatives, including a ban on credit default swaps that are purely speculative transactions.

II. THE MAD CONSULTATION

In the MAD Consultation, the Commission notes that the scope of the MAD was largely based on the scope of the now-repealed Investment Services Directive, the predecessor of the Markets in Financial Instruments Directive (“MiFID”).¹⁰ The Commission proposes to revise the MAD to prevent market abuse on the derivatives markets, in particular in relation to commodities and emission allowances derivatives, which fell outside the scope of the Investment Services Directive, but which are now within the scope of MiFID. More specifically, the Commission proposes to:

- **Instruments traded on multilateral trading facilities (“MTFs”) but not on a regulated market:** Since a significant portion of financial instruments, notably commodity derivatives and emission allowances, are currently traded on MTFs but not on regulated markets, the Commission proposes to extend the scope of the MAD to cover instruments that are admitted to trading (or for which an application has been made) on an MTF in at least one Member State, but not admitted to trading on a regulated market.
- **The use of OTC instruments that can influence the prices of financial instruments traded on regulated markets or MTFs:** The proposed prohibition of market manipulation would also apply to those financial instruments not admitted to trading on a regulated market or an MTF but that can have an impact on the value of a financial instrument admitted to trading on a regulated market or an MTF.
- **Attempted market manipulation:** The Commission proposes to remove any requirement to demonstrate that behaviour intended to manipulate the market in fact had that effect.
- **The definition of inside information for commodity derivatives:** MAD currently defines inside information in relation to commodity derivatives as information that users would expect to receive in accordance with accepted

¹⁰ <http://tinyurl.com/MiFID2004>

market practices. The Commission proposes to replace this definition with a definition that is closer to the test applied in relation to other forms of investment; that is, information of a precise nature that has not been made public, relating, directly or indirectly, to one or more such derivatives and which, if it were made public, would be likely to have a significant effect on the prices of such derivatives or affect the price of the underlying asset.

III. THE DERIVATIVES CONSULTATION

In the Derivatives Consultation, the Commission lays out proposals to reduce counterparty risk by mandating CCP clearing where possible; to ensure stringent and harmonized organizational, conduct of business and prudential requirements for CCPs; to improve efficiency in the EU post-trading market by removing barriers preventing interoperability between CCPs; and to increase transparency by requiring mandatory reporting to trade repositories.

- **Mandatory CCP clearing of OTC derivatives:** The Communication supports mandatory clearing of “standardized” OTC derivatives through a CCP, in line with the G-20 decisions of September 2009¹¹ and June 2010. The Commission is seeking to design a process through which standardized contracts can be distinguished from customized derivative contracts that should not be subject to the central clearing obligation. It is therefore consulting on the respective roles of CCPs, national regulatory authorities, and the proposed European Securities and Markets Authority (“ESMA”) and European Systemic Risk Board (“ESRB”). The Commission is also consulting on the circumstances in which corporate end-users that use OTC derivatives to hedge their commercial risk will be subject to the mandatory clearing obligations or be obliged to report these positions to their national regulators.
- **CCP requirements:** CCPs are currently regulated at national level, subject to non-binding recommendations issued by the European System of Central Banks and CESR. To avoid regulatory arbitrage, the Commission proposes further harmonization of the regulatory framework governing CCPs. The

¹¹ The G-20 decisions of September 24 and 25, 2009 in Pittsburgh stated that “*all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms*”
<http://tinyurl.com/G20Sept09>

Derivatives Consultation also outlines a number of possible requirements for CCPs, including in relation to the nature of their governance structures; the creation of an independent internal risk committee; an obligation to maintain effective written organizational arrangements and conflict-of-interest procedures; requirements governing outsourcing; transparent and non-discriminatory principles for admitting clearing members to ensure that they have sufficient financial resources and operational capacity to meet their obligations; and transparency obligations relating to their pricing structure, risks and risk management. In addition, the Commission proposes to introduce harmonized prudential requirements to ensure that CCPs become an effective source of stability. Finally, the Commission considers that a CCP established in a third country could be allowed to provide clearing services to entities established in the European Union, subject to the Commission having adopted a decision recognizing the legal and supervisory framework of that third country as equivalent to the regulatory framework of the European Union, and the existence of co-operation arrangements between the relevant competent authorities. It should be noted that the Langen Report takes the position that all transactions in derivative products denominated in an EU currency, relating to an EU entity and to which an EU financial institution is party should be both cleared and reported in EU-based clearing houses and repositories.

- **Interoperability:** The Commission notes that post-trading operations (*i.e.*, clearing and settlement) for derivatives remain fragmented along national lines. Fragmentation undermines the efficiency of each national system and increases the cost of cross-border transactions. Accordingly, the Commission proposes that CCPs could be permitted to enter into “interoperability agreements” with other CCPs, subject to prior regulatory approval by the competent authorities. The Commission is consulting both in relation to the general principles that should underpin such agreements and the manner in which the risks arising from the arrangement should be managed.
- **Mandatory reporting to trade repositories:** In the Commission’s view, derivatives markets have suffered from the lack of transparency of prices, transactions and positions. Accordingly, the Commission plans to introduce a mandatory obligation to report all derivatives transactions to trade repositories. If a trade repository is not capable of recording the details of a specific derivatives contract, or no trade repository exists for a particular type of contract, financial counterparties should report the details to their

competent authorities. The Commission believes that trade repositories should be subject to mandatory registration and supervision and are considering requiring that trade repositories be located in the EU, recognizing third-country trade repositories operating within the EU, or establishing a “self standing EU trade repository” as a public utility.

IV. THE SHORT SELLING/CDS CONSULTATION

On June 14, 2010, the Commission published the Short Selling/CDS Consultation, setting out the options for a forthcoming legislative proposal on the regulation of short selling and CDS. During the financial crisis, EU Member States have taken markedly different approaches to the regulation of short selling. The Commission aims to harmonize regulatory measures in this area to prevent regulatory arbitrage and to increase the resilience and stability of financial markets. Although this Consultation considers policy options in relation to short sales generally, including in respect of securities, this Memorandum focuses on the Commission’s comments relating to derivatives, and in particular CDS.

- **Scope:** The Commission is consulting on whether potential rules on short selling should apply uniformly to every type of financial instrument traded in the EU, or whether the requirements should apply only to specific financial instruments. Types of financial instruments to which different rules might apply include EU shares and their derivatives, EU sovereign bonds and their derivatives, and CDS on EU sovereign bonds. The Commission also asks to what extent the rules should apply to transactions outside the EU.
- **Transparency:** The Commission proposes various options for increasing the transparency of net short positions as a means of exposing risk in the market and enabling regulators to monitor and investigate potentially abusive short selling. The policy options are based on the two-tier transparency model set out in CESR’s Model for a Pan-European Short Selling Disclosure Regime.¹² The Commission is considering two possible policy options: (i) to apply the CESR disclosure model to all types of financial instruments admitted to trading in the EU that can be the subject of short selling or (ii) to apply it only to shares of EU companies and to short positions in EU sovereign bonds, including through the use of CDS.

¹² <http://www.cesr.eu/popup2.php?id=6487>.

- **Naked short sales:** The Commission believes that uncovered, or “naked,” short selling can increase the risk of settlement failure and result in increased price volatility. The Consultation regards a “naked CDS” as the situation in which the CDS is used by the buyer not to hedge a risk but to take a position. To reduce such risk, the Commission suggests placing conditions on uncovered short selling and trading venues to ensure that, if a person who enters into a short sale of the shares on the venue is not able to deliver those shares for settlement within a specified number of trading days, procedures are triggered to buy in the shares for settlement. The Commission is also consulting as to whether the risks involved in uncovered short selling justify a permanent ban or whether more limited procedures directed at the prevention of settlement failures are sufficient.
- **Emergency powers of competent authorities:** The Commission proposes that competent authorities be given powers to restrict or ban short selling and naked CDS in an emergency, which would potentially include developments constituting a serious threat to financial stability or to market confidence within a Member State or the EU. As the Commission’s objective is to harmonize regulatory responses to financial crises across EU Member States, it has suggested that ESMA perform a facilitation and coordination role in relation to the use of such emergency powers.¹³ Authorities would also be required to publish notices of emergency actions, detailing the measures imposed and the grounds upon which they are believed necessary. Any restrictions imposed would be for periods not exceeding three months, but they could be renewed under exceptional circumstances.

V. CONCLUSION

As noted, the Commission intends to publish legislative proposals based on the consultations in September 2010. The resulting legislation, which is expected to be adopted in 2011, will mark a significant restructuring in the EU derivatives markets.

The EU approach is broadly consistent with the approach being taken in the United States in many key areas, including expansion of market abuse authorities to cover OTC derivatives, mandatory CCP clearing of standardized OTC derivatives, and mandatory

¹³ For more information on ESMA, see the proposed regulation establishing ESMA published by the Commission on September 23, 2009 <http://tinyurl.com/esmaregulation>.

reporting to trade repositories. Both the EU and the United States have also focused on CCP governance and interoperability, although at this stage it appears that the U.S. approach may turn out to be more restrictive and less open to new entrants.

The two jurisdictions differ significantly, however, in their approaches to speculative trading in derivatives. While EU policymakers have honed in on speculation in credit default swaps, the U.S. legislators have instead painted with a broader brush. In particular, recent U.S. regulatory reform legislation includes two provisions -- the so-called "Volcker Rule" and the "push-out" requirement -- that would limit banks' ability to engage in a wide range of proprietary and dealing activities in derivatives. As a result, to the extent that European banks are not subject to these new U.S. requirements, and are not subject to similar EU requirements, they may have a significant competitive advantage over their U.S. counterparts.

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http://www.cgsh.com/financial_crisis_resource_center/eu_resources/.

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