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Derivatives

No Crisis Wasted: Proposed EU and U.S. Regulation of OTC Derivatives (Part I)

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In July 2010, the U.S. Congress established a framework for the reform of derivatives regulation in the U.S. through the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[1] Although most of Dodd-Frank is not effective until July 2011 and still requires substantive implementing rules, Dodd-Frank casts a wide regulatory net over originators and users of over-the-counter (OTC) derivatives. It includes mandatory central clearing, exchange trading, mandatory margin and reporting obligations for banks, investors and end-users under the supervisory authority of both the U.S. Commodity Futures Trading Commission (CFTC) and the U.S. Securities and Exchange Commission (SEC).

In September 2010, the European Commission published a proposal for regulation of the derivatives market in the EU (Proposal).[2] The Proposal is not yet effective. It is subject to the approval by the European Parliament and the European Council and may still change. The Proposal largely follows Dodd-Frank, but deviates from it on a number of substantive issues (notwithstanding the shared aspirations of regulatory harmony and avoidance of the potential for regulatory arbitrage). Therefore the promulgation of these respective regimes may create more uncertainty for investors than market efficiency, including by building up a legal wall over the Atlantic and forcing investors and dealers to trade either on one side of the Atlantic or the other.

As of December 2009, the total notional amount outstanding of OTC derivatives was around $615 trillion worldwide[3] and has kept growing over recent years despite the financial crisis. Following the crisis, additional regulation of this market was perhaps inevitable as (rightly or wrongly) the market had been considered in some quarters to be insufficiently regulated. While financial intermediaries in the market are subject to regulation in both the U.S. and the EU, the market itself has not been burdened with a specific regulatory regime. This now will change.

This article discusses these proposed reforms. It does not purport to be comprehensive. It does not cover, among other things, authorisation and supervision in the EU, trade repositories, interoperability arrangements, trading and post-trading transparency and the bank “push-out” rule under Dodd-Frank. As used in this article, for simplicity, “clearing house” includes 1) a “central counterparty" (CCP) under the Proposal and 2) a "derivatives clearing organisation" (DCO) and a "clearing agency" (CA) under Dodd-Frank, as the case may be. References to a "clearing member" or a "participant" are to a clearing member or a participant of a clearing house. References to a "dealer" include references to 1) a "clearing member" under the Proposal and 2) a "futures commission merchant" (FCM), a "swap dealer," a "broker/dealer" and a "security-based swap dealer" under Dodd-Frank, as appropriate. Unless the context requires otherwise, references to a "swap dealer" include references to a "security-based swap dealer" and references to a "major swap participant" include references to a "major security-based swap participant". References to "clients" or "customers" are to clients and customers of a dealer (and not of the clearing house).

The Derivatives Covered

In the EU

The Proposal applies to certain specified derivatives that are traded OTC (that is, executed otherwise than on a regulated market[4]). In particular, it applies to those derivatives that are options, futures, swaps, forwards or other derivative contracts and 1) are physically or cash-settled and relate to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices, or financial measures; or 2) are cash-settled and relate to commodities; or 3) are physically-settled and relate to commodities (but subject to certain conditions and exclusions). The Proposal also applies to credit default swaps (CDS) and financial contracts for differences.[5] The Proposal does not cover spot FX transactions and should exclude commercial forward FX transactions.

In the U.S.

By its terms, Dodd-Frank applies to "swaps"[6] and "security-based swaps"[7] (though both those terms are defined by statute in a manner that goes well beyond common English usage). Swaps fall in the CFTC's realm, whilst security-based swaps in the SEC's. There are several types of derivatives that do not constitute a "swap" under Dodd-Frank.[8] The Secretary of the Treasury may exclude FX swaps and forwards. It is not clear whether the term "swap" should include contingencies such as most credit agreements, mortgage loans, floating rate commercial loans and insurance contracts.

Concerns

The distinction between swaps and security-based swaps has an impact on the way these are regulated in the U.S., but is arbitrary from a market perspective[9] and more the result of political compromise than the logic of regulation. Further, the types of derivatives covered by the U.S. and EU regimes do not always match (*e.g.,* physically settled commodity transactions generally are not considered derivatives in the U.S.).

The demarcation of authority between the CFTC and the SEC (and its occasional overlap – *e.g.,* over security-based swap agreements when fraud is at issue or over mixed swaps) may confuse European counterparties (as well as U.S. counterparties) dealing with dealers in the United States. Likewise, U.S. investors should be mindful of the different allocation of authority between the

Commission, the newly created European Securities and Markets Authority (ESMA) and the national authorities (and the different sets of national regulations applicable) when dealing with European counterparties.

Financial Counterparties and End-users

Broadly speaking, the EU and U.S. reforms apply to financial intermediaries (being "financial counterparties" (FCs) and "financial entities", respectively) and, to a lesser extent, end-users. There are important differences between the two regimes though.

In the EU

In the Proposal, an FC[10] includes the majority of the financial intermediaries authorised in the EU, such as investment firms under MiFID, credit institutions under the Capital Requirements Directive,[11] insurance and reinsurance undertakings, UCITS, pension funds and alternative investment asset managers (*e.g.,* hedge fund managers and private equity firms, but not the funds under their management) as defined under the AIFM Directive (not yet adopted).[12] Any other undertaking established in the EU falls in the definition of "non-financial counterparty" (NFC)[13] and, above certain thresholds, may be subject to clearing and reporting obligations.[14]

In the U.S.

Dodd-Frank applies primarily to swap dealers,[15] security-based swap dealers, major swap participants,[16] major security-based swap participants, commodity pools, private funds, employee benefit plans and other entities predominantly engaged in the banking business or financial activities (but as to some of the requirements, regulators can exempt certain small banks, savings associations, *etc.*). Persons who 1) are not financial entities (commercial entities, in U.S. parlance), 2) use the contract to "hedge or mitigate commercial risk" and 3) notify the relevant Commission, benefit from certain exemptions under Dodd-Frank, including an exemption from mandatory clearing.[17]

Concerns

Although the policy behind the distinction between FCs and NFCs under the Proposal, and financial entities and commercial users under Dodd-Frank, may be similar, the interplay between the EU and U.S. regimes is not straightforward. In transactions involving EU and U.S. counterparties, for example, a large European corporation that is a NFC under the Proposal, may be subject to regulation as a major swap participant in the U.S. and, potentially, may be required to clear transactions in the U.S. but not in Europe. Similarly, a NFC that trades under the reporting threshold under the Proposal may be subject to reporting obligations in the U.S., but not in Europe.

The Proposal may be unclear in its application to 1) alternative investment fund managers and 2) the funds they manage (broadly speaking, hedge funds and private equity funds). As to 1), the definition of FC refers to ". . . alternative investment funds managers as defined in Directive 2010/.../EU".[18] As drafted, it seems to apply to all alternative investment fund managers whether or not they are subject to the AIFM Directive,[19] as long as they fall under that definition. As to 2), the definition of FC does not refer to the alternative investment funds managed by such managers. This opens the question of whether or not such funds should then fall under the definition of NFC, if established in the EU. Considering alternative investment funds (as opposed to their managers) as NFC appears counterintuitive as their business is quintessentially financial. For example, in the hedge fund industry, positions in derivatives are usually taken by the funds directly or by the manager acting as their agent. The funds (not their managers) end up with large exposures to derivatives and may create systemic risk. Recital 17 of the Proposal[20] is of little assistance in this respect.

Mandatory Clearing and the End-user Exemption

With the twin aspirations of market transparency and the mitigation of systemic risk, both regimes mandate clearing of derivatives, unless certain exceptions apply. At present, neither regime specifies which types or classes of derivatives are subject to mandatory clearing. This determination is left to the regulators. Under the Proposal, FCs and, above certain thresholds, NFCs (such NFCs being referred to in this article as "Article 7 NFCs") are required to clear all OTC derivatives contracts deemed eligible by ESMA and the competent national authorities. [21]

In the EU

Under the Proposal, the clearing obligation applies to a FC executing an OTC derivative contract (if that contract is an eligible one) with another FC (*e.g.,* European bank X dealing with European bank Y). In the case of an FC facing an NFC (*e.g.,* European bank X dealing with European company Y) an exemption from the clearing obligation may be available to both, if the NFC is not an Article 7 NFC. If there are two NFCs facing each other, an exemption from the clearing obligation may be available if neither such NFC is an Article 7 NFC. This conclusion is less obvious if one only (and not the other) is an Article 7 NFC.

Derivatives that are "objectively measurable as directly linked to the commercial activity" of an NFC [22] do not count against the clearing threshold of that NFC, but they still do count against the information threshold for reporting purposes. Once the clearing threshold is exceeded, all derivatives transactions of the Article 7 NFC should be cleared (not just those above such a threshold).[23]

ESMA is accorded the power to determine, in respect of a class of derivatives, whether derivatives in that class are eligible for clearing.[24] There are two approaches to eligibility (bottom-up and top-down). ESMA may take the initiative to designate a given class of derivatives as being eligible for clearing at EU level. Alternatively, the initiative may be taken by a clearing house, with the clearing of a given class being authorised by the national authorities at Member State level, followed by ESMA's decision at EU level.[25]

In the U.S.

In the U.S., a DCO must submit to the CFTC its intention to clear a swap or a class of swaps, and the CFTC will decide whether clearing is required. Separately, the CFTC is required to review other classes of swaps to determine if clearing should be mandatory for such classes of swaps, even if no

DCO currently clears them. A similar procedure is set out for security-based swaps and the SEC.[26] As in the EU, derivatives that are entered into "to hedge or mitigate commercial risk" by non-financial entities are not subject to mandatory clearing, albeit subject to certain substantial conditions.[27] However, a non-financial entity may still opt for clearing if it faces a financial entity in the transaction.

Concerns

In Europe, the biggest incentive (or threat) for FCs to clear is the potential imposition of higher capital requirements if they do not. Although not set out in the Proposal, this change is likely to be adopted in the near future (by amending the Capital Requirements Directive) and will create controversy in the EU.

Another, related issue is contract standardisation. If some classes (*e.g.,* interest rate swaps and other highly standardised derivatives) are likely to be cleared, other more bespoke classes may not be suitable for clearing. Drawing a line between what is bespoke and what should be cleared may be difficult and require counterparties to re-negotiate the terms of their derivatives contracts with their clearing house or dealer. Institutions may try to deal only in "off-the-list derivatives" (that is, derivatives not subject to mandatory clearing) but may risk higher capital charges if they do. The dilemma may be: 1) to use ostensibly-bespoke derivatives to better reflect their financial requirements (but with the risk of higher capital charges) or 2) to use standardised terms and clearing (with lower capital charges, but increased basis risk). The spectre of illegality also looms if the derivative is miscategorised for these purposes.

The idea behind the end-user exemption is to balance the policy aspirations of the reforms with the commercial interests of end-users, by exempting them from clearing (and related margin requirements) for derivatives that are used only to hedge their commercial activities. If good on paper, it may not work so well in practice where distinguishing between hedging to mitigate commercial risk and hedging as investment may prove difficult.[28]

Trading on Exchanges

Under Dodd-Frank, transactions that are subject to mandatory clearing are also required to be traded on 1) a designated contract market or a "swap execution facility" (for swaps) and 2) a national securities exchange or a "security-based swap execution facility" (for security-based swaps), unless no such venue accepts the relevant transaction.[29] Where an end-user opts to exercise the end-user exemption for clearing, the trade execution requirements will not apply.

Concerns

There is a substantive difference between Dodd-Frank and the Proposal. The latter does not address execution on exchanges, position limits and post-trade transparency.[30] The potential for an unbalanced marketplace exists where derivatives in the U.S. should be traded on exchanges or similarly regulated venues (with some exceptions) whilst in the EU trading is still via the dealers' market. In practice, if a trade involves U.S. and EU counterparties, such a trade may need to be executed on a U.S. exchange (with consequential operational difficulties for the EU counterparty).

Co-ordination between the two regimes is welcomed on this point. That said, the difficulties in co-ordinating the regulation of exchanges likely pale in comparison to those of co-ordinating regulation of clearing corporations, handling of margin and bankruptcy regimes.

Supervision of Clearing Houses

Clearing of eligible derivatives has to be carried out with CCPs (in the EU)[31] and DCOs[32] for swaps and CAs[33] for security-based swaps (in the U.S.). These entities will be subject to authorisation and supervision in the EU and U.S., respectively.

On the operational side, things will change radically. Currently, counterparties wishing to trade may simply do it bilaterally (*e.g.,* hedge fund X enters into an interest rate swap with bank Y). Following the reforms, the parties will have to involve participants in a clearing house and the clearing house itself. In the example, hedge fund X now enters into the swap with dealer A (as a participant in clearing house K). Dealer A enters into a separate contract with clearing house K. Clearing house K in turn enters into a matching contract with dealer B who faces bank Y (unless bank Y is a participant in clearing house K itself).

In the EU

The prudential, operational and conduct of business requirements for CCPs under the Proposal are extensive.[34] CCPs must be authorised and have 1) a minimum capital of €5 million, 2) sufficient capital to ensure an orderly winding down or restructuring of their activities and 3) access to adequate liquidity from a central bank or creditworthy commercial bank. CCPs will have to ensure robust governance, internal control mechanisms and reporting lines, adequate risk management and remuneration policies, IT infrastructures, independent directors and a risk committee, record-keeping, shareholder transparency and conflicts of interest management. In this respect, a CCP must identify and manage potential conflicts between itself, its clearing members or their clients, or between them. A CCP must establish, implement and maintain an adequate business continuity policy and a disaster recovery plan that, at a minimum, allows for the recovery of all transactions at the time of disruption so that the CCP will continue to operate with certainty and complete its settlements on time.

When providing services, a CCP must act fairly and professionally in accordance with the best interests of the clearing members and clients and sound risk management. The CCP must establish the categories of admissible clearing members and admission criteria, which must be non-discriminatory, transparent and objective. Unlike under Dodd-Frank, there are no ownership caps for CCPs under the Proposal (although those with a qualified holding in the CCP will be subject to a suitability test).

In the U.S.

To be registered and maintain registration, a DCO must comply with 18 core principles set out in Dodd-Frank,[35] as well as in the CFTC regulations. Under those, a DCO must, among other things, 1) have adequate financial, operational and managerial resources, as determined by the CFTC and 2) ensure that it possesses the ability to manage the risks associated with its business.

The CFTC shall adopt rules to mitigate conflicts of interest within DCOs. As under the Proposal, DCOs are required to establish system safeguards to minimise operational risk and establish emergency procedures, backup facilities, and a plan for disaster recovery that allows for, among other things, the timely recovery and resumption of operations of the DCO. Special provisions apply to board composition, risk committees and record-keeping for at least five years (as opposed to 10 years under the Proposal), outsourcing, objective participation requirements and price transparency. Segregation and margin requirements, default procedures and bankruptcy will be discussed in Part II of this article.

Concerns

Mandating the clearing of most derivatives may increase transaction and operational costs as cleared trades will 1) have to be processed by dealers and clearing houses and 2) be subject to margin and collateral-posting requirements for counterparties imposed by such clearing houses and dealers. This may not be the optimal solution if clearing 1) is fragmented across several clearing houses as counterparty exposure is thought to increase relative to clearing in a single clearing house and 2) takes place for one class of derivatives only.[36] On the other hand, concentrating all credit risk in a single clearing house may increase systemic risk substantially.

In addition, the Proposal (and, to a lesser extent, Dodd-Frank) may be premised on the platonic conception of a clearing house that 1) never goes bankrupt (even under "extreme but plausible market conditions"), 2) takes care of everybody's interests (including the interests of dealers' clients) and 3) manages risk infallibly, yet without forcing margin levels so high that it will discourage hedging transactions. This platonic ideal may not survive the real world. In this regard, it is not clear if the Proposal intends to make CCPs to any certain extent liable to clients directly for non-compliance by the CCP with its duties. If it does, this would be a change from the way clearing markets currently work.

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1 *See* http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf.

2 *See* Proposal for a Regulation of the European Parliament and of the Council on OTC

derivatives, central counterparties and trade repositories – European Commission, COM(2010) 484 final of 15 September 2010.

3 *See* OTC derivatives market activity in the second half of 2009 – Bank of International Settlements Press Release, 11 May 2010.

4 For the purposes of Directive 2004/39/EC on markets in financial instruments (MiFID).

5 *See* Article 1(1) Proposal.

6 A "swap" is defined in Section 721 Dodd-Frank and includes (subject to some exclusions) an agreement, contract or transaction that is 1) one of a list of common swap transactions (*e.g.,* equity swaps, interest rate swaps, currency swaps, energy swaps, and so on) 2) an option on virtually anything, 3) a CDS, 4) an agreement that provides for the exchange of payments based on the value or level of any property, rate or quantitative measure and that transfers financial risk associated with a future change in any such value or level without also conveying a current or future ownership interest in the underlier, 5) an agreement that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence and 6) any combination or permutation of the above. The term "swap" carves out a "security-based swap".

7 Under Section 761 Dodd-Frank, the term "security-based swap" is limited to the following types of transactions that would otherwise be swaps: 1) those referencing a narrow-based security index, 2) those referencing a single security or a loan and 3) CDSs relating to single issuers or the components of a narrow-based security index.

8 Under Section 721 Dodd-Frank, exceptions include the following: 1) listed futures, security futures and other transaction types already regulated by the CFTC, 2) any sale of a non-financial commodity for deferred shipment or delivery, so long as such transaction is intended to be physically settled (what we would commonly call a "forward"), 3) an option on a security that is "subject to" the U.S. Securities Act of 1933 (Securities Act) or the U.S. Securities Exchange Act of 1934 (Exchange Act), 4) foreign currency options listed on U.S. securities exchanges, 5) an agreement as to the sale of one or more securities on a "fixed basis" and that is "subject to" the Securities Act and the Exchange Act, 6) an agreement as to the sale of one or more securities on a contingent basis and that is "subject to" the Securities Act and the Exchange Act, but not a CDS (a CDS can be a swap or a security-based swap), 7) a note or other evidence of indebtedness that is a "security" as defined in the Securities Act; 8) any agreement that is based on a security and entered into directly or through an "underwriter" (as defined in the Securities Act), by the issuer of the security for the purposes of managing a risk associated with capital raising, 9) an agreement with the U.S. government, a Federal Reserve Bank or a federal agency that is fully backed by the full faith and credit of the United States and 10) a security-based swap other than a mixed swap.

9 For example, a CDS can qualify as a security-based swap if the underlying asset is a basket with nine or fewer constituents or as a swap if more.

10 *See* Article 2(6) Proposal.

11 *See* Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

12 *See* the recent draft of the Proposal for a Directive of the European Parliament and of the

Council on Alternative Investment Fund Managers and amending directives 2003/41/EC and 2009/65/EC.

13 *See* Article 2(7) Proposal.

14 *Id.* Article 7 Proposal.

15 A "swap dealer" is a person who 1) holds itself out as a dealer in swaps, 2) makes a market in swaps, 3) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or 4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps (*see* Section 721 Dodd-Frank).

16 A "major swap participant" is person who is not a swap dealer and 1) maintains a substantial position in any major swap category, excluding positions held by pension plans or for hedging or mitigating commercial risk, 2) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets or 3) A) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by a Federal banking agency and B) maintains a substantial position in any major swap category (*see* Section 721 Dodd-Frank).

17 *See* Section 723(a)(3)"(h)(7)" Dodd-Frank.

18 *See* Article 2(6) Proposal.

19 As currently drafted, the AIFM Directive (not yet approved) applies only to alternative investment fund managers managing assets above certain thresholds, not to the funds they manage. Alternative investment fund managers managing assets below such thresholds are subject to simplified regulation.

20 "A contract entered into by a fund, whether managed by a fund manager or not, should be considered within the scope of this Regulation" (*see* Recital 17 Proposal).

21 *See* Articles 3, 4 and 7 Proposal.

22 *Id.* Article 7(4).

23 *Id.* Article 7(2).

24 *Id.* Article 4.

25 ESMA must base its decision on several factors including 1) the reduction of systemic risk in the financial system, 2) the liquidity of contracts, 3) the availability of pricing information, 4) the ability of the CCP to handle the volume of contracts and 5) the level of client protection provided by the CCP (*see* Article 4(3) Proposal)).

26 In determining whether a swap is to be subject to mandatory clearing, the CFTC and the SEC are required to consider whether a DCO, for swaps, or a CA, for security-based swaps, has adequate risk management policies and procedures and to take into account the following factors: 1) the existence of significant outstanding notional exposures, trading liquidity and adequate pricing data, 2) the availability of infrastructure to clear the swap on terms that are consistent with the material terms and trading conventions on which the contract is then traded, 3) the expected mitigation of systemic risk, taking into account the size of the market and the resources of the clearing house, 4) the effect on competition, including appropriate fees and 5) the existence of reasonable legal certainty in the event of the insolvency of the clearing house or one or more of its members with respect to the treatment of counterparty positions and collateral (*see* Section

723(a)(3)"(h)(2)(D)" Dodd-Frank).

27 *Supra*. note 17.

28 For example, airline company X may hedge against future increases in oil prices by entering into a forward contract; however, such contracts can be devised to allow airline company X to gain exposure or profit from oil prices going down beyond its hedging needs (*e.g.,* by using a notional amount higher than its commercial exposure).

29 *See* Section 723(a)(3)"(h)(8)" Dodd-Frank. Additionally, where a counterparty to a swap is not an "eligible contract participant" (in essence, financial institutions, insurance companies, investment companies, commodity pools, broker/dealers and other sophisticated investors, as defined under the CEA), the swap must be traded on a designated contract market or a national securities exchange (trading on swap execution facilities is not permitted).

30 *See* Standardisation and exchange trading of OTC derivatives – Committee of European Securities Regulators Consultation Paper, CESR/10-610 of 19 July 2010.

31 *See* Article 3 Proposal.

32 *See* Section 725 Dodd-Frank.

33 *Id.* Section 763(b).

34 *See* Titles III and IV Proposal.

35 *Supra*. note 32.

36 See Darrell Duffie and Haoxiang Zhu, Does a central clearing counterparty reduce counterparty risk?, 24 July 2010.

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