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

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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). 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 EU Commission published a proposal for regulation of the derivatives market in the EU (Proposal). The Proposal is not yet effective. It is subject to approval by the EU Parliament and the EU 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.

Part I of this article discussed,[1] among other things, the derivatives covered by the EU and U.S. regulations, financial counterparties and end-users, mandatory clearing and the end-user exemption, trading on exchanges and supervision of clearing houses.

Margin and Collateral Segregation

Both regimes are focused on reducing default and bankruptcy risks for counterparties by mandating margin requirements and collateral segregation at clearing house level (under the Proposal) and at dealer level (under Dodd-Frank). Special rules apply to clearing houses under Dodd-Frank.

In the EU

Onerous obligations on central counterparties (CCPs) are imposed in respect of risk-management, margin requirements and segregation of collateral.[2] Margin requirements are imposed on CCPs to cover losses that result from at least 99 percent of exposure movements over an appropriate time horizon, with full exposure collateralisation. CCPs should 1) measure liquidity and credit exposures on a near-to-real time basis with intraday margin calls and 2) set up a default fund to cover losses arising from the default, including opening of an insolvency proceeding, of one or more clearing members. In addition, a CCP must maintain sufficient available financial resources to cover potential losses exceeding margin requirements and the default fund including liquidity lines, loss-sharing arrangements, insurance and guarantees. The default fund combined with the other financial resources should at all times enable a CCP to withstand 1) the default of the two clearing members to which it has the largest exposures and 2) sudden sales of financial resources and rapid reductions in market liquidity.

With respect to segregation requirements, a CCP must keep records and accounts to enable it at anytime and without delay to identify and segregate the assets and positions of one clearing member from 1) the assets and positions of any other clearing member and 2) from its own assets. Additionally, a CCP must require each clearing member to distinguish and segregate in accounts held with the CCP the assets and positions of that member from those of its clients. The Proposal contemplates (but does not require) segregation of one client's assets from those of another client of the same clearing member. The recitals to the Proposal record the aspiration that clients of clearing members should be granted a high level of protection, but the Proposal goes on to say that the actual level of protection depends on the level of segregation that those clients choose. The Proposal is less than clear when it sets out that "[a] CCP shall allow clients to have a more detailed segregation."[3] Does this mean that clients can demand complete segregation of their assets from those of other clients of the same clearing member? Does "detailed" refer to some sort of disclosure requirements, irrespective of actual segregation? Some clarification from the EU regulators will be helpful on this point.

In the U.S.

Dodd-Frank imposes specific margin and collateral management requirements on FCMs, swap dealers, security-based swap dealers and clearing houses.[4] Dodd-Frank provides that only a FCM, in respect of swaps, or a broker/dealer or a security-based swap dealer, in respect of security-based swaps, is permitted to accept collateral of a swaps customer that requires the use of an intermediary in order to effectuate clearing (*e.g.*, because the customer is not a direct member of a clearing house). That is, the U.S. Congress has effectively mandated that the FCM model for clearing swaps regulated by CFTC is the only acceptable way to provide intermediated clearing. Other models that provide for intermediation by banks or other financial institutions, including non-U.S. institutions, are effectively prohibited. This is likely to serve as a strong barrier to cross-Atlantic trading. Substantively, the segregation requirements for cleared swaps are generally modelled after the current requirements imposed by the CFTC for futures contracts and related collateral. Futures commission merchants (FCMs) are required to segregate customer collateral from proprietary assets and treat them as belonging to customers, provided that (unlike under the Proposal) assets of multiple customers can be segregated in an omnibus account with a third-party custodian for convenience. Customer funds and property may be withdrawn from segregation to the extent necessary to provide margin for, or settle, the customer's cleared swaps with the relevant derivatives clearing organisation (DCO), and customer cash may be invested in government securities, municipal securities or other assets prescribed by the CFTC.

Similar segregation requirements apply to 1) security-based swap dealers and broker/dealers and 2) DCOs. In addition, Dodd-Frank requires DCOs to 1) hold member and participant funds in a manner so as to minimise the risk of loss or delay in the access by the DCO to the assets and funds, 2) have procedures for the efficient, fair, and safe management of events in which members or participants become insolvent or otherwise default, 3) possess the ability to manage the risks associated with operating a DCO, 4) through margin requirements and other risk control mechanisms, limit the DCO's exposure to potential losses from defaults by members and participants and 5) ensure that operations of the DCO would not be disrupted and non-defaulting members would not be exposed to unexpected losses. The margin requirements shall be sufficient to cover potential exposures in normal market conditions. Models and parameters used in setting margin requirements must be risk-based and reviewed on a regular basis.

Concerns

The Proposal arguably requires CCPs to impose a high margin requirement on dealers (*i.e.*, covering losses that result from at least 99 percent of exposure movements). The cost associated with this may be high. The Proposal contemplates that CCPs may offer a client complete segregation of the client's assets (at a cost). However, the Proposal does not articulate any general principles applicable to segregation of client assets by the CCP (which presumably will be a matter of applicable law). The Proposal obliquely acknowledges[5] that a client may be exposed to the default risk of the dealer (or another client of the dealer) by positing the client's entitlement (for regulatory capital purposes) to treat its counterparty credit risk exposure value as zero on such risks being absent in fact. Unlike Dodd-Frank, the Proposal does not cover dealer regulation, which in the EU falls under Directive 2004/39/EC (MiFID) and its implementing rules at Member State level. However, these may need to be updated in the context of mandatory clearing.

Default Procedures, Loss Mutualisation & Bankruptcy

In the case of a dealer's default, a waterfall mechanism is mandated in both regimes and predicated on the protection of non-defaulting members and loss mutualisation.

In the EU

In the case of the default of a dealer which is a clearing member, a CCP must use the margin posted by the defaulting member prior to using other financial resources to cover losses. If insufficient, the CCP must next use the defaulting member's default fund contribution and the CCP's own funds. If still insufficient, a CCP may then use default fund contributions and other contributions of non-defaulting members, but may not use margins posted by non-defaulting clearing members. To minimise systemic risk, special rules apply to default procedures, eligibility criteria for collateral, investment policies, review of models, stress testing and back testing.[6] There are no special rules protecting the interests of the non-defaulting clearing members in the case of insolvency of a CCP in the EU. As regards client assets, the Proposal merely requires that the CCP takes reasonable steps to ensure that it has the legal powers to transfer or liquidate the client positions of the defaulting member.[7] It is not clear if the client has a right of recourse against the CCP if it fails to take these steps.

In the U.S.

A DCO is required to have adequate financial, operational, and managerial resources, as determined by the CFTC, to discharge its responsibilities. Those financial resources shall, at a minimum, exceed the total amount that would enable the DCO to meet its obligations despite a default by a member creating the largest financial exposure in extreme, but plausible, market conditions and enable the DCO to cover its operating costs for a one-year period. DCOs must have procedures for the efficient, fair and safe management of events in which members or participants become insolvent or otherwise default.

A special regime is granted to claims of customers of FCMs and broker/dealers in bankruptcy. Claims against FCMs will be treated as claims under "commodity contracts" and will be considered to be "net equity claims" under the Bankruptcy Code, with a best efforts obligation on the bankruptcy trustee to effectuate a bulk transfer of open commodity contracts to a solvent FCM. A similar treatment will apply to customers' claims against broker/dealers and security-based swap dealers except for the bulk transfer obligation, although many of the details are less clear on the securities side. In either case, customers' claims will benefit for a better treatment than that reserved to general unsecured claims. Special rules on loss mutualisation apply to the insolvency of a clearing house: for DCOs, customers of a particular account class (*e.g.*, futures, foreign futures) have a priority claim to a pro rata share of customer assets (irrespective of segregation)

Concerns

In the EU the operation of default procedures will ultimately depend upon the contracts entered into by the CCP, the property rights established by the clearing members and their clients and the local insolvency regime to which the CCP may be subject. In contrast to the U.S. (where bankruptcy proceedings are regulated by federal law under the Bankruptcy Code), default procedures in the EU may be more fragmented in practice, given the substantial differences between national insolvency laws.

Non-cleared Derivatives

Both regimes regulate derivatives that are not accepted for clearing in a similar way, including collateral posting and mark-to-market, but vary in terms of the obligations applicable to end-users.

In the EU

Financial counterparties (FCs) and Article 7 non-financial counterparties (NFCs)[8] must ensure that arrangements are in place to measure, monitor and mitigate operational and credit risk, by at least, 1) where possible, using electronic confirmation of the contract terms and 2) having in place robust, resilient and auditable processes for portfolio reconciliation, to manage the risk and to identify disputes between parties early, and to monitor the value of outstanding contracts.[9] Value determinations must be based on daily mark-to-market, and risk management procedures must require the timely, accurate and appropriately segregated exchange of collateral or the appropriate and proportionate holding of capital.

In the U.S.

With respect to segregation of margin collateral posted for non-cleared swaps, the segregation requirement for initial margin is imposed on a dealer only at the request of a customer.[10] If so requested by a customer, the margin account must be held with an independent third-party custodian. In the case of swaps regulated by the CFTC, the margin would have to be held at a CFTC registered FCM. If a swap dealer does not segregate, it must report quarterly to the counterparty that its procedures with respect to margin collateral comply with the parties' agreement.

Concerns

Under the Proposal, NFCs potentially become subject to substantive regulation of their derivatives activities. As this will be completely new to them, it may be difficult for them to comply from day one. Another open issue is what capital rules (if any) should apply to NFCs since these entities are not (by definition) currently subject to prudential regulation as such.

It is still not clear if, or at least when, margin and capital requirements apply to U.S. end-users. European end-users trading with U.S. end-users may find it difficult to manage margin and collateral posting as the EU regime does impose margin and capital requirements whilst it is not clear what the U.S. regime requires.

Reporting Obligations

To enhance market transparency, both regimes impose reporting obligations on counterparties. Although the type of information to be included in the reports is yet to be defined, the policy is identical: monitoring transaction volumes, volatility and market movements.

In the EU

An FC and an Article 7 NFC must report to a registered trade repository the details of any derivatives contract that it has entered into, and any modification or termination, no later than the working day following the execution, clearing, or modification of the contract.[11] If a trade repository is not able to record the details of a transaction, financial counterparties must report the details of their positions in such transaction to the national regulator.

In the U.S.

Under Dodd-Frank all swaps, including those that are exempt from mandatory clearing, are subject to reporting requirements.[12] With respect to swaps that are cleared, regulatory reporting and public dissemination of swap information is handled by the relevant clearing house and/or swap execution facility. Swaps that are not accepted for clearing at a clearing house must be reported to a "registered swap data repository" or a "registered securities-based swap data repository" or, if no swap data repository will accept the report, directly to the CFTC or the SEC.

To a large extent, reporting is an obligation of financial intermediaries rather than end-users. For swaps where only one of the parties is a swap dealer or major swap participant, the swap dealer or major swap participant is required to report. Where one of the parties is a swap dealer and the other is a major swap participant, the swap dealer is required to report. However, where neither party is a swap dealer nor major swap participant (or where both parties are swap dealers or major swap participants), then parties must decide between themselves which party will report. Therefore, all parties to swaps will be required to develop and implement compliance procedures to satisfy reporting requirements and to provide for the timely submission of reports when they are required.

Concerns

The biggest discrepancy between the EU and U.S. regimes is that in the U.S. there is no information threshold for reporting by end-users (*i.e.*, all trades must be reported). European counterparties dealing with the U.S. should be mindful of that, as they may be required to report to the U.S. regulators even though they are under no obligation to do so in the EU.

Regulation of Dealers, Major Swap Participants and End-users

In the U.S., supervision goes beyond clearing houses, and affects swap dealers, major swap participants and to some extent, end-users as well. In contrast, the Proposal does not, as such, establish an authorisation regime for participants in the derivatives markets.

In the EU

European dealers that are investment firms are subject to MiFID and other applicable national regulations including conduct of business, client protection, conflicts of interest, best execution and client asset rules. Under the Proposal, there is no equivalent to the U.S. category of major swap participants. Hedge fund managers are considered FCs if they qualify as "alternative investment fund managers" under the AIFM Directive without reference to the systemic or counterparty risk they pose.[13] NFCs may be subject to certain requirements under the Proposal in the EU, but are not subject to an authorisation requirement as such.

In the U.S.

Dodd-Frank contains two sets of registration requirements, one applicable to swap dealers, the other applicable to major swap participants.[14] Swap dealers must register with the CFTC as "swap dealers" or with the SEC as "security-based swap dealers", depending on whether they deal with swap or security-based swaps. Similarly, major swap participants must register with the CFTC or the SEC, as appropriate. There are a number of specific requirements to be followed by swap dealers and major swap participants including 1) capital requirements, 2) margin requirements, 3) books and records, 4) conduct of business rules, 5) documentation and back-office standards and 6) research and conflicts of interest.

The main issues are 1) how capital and prudential requirements should apply to major swap participants which have not traditionally been subject to capital regulation in the U.S. and 2) whether or not end-users (not qualifying as major swap participants) are exempted from margin requirements.

Under Dodd-Frank, there are additional requirements that apply to all persons entering into or dealing with swaps (including end-users) including 1) complying with position limits in swaps and security-based swaps,[15] 2) reporting to the CFTC or SEC swap positions (aside from specific transactions) above certain quantitative levels and 3) reporting swaps that are not centrally cleared and not reported to a swap repository (because they are not accepted by such repository).

Concerns

One of the concerns for European counterparties which are currently not subject to an authorisation requirement in Europe (*e.g.*, hedge funds or corporations) when dealing with the U.S. is being considered major swap participants. This may trigger (for example) a registration requirement (with the CFTC or the SEC), where there is no EU equivalent. Again, these requirements are likely to discourage European end-users from trading with U.S. dealers.

Cross-border Issues

As derivatives markets are global, the potential interaction between Dodd-Frank and the Proposal is important.

In the EU

For mandatory clearing, the Proposal provides that the clearing obligation may apply both to FCs (which are defined by reference to being regulated under EU law) and NFCs (which are defined by reference to being established in the EU) who enter into eligible OTC derivatives with third country entities.[16] Arguably, the reporting obligation should be co-terminus with the clearing obligation in this regard, although the Proposal is not explicit on this point. Accordingly, it may be the case, for example, that the reporting obligation is applicable even to a FC trading with a U.S. corporation (which is not a FC or a NFC under the Proposal). Under the Proposal, clearing and reporting obligations should not apply to entities based outside the EU.

For clearing house supervision, a CCP established outside the EU may provide clearing to entities established in the EU only if the CCP is recognised by the newly created European Securities and Markets Authority (ESMA). ESMA must recognise the CCP if 1) the EU Commission has adopted a decision that the legal/supervisory arrangements in the foreign country ensure that the CCP complies with legal requirements that are equivalent to the EU's requirements and the CCP is subject to effective supervision and enforcement, 2) the CCP is authorised in, and subject to, effective supervision in its home jurisdiction and 3) co-operation arrangements have been established between ESMA and the relevant national regulators of the foreign jurisdiction.[17] A similar process applies to the recognition of non-EU trade repositories.[18]

In the U.S.

The provisions of Dodd-Frank may not apply to derivatives activities wholly outside the U.S., but the reach of Dodd-Frank is not clear, and the U.S. regulators may adopt regulations to prevent evasion of U.S. rules and may prohibit entities in countries whose regulations undermine U.S. financial stability from participating in the U.S. in derivatives activities. Generally, it is likely that Dodd-Frank will not reach persons outside the U.S. who do not trade with persons inside the U.S., but it may regulate non-U.S. persons who transact using "interstate commerce" with U.S. persons.[19] With respect to swaps, the jurisdictional limitation on the CFTC is less explicit: activities outside the U.S. may be regulated by the CFTC if they have a direct and significant connection with activities in the U.S.

With regard to clearing house supervision, Dodd-Frank provides that US regulators may exempt a non-US clearing house from U.S. regulation if the non-U.S. clearing house is subject to comparable, comprehensive regulation in its home country. Such an exempt clearing house would be eligible to clear swaps. However, Dodd-Frank does not contain any provisions allowing the recognition (or exemption) of non-U.S. clearing house members, but such entities might be able to register with the CFTC if they can comply with its requirements.

Concerns

The Proposal conflicts with Dodd-Frank as the former does not expressly impose clearing and reporting obligations on non-EU entities whilst the latter may do so on non-U.S. counterparties. In fact, Dodd Frank may apply to EU counterparties transacting with U.S. counterparties and, in the case of certain swaps (even in the absence of a US counterparty), where the transaction has a direct or significant connection with activities or commerce in the US. As a result, a FC in the EU that is within the definition of "swap dealer" under Dodd-Frank and which enters into, for example, an interest rate swap with a U.S. counterparty may be subject to both EU and U.S. regulation (including the U.S. registration requirement). An Article 7 NFC in the EU (*e.g.*, a large corporation or a hedge fund (if considered a NFC) above clearing and reporting thresholds) that qualifies as "major swap participant" when dealing with U.S. counterparties may be subject to U.S. and EU regulation at the same time.

Effective Date

In the EU

Once the Proposal is approved by the EU Parliament and EU Council (which may take months), it will enter into force 20 days after official publication. Under the Proposal, CCPs that have an existing national authorisation would have two years from the entry into force of the Proposal to obtain authorisation. Some other provisions would not take effect until implementing regulatory standards are adopted (*e.g.*, the information and clearing thresholds for NFCs). Still, other provisions have no transitional arrangements. The current draft of the Proposal is not clear as to when existing derivatives shall be reported or cleared.

In the U.S.

Under Dodd-Frank, the effective date of most provisions is 360 days after enactment (*i.e.*, 16 July 2011) or, if rulemaking is required, 60 days after publication of the final rule. The deadline for most rulemaking is July 2011. Dodd-Frank specifically states that its enactment will not generally give rights to parties to terminate, amend or modify an existing swap and explicitly exempts contracts entered into before the clearing obligation becomes effective from the mandatory clearing obligation, so long as they are reported.

Conclusion

"I am confident that we will bring strong and consistent regulation to both the European and U.S. swaps markets" said Gary Gensler, chairman of the CFTC, recently. [20] That may be the case when the details of the respective regimes are clear. Currently, however, the potential for divergence on a number of substantive issues continues, including the classes of derivatives covered, cross-border application and mutual recognition, margin, collateral segregation, bankruptcy protection, reporting, end-user exemption and trading on regulated exchanges. Implementing rules may address these issues only with extensive co-operation between regulators and industry consultation in the following months.

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[1] *See* Steven Lofchie, Edmond Curtin and Marco Crosignani, Cadwalader, Wickersham & Taft LLP, No Crisis Wasted: Proposed EU and U.S. Regulation of OTC Derivatives (Part I), Bloomberg UK Financial Services Law Journal (1 November 2010).
[2] *See* Articles 37-39 Proposal.
[3] *See* Article 37(2) Proposal.
[4] *See* Section 724 Dodd-Frank.
[5] *See* Article 37(4) Proposal.
[6] *See* Articles 40-46 Proposal.
[7] *See* Article 45(4) Proposal.
[8] For further explanation on Article 7 NFCs, *see* Part I of this article.
[9] *See* Article 8 Proposal.
[10] *See* Section 724(c) Dodd-Frank.
[11] *See* Article 6 Proposal.
[12] *See* Section 727 Dodd-Frank.
[13] *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.
[14] *See* Section 731 Dodd-Frank.
[15] More specifically, the CFTC would have authority to establish aggregate position limits for 1) listed commodities contracts, 2) contracts traded by U.S. participants on foreign boards of trade and 3) swaps that perform or affect "a significant price discovery function" with respect to regulated markets, while the SEC would have authority to establish aggregate position limits with respect to 1) securities traded on a U.S. exchange, and 2) security-based swaps that perform "a significant price discovery function" in regulated markets.
[16] *See* Article 3(1) Proposal.
[17] *See* Article 23 Proposal.
[18] *See* Article 63 Proposal.
[19] *See* Sections 722(d) (for swaps) and 772(b) (for security-based swaps) of Dodd-Frank.
[20] *See* Joint Statement by Commissioner Michel Barnier and CFTC Chairman Gary Gensler on the financial reform agenda – European Commission, 28 September 2010.