

EU financial reforms

Impact on OTC derivative and commodities markets

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The importance of the European Commission's (the Commission) proposals (the Commission proposals) on OTC (over-the-counter) derivatives cannot be underestimated (*see box "What are derivatives?"*). The Commission, in conjunction with the G-20, is seeking to tame a market that it believes has been fuelled by excessive speculation. If the proposals are enacted as currently drafted, trading companies operating on a cross-border basis will have to consider changes to long-standing business practices.

This article:

- Examines the main proposals put forward by the Commission and how they will affect trading entities both in the EU and the US.
- Considers the key differences and the points of overlap between the Commission proposals and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).
- Addresses potential additional reforms that may be implemented with respect to physical commodities markets.



What are derivatives?

Derivatives are financial instruments whose price and value derive from the value of the underlying assets or other variables; these could be, for example, equity indices such as the S&P 500, individual shares, debt securities and their issuers, commodities and interest rates. New underlying assets or variables classes include the weather, inflation, carbon emissions and available bandwidth on the radio spectrum.

The most common types of derivative are forwards, futures, options, swaps and credit derivatives, such as credit default swaps.

Derivative contracts are commonly entered into to hedge (or protect) against market risks. They may be traded on an exchange or over-the-counter (OTC). Exchange-traded derivatives are sometimes thought to be safer, as they are traded in a regulated and liquid market where there is a high degree of price transparency, but exchange-traded derivatives do not lend themselves to being tailored and geared in the same way as OTC derivatives.

OTC derivatives trading is concluded directly (often by telephone) between the parties, with documentation evidencing the trade exchanged between the contracting parties. OTC derivatives are not listed or traded on a recognised exchange.

(For background, see feature articles "Derivatives uncovered: swaps, futures and all that jazz", www.practicallaw.com/9-201-2879 and "M&A in the commodities sector: still going strong", www.practicallaw.com/4-386-8835.)

GLOBAL FINANCIAL REFORM

In September 2009, at the G-20 Pittsburgh Summit, the leaders of the world's 19 biggest economies, along with the EU (categorised as the G-20's 20th member (four EU member states are represented directly: France, Germany, the UK and Italy)), agreed that:

- All standard OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest.
- OTC derivative contracts should be reported to trade repositories and non-centrally cleared contracts should be subject to higher capital requirements.

In June 2010, EU member states undertook to conclude all of the negotiations relating to the G-20 commitments on financial reform by the end of 2011.

Given that OTC derivatives account for almost 90% of the global derivative market and are currently largely unregulated, it was essential to regulators that a strong legislative and regulatory framework be put in place. The Commission proposals cover all areas of the OTC derivative market, including interest rates, credit, equity, foreign exchange and commodities.

Michel Barnier, the European Commissioner leading the Commission proposals, has underlined the Commission's view that OTC derivatives have had a wide-reaching impact on the economy, affecting everything from mortgages to food and energy prices. The aim of the increased regulation is to remove the fundamental uncertainty which allegedly underpins the OTC derivative market.

Commissioner Barnier has also confirmed that the Commission will use its ongoing review of the Markets in Financial Instruments Directive (2004/39/

EC) (MiFID) as part of its more general reform of the raw materials markets, in parallel with the Commission proposals (MiFID review) (*see box "MiFID review"*). The Commission intends to strengthen the transparency of trades for market users and regulators, to provide a "better framework" for raw materials markets and to "increase controls" on the various players in these markets.

On an international level, the need for reform has been addressed by the introduction of the Dodd-Frank Act in the US, and there are proposals for change in several countries operating in the Asian markets, including Japan and Hong Kong, among others.

COMMISSION PROPOSALS

In September 2010, the Commission published its formal proposals designed to regulate the OTC derivatives markets (www.practicallaw.com/8-503-4270). Its three-pronged approach aims to reform the markets by: increasing transparency; reducing counterparty risks; and reducing operational risks.

Increasing transparency

Under the current system, neither policy regulators nor market participants are clearly or expeditiously able to get a comprehensive snapshot of the position of the OTC derivatives markets at any given time, due to the absence of mandatory reporting requirements.

The Commission proposals aim to increase transparency by mandating the reporting of OTC derivative trades to various central data centres, known as *trade repositories* (*see Glossary*). Under the proposals, to obtain registration, a trade repository would have to comply with strict requirements ensuring the confidentiality, integrity and protection of the information that it receives and maintains.

Access to trade repositories would be granted to EU and non-EU financial services regulators, in order to allow for a better monitoring of the market and the ability to detect any concerns or risks before they materialise or es-

calate. Trade repositories will be required to publish *positions* by classes of derivatives, giving a clearer and more transparent view of the OTC derivatives markets.

There are currently two alternatives for which authority will regulate and supervise the trade repositories: the trade repository would register with its national competent authority, which would be responsible for ensuring the trade repository's proper functioning (but would be required to pass information on to the European Securities and Markets Authority (ESMA)); or the trade repository would be registered with, and run by, ESMA. The Commission prefers the ESMA option from a cost/benefit perspective.

Reducing counterparty risk

It is felt that the credit risk of counterparties (the two parties to a derivatives contract) is too high due to inadequate or non-existent *collateralisation* of trading positions. Consequently, a risk arises every time one party to an OTC transaction is unable to make the required payment as and when it is due.

The Commission hopes to neutralise this concern by requiring the clearing of standardised OTC derivatives through central clearing counterparties (CCPs). (The UK currently has three Commission-recognised CCPs: LCH.Clearnet Ltd; Euro CCP; and ICE Clear Europe.) Clearing an OTC derivative contract through a CCP will usually involve the posting of higher amounts of collateral than if a contract is not cleared through a CCP. Therefore, increased collateral would be held by the CCP, automatically safeguarding each party against the failure of the other.

CCPs would act as an intermediary between the buyer and seller, and would provide a safety net, preventing the automatic collapse of one market participant following the collapse of another market participant. The CCP would be able to choose which contracts to clear, and the authority to carry out that clearing would be granted by a national authority.

MiFID review

The European Commission (the Commission) is currently undertaking a formal review of the Markets in Financial Instruments Directive (2004/39/EC) (MiFID), which has been in force since 2007 (see feature articles "MiFID: transforming EU financial services?", www.practicallaw.com/5-372-6954, and "MiFID: a changing environment for EU financial services", www.practicallaw.com/7-382-2186). Reform of MiFID will assist in the overall efforts to reform commodity oversight in Europe. The review focuses on pre- and post-trade transparency, including the imposition of new obligations for achieving greater trading transparency. Investor protection measures will also be revisited, including an analysis of client classification.

In July and October 2010, the Committee of European Securities Regulators (CESR) published technical advice on OTC (over-the-counter) derivatives for the Commission in the context of the MiFID review (www.practicallaw.com/1-503-1604; www.practicallaw.com/3-503-7006). This included advice on proposals for the organised platform of OTC derivatives, aimed at increasing the standardisation of OTC derivatives, and encouraging more trading of standardised derivatives on organised trading venues. The advice also focused on post-trade transparency standards and client categorisation.

The CESR advice will allow the Commission to report to the European Parliament on possible changes to MiFID in the first quarter of 2011. There is currently no implementation date for the revised Directive.

The increased amount of collateral that would be held by CCPs means that the CCPs themselves would be subject to increased risk. To mitigate the risk that CCPs would, in turn, pose to financial systems, the Commission proposals, along with other pieces of legislation, including MiFID, the Market Abuse Directive (2003/6/EC) (MAD), the Transparency Directive (2004/109/EC) and the Capital Requirements Directive (2006/48/EC; 2006/49/EC) (CRD), will impose stringent conduct of business rules, internal governance, audit checks and requirements, and organisational and prudential requirements.

CCPs would also be required to demonstrate that they have access to adequate levels of liquidity; this would be available to CCPs from central banks and creditworthy commercial banks.

Reducing operational risk

The Commission hopes to encourage the use of electronic facilities to confirm the terms of an OTC derivative contract, as opposed to the current system of complex, bespoke contracts, which increase the risk of human error. It is

thought that reducing the requirement for manual intervention in the various stages of the buying and selling process will decrease the operational risk that surrounds the trading of derivatives on OTC markets.

It has also been suggested that electronic reconciliation and confirmation of the contract is a potentially valuable tool to ensure that details of trades are agreed early and accurately, and can be used in both high- and low-velocity markets.

Application

The Commission proposals are aimed primarily at OTC market traders, banks (both universal banks and investment banks), insurance companies and funds.

The Commission proposals do not apply to *spot contracts* or *forward contracts*.

They will apply to non-financial firms such as energy companies, airlines and manufacturers that have large positions in OTC derivatives. These types of firm often carry out commercial hedging us-

ing OTC derivatives to secure the price at which they buy fuel, for example, or exporters may use OTC derivatives to shield themselves from fluctuations of exchange rates.

However, non-financial firms would be exempt from the CCP clearing and reporting requirements unless their OTC derivatives positions reach a threshold at which they are considered to be systemically important (see “*Clearing exemption*” and “*Reporting obligations*” below). The rationale behind the clearing exemption for non-financial entities appears to be the same in all jurisdictions: non-financial counterparties are not seen as posing the same level of risk to the markets as financial counterparties.

ESMA, together with the European Systemic Risk Board (ESRB) and other relevant authorities, will draft technical standards on what these thresholds should be. No date has been set for when these will be published.

EU/US COMPARISON

Market commentators have said that the Commission proposals will result in increased convergence of EU financial regulation with that of the US (see box “*European Commission proposals vs Dodd-Frank Act*”). There will, therefore, be fewer opportunities for market players outside the EU and the US to exploit the differences between the two systems of regulation and attract OTC derivative business to their markets.

The Dodd-Frank Act has the stated aim of “promoting the financial stability of the US by improving accountability and transparency in the financial system”. The scope of both the Dodd-Frank Act and the Commission proposals are, on the whole, very similar. Both apply to a broad class of OTC derivatives, and exclude spot contracts and forward contracts.

Both legislative approaches also allow for the recognition of non-domestic CCPs, thereby permitting cross-border clearing in certain circumstances.

In a clear sign that transatlantic co-operation is seen as essential to the success of the Commission proposals and the Dodd-Frank Act, Commissioner Barnier and the US Commodity Futures Trading Commission (CFTC) Chairman, Gary Gensler, reaffirmed their close working relationship in November 2010 and confirmed their determination to co-operate closely in strengthening the global financial system. Commissioner Barnier said, after his meeting with his US counterpart: “I look forward to the continued close co-operation with Chairman Gensler and his staff in order to ensure that Europe and the United States continue to make progress in parallel on these important matters.”

In addition, the CFTC’s Global Markets Advisory Committee hosted senior personnel from the Commission and the Japanese Financial Services Authority on 5 October 2010. The participants at the conference discussed their respective approaches to OTC derivatives reform.

Clearing exemption

The clearing exemption for non-financial counterparties in the Commission proposals (see “*Application*” above) is similar to the end user exemption from clearing in the Dodd-Frank Act. Under the Dodd-Frank Act, a non-financial entity may opt out of the clearing obligation if it is using a *swap* and notifies the CFTC of how it meets its financial obligations associated with entering into non-cleared swaps.

However, unlike in the Commission proposals, the end user exemption does not require the non-financial entities’ OTC derivatives positions to fall below the systemically-important threshold. Some commentators believe that this provision in the Commission proposal could be abused, depending on what threshold the Commission sets for a position to be considered systemically important.

Mandatory clearing obligations

The Commission proposals require mandatory clearing of many OTC derivative contracts and set out two

tranches to determine which contracts must be cleared:

- A “bottom-up” approach, in which the relevant competent authority in the member state in question would authorise the CCP to clear a class of derivatives, following which the competent authority would then be obliged to inform ESMA of who will have the powers to decide whether a clearing obligation should apply to that class of derivatives in the EU.
- A “top-down” approach, in which ESMA, on its own initiative and in consultation with the ESRB, would identify contracts that should be subject to the clearing obligation, but for which no CCP has yet received authorisation.

The bottom-up and top-down approaches would work in parallel with one another, rather than being mutually exclusive. So a swap would have to be cleared if it meets either test.

This two-pronged requirement ensures that no OTC derivative contract that should be cleared slips through the net. For example, if the competent authority in a particular EU member state does not authorise a CCP to clear a class of derivatives, ESMA would have the power to overturn the decision made by the competent authority and require that a particular contract be cleared, even if the CCP has not received the approval for clearing from its competent authority. This approach also ensures that the clearing requirement applies to new products for which formal legislative proposals have not yet been considered.

The Commission proposals set out specific criteria for ESMA to determine whether a contract should be cleared, including the following:

- Whether or not the clearing would result in the reduction of systemic risk in the financial system.
- The liquidity of the contracts proposed for clearing.

- What information on pricing is available at the time the decision is made by ESMA.
- The volume of contracts being proposed for clearing and whether the CCP is able to handle that volume of contracts.
- The level of client protection provided by the CCP.

The subjectivity of some of these criteria (namely, whether the clearing of the contract reduces systemic risk in the financial system) suggests that ESMA has a certain amount of discretion when deciding whether to clear an OTC derivative contract.

The Commission explained its rationale for not imposing mandatory clearing for all OTC derivatives by referring to the customised nature of certain derivative contracts to meet particular counterparty or end user needs. Highly bespoke OTC derivatives will not, therefore, meet the standards required for central clearing as they will not pose a high enough level of risk.

In one sense, the Commission proposals appear slightly stricter than those under the Dodd-Frank Act in that they require clearing if the (currently unascertained) threshold is exceeded. On the whole, though, the Commission proposals are viewed as being slightly less onerous on end users than the US legislation.

In the US, as clearing obligations are determined according to the type of contract that is being traded, rather than according to the status of the entity trading the product, all contracts which are accepted by designated clearing organisations (DCOs) (the US equivalent of CCPs), would have to be cleared. It would also be up to the appropriate regulators to determine which OTC derivatives are subject to the mandatory clearing obligation. The subjectivity afforded to regulators has the potential to lead to more financial counterparties being the subject of mandatory clearing requirements.

Reporting obligations

Under the Commission proposals, there is a similar exemption to the clearing exemption for non-financial counterparties from the reporting obligation (*see "Clearing exemption" above*). This exemption could potentially be viewed as a way of justifying the concerns of certain traders and hedge funds who believe that the Commission proposals will not give a fair and accurate portrayal of the OTC market as a whole, which was the Commission's stated aim at the outset of the consultative process, particularly as focusing the mandatory reporting requirements on financial institutions may give market participants a distorted view of the status of the market.

There is no equivalent end user reporting exemption for non-financial counterparties under the US legislation. Under the Dodd-Frank Act, all uncleared swaps must be reported to a registered trade repository.

On 1 October 2010, the CFTC approved an interim rule on the reporting obligations for pre-enactment swaps (that is, those outstanding on 21 July 2010). Although the reporting of pre-enactment swaps is required by the Dodd-Frank Act, the interim rule does not yet require any specific reporting; it aims to provide for retention of certain swap data until the CFTC establishes permanent reporting rules, to be proposed later this year.

Business conduct standards

One of the main distinctions between the Dodd-Frank Act and the Commission proposals is that certain issues concerning the trading and transparency of OTC derivatives will not be addressed by the Commission proposals, as they will be dealt with separately under the MiFID review (*see box "MiFID review"*).

Furthermore, whilst the Dodd-Frank Act requires the registration of swap dealers and major swap participants, this, along with other conduct of business rules, is dealt with in the EU by MiFID, and the Commission proposals do not extend the registration requirements.

In the US, the CFTC will establish new conduct of business rules, along with those prescribed by the Dodd-Frank Act.

Certain aspects of the Dodd-Frank Act are also covered in MAD, which prohibits short selling when used to manipulate the market when combined with insider information, and the Transparency Directive, which requires the disclosure of significant long positions. Certain amendments will also be made to the CRD, which will deal with the differentiation of capital charges between CCP-cleared and non-CCP-cleared contracts. However, not all aspects covered by these EU directives are covered by the Dodd-Frank Act.

Both the Commission proposals and the Dodd-Frank Act impose restrictions and obligations on financial counterparties, although the details differ. Under the Commission proposals, financial counterparties must have in place certain arrangements which would allow for the mitigation of any operational and associated credit risk. This would be achieved via a system of electronic confirmation of contracts, to avoid human error that arises on the use of bespoke contracts (*see "Reducing operational risk" above*).

Other arrangements include swap dealers and major swap participants having capital and margin requirements with regard to uncleared trades; it is not yet certain whether these will apply to uncleared trades with end users. Whilst swap dealers and major swap participants will also be required to verify their contract participants and eligible contract participants, there is no further suitability determination required at this point.

Swaps have been particularly focused on by the Commission proposals, as they, like other OTC derivatives, have been largely unregulated in the past. In March 2010, the Financial Services Authority (FSA) Chairman Lord Turner stated that credit default swaps should be the subject of tighter regulation. Previously, Lord Turner had also stated that credit default swaps were initially

European Commission proposals vs Dodd-Frank Act

	European Commission proposals	Dodd-Frank Act
Who is affected?	OTC (over-the-counter) derivative dealers, financial and non-financial counterparties, trade repositories, central clearing counterparties (CCPs).	OTC derivative dealers, financial and non-financial counterparties, trade repositories, designated clearing organisations (DCOs).
Applicability	Wide range of OTC derivatives. Spot foreign exchange transactions and commercial foreign exchange transactions excluded. Some physically settled commodity transactions excluded.	Wide range of OTC derivatives. Spot foreign exchange transactions are not covered. Treasury Secretary has the power to exempt foreign exchange swaps and forwards from the clearing obligation. Forward contracts are excluded.
Clearing obligations	<p>Mandatory clearing by financial counterparties European Securities and Markets Authority (ESMA) determines which OTC derivatives are subject to the clearing obligation. ESMA identifies contracts for clearing even if no CCP clears the contract. “Bottom-up” and “top-down” approach.</p> <p>Clearing by non-financial counterparties May be subject to mandatory clearing if positions exceed a certain threshold. Counterparty will have to justify exceeding the threshold.</p>	<p>Mandatory clearing by financial counterparties Clearing will apply according to the type of contract, rather than the status of the entity. Therefore, all contracts will have to be cleared if they are accepted by DCOs, but end users can choose not to have the transaction cleared in certain circumstances.</p> <p>Regulators determine which OTC derivatives are subject to the mandatory clearing obligation. The contract will need to be cleared only if there is a DCO that currently clears the contract.</p> <p>Clearing by non-financial counterparties: end user exemption End user can opt out of the clearing obligation if using the derivative for hedging or mitigating commercial risk and notifies the regulator as to how it generally meets its obligations under non-cleared swaps.</p>
Reporting obligations	<p>Non-financial counterparties will only have to report their OTC derivative contracts if certain limits are exceeded. Will be required to justify exceeding the threshold.</p> <p>Financial counterparties will have to report their OTC derivatives contracts to registered trade repositories, or the regulator.</p>	All uncleared swaps must be reported to a registered swap data repository or the regulator. Pre-enactment swaps (that is, those entered into before the enactment of the Dodd-Frank Act and existing on the date of the Act) must also be reported. The US Commodity Futures Trading Commission (CFTC) issued an interim final rule in October 2010 specifying what records must be retained; this takes effect immediately.
Additional obligations	<p>Margin requirements and capital requirements for uncleared OTC transactions must be met.</p> <p>Margin requirements apply to non-financial parties only in certain circumstances. Capital requirements apply to non-financial counterparties when a certain threshold is cleared.</p> <p>CCPs will impose margin requirements on clearing members.</p>	<p>Margin requirements and capital requirements to uncleared OTC transactions must be met.</p> <p>Capital requirements will only apply to non-bank swap dealers and major swap participants.</p> <p>Margin requirements apply only to swap dealers and major swap participants.</p> <p>The CFTC does not have the authority to impose a margin requirement on end users.</p>
Conduct of business	<p>Most conduct of business rules to be dealt with under reviews of the Markets in Financial Instruments Directive (MiFID), the Market Abuse Directive, the Capital Requirements Directive and the Transparency Directive. The European Commission’s proposals (Commission proposals) do not go further than these Directives. MiFID already requires the authorisation of EU dealers in OTC derivatives.</p> <p>Restrictions and obligations placed on financial counterparties. Financial counterparties must have in place certain arrangements which would allow for the mitigation of any operational and associated credit risk.</p>	<p>The CFTC will establish new business conduct rules.</p> <p>The Dodd-Frank Act requires swap dealers and major swap participants to register with the National Futures Association, verify that their counterparties are eligible contract participants and comply with various disclosure requirements.</p>

European Commission proposals vs Dodd-Frank Act (continued)

	European Commission proposals	Dodd-Frank Act
Conduct of business (continued)	<p>Restrictions and obligations placed on financial counterparties via a system of electronic confirmation of contracts.</p> <p>Valuation of counterparty portfolio and the reconciliation and appropriately segregated exchange of collateral or an adequate holding of capital.</p>	
Regulation of CCPs/DCOs	<p>Provisions regarding the regulation of CCPs include conduct of business and organisational structure. Particular requirements include ensuring that the CCP has access to liquidity (through the central bank and/or a creditworthy and reliable commercial bank) and the specification of margins covering 99% of risk exposure movements over a certain period of time. No restriction regarding the ownership of CCPs, so they can be owned by large banks and financial holding companies. However, the shareholders in a CCP must be identified to the CCP's regulator. The regulator is entitled to refuse authorisation of the CCP if it is not satisfied with the suitability of the CCP's shareholders.</p>	<p>Regulators tasked with setting the standards for the organisational and business conduct of DCOs. Requirements regarding collateral for cleared swaps to be held with a futures commission merchant or a broker, dealer or securities swap dealer.</p> <p>A registered DCO is not required to accept the credit risk of another DCO.</p> <p>Regulators will determine whether certain companies, such as financial holding companies supervised by the Federal Reserve and large banks, should be prevented from owning or governing DCOs. The CFTC is currently undertaking a rulemaking to that effect; it would indicate a clear "separation of powers". In theory, a large bank or holding company should not have the power both to own a DCO and carry out extensive trades through it.</p>
Non-cross-border provisions	<p>No corresponding provisions to those under the Dodd-Frank Act in the Commission proposals. EU banks not restricted from entering into OTC derivatives contracts.</p> <p>Risk is mitigated by the posting of collateral to CCPs when the trade is entered into.</p>	<p>The "Volcker Rule" prohibits any "banking entity" from engaging in proprietary trading. This includes foreign banks with US affiliates. There are various exceptions for "permitted activities", including trading that occurs solely outside the US.</p> <p>The "push-out" provision limits the ability of federally-insured "swap entities" (for example, swap dealers and major swap participants) to engage in certain swap-related activities. This provision becomes effective two years following the date on which the Dodd-Frank Act becomes effective.</p>
Territorial scope	<p>Not yet entirely clear.</p> <p>Provide for co-operation with third countries, ensuring competent authorities exchange information. ESMA charged with the co-ordination and development of the co-operation agreements between EU member states.</p>	<p>The US legislation does not expressly apply to derivatives traded wholly outside the US (and with non-US counterparties), although regulators have the option of making regulations and imposing them on entities in countries whose regulations may affect the financial stability of the US and preventing them from participating in US derivative activities.</p> <p>Activities carried out outside the US are not regulated, unless the activities: have a direct and significant connection with activities in, or effect on, commerce of the US; or contravene such rules or regulations as the US Securities and Exchange Commission may prescribe or promulgate.</p>
Timeframe for implementation	<p>Come into force over the course of 2012, 20 days after publication in the Official Journal. Precise dates for the various provisions vary.</p>	<p>Most provisions of the Dodd-Frank Act will not take effect until at least 360 days after enactment or, to the extent that any provision requires a rulemaking, 60 days after the final rule is promulgated, whichever is later.</p>

created to hedge volatility, but often had the opposite effect, by creating more volatility.

The remaining arrangements for mitigating risk deal with the reconciliation and exchange of collateral and an adequate holding of capital (the level of which is yet to be ascertained). The initial margin will have to be segregated by swap dealers and major swap participants if requested by the end user.

The Dodd-Frank Act requirements focus more on the swap dealers and major swap participants themselves, including the imposition of capital and margin requirements. This would apply to those who enter into uncleared swaps. The level of capital and margin requirement would be appropriate for the heightened risks posed by uncleared swaps.

CCPs and DCOs regulation

Under the Commission proposals, particular requirements for CCPs include ensuring that the CCP has access to liquidity (through the central bank and/or a creditworthy and reliable commercial bank) and the specification of margins covering 99% of risk exposure movements over a certain period of time.

Under the Dodd-Frank Act, regulators set the standards for the organisational and business conduct of DCOs; for example, collateral for cleared swaps must be held with a futures commission merchant or a broker, dealer or securities swap dealer, and a registered DCO is not required to accept the credit risk of another DCO.

US regulators will have the power to determine whether or not large banks and financial holding companies supervised by Federal Reserve should be prevented from owning DCOs. The CFTC appears to be taking the position that a large bank or financial holding company should not have the power to both own a DCO and carry out extensive trades through it.

There is no corresponding provision in the Commission proposals specifically

relating to large banks and financial holding companies. However, CCPs must disclose, and monitor vigorously, the identity of their shareholders, and a regulator is entitled to refuse to authorise a CCP if it is not satisfied with the suitability of the CCP's shareholders. The CCP must also disclose any close links that it has with any natural or legal persons. If the regulator considers the persons to be heavily influential in managing the CCP, the regulator will take "appropriate measures to terminate the situation", including removing a board member.

Non-cross-border provisions

Two much-discussed provisions of the Dodd-Frank Act have been the "Volcker Rule" and the "push-out" provision.

The Volcker Rule prohibits any banking entity (for example, an insured bank, a company that controls an insured bank, a bank holding company, or any affiliate of such an entity) from engaging in proprietary trading (that is, where a firm trades using its own money, rather than client money, to make a profit for itself). The Volcker Rule applies to foreign banks with US affiliates, as well as to those banks operating in the US. There are various exceptions for permitted activities, including certain risk-mitigating hedging activities and certain proprietary trading that occurs solely outside the US. De minimis investments that comply with certain requirements are also permitted.

The push-out provision limits the ability of federally insured swap entities (for example, swap dealers and major swap participants) to engage in certain swap-related activities. Bona fide hedging involving interest rates, currencies and certain assets (for example, gold, silver and other forms of bullion) are excluded from the prohibition. Other swap activity must be pushed out to a separate swap affiliate that complies with the requirements of certain provisions of the Federal Reserve Act and other regulations that may be promulgated by the US Securities and Exchange Commission (SEC), CFTC and/or Federal Reserve System.

There is no equivalent provision for either of these two rules in the Commission proposals. This means that banks within the EU are not limited as to how much OTC derivative business they carry out. As a result, the only way that the risk can be mitigated is by the posting of collateral to CCPs before the transaction is entered into. There are also fewer restrictions being placed on swap entities. Of course, there is still time for the Commission proposals to be amended to include equivalent provisions.

Territorial scope

The Dodd-Frank Act does not apply to any derivatives traded wholly outside the US that only involve non-US counterparties. However, US regulators can make regulations and impose them on entities in countries whose regulations may affect the financial stability of the US and, if necessary, prevent them from participating in US derivative trading activities.

Activities that are carried out outside the US may be regulated, to the extent that the activities:

- Have a direct and significant connection with activities in, or effect on, commerce of the US.
- Contravene such rules or regulations as the SEC may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of the act that was enacted by the Wall Street Transparency and Accountability Act 2010.

The CFTC has historically construed "activities" to be separate from "transactions", so it is unclear how this provision applies to swap transactions as opposed to soliciting, entering into and advising US customers about swap transactions.

The territorial application of the Commission proposals is not as yet entirely clear, although they do provide for cooperation with third countries (that is, non-EU), ensuring that the competent authorities exchange information. ESMA is charged with co-ordinating

and developing the co-operation agreements between member states.

The Commission is hoping for positive interactions with third countries. In order to recognise a third country CCP, ESMA will first need the Commission to evaluate and conclude that the legal and supervisory framework of that third country is equivalent to that of the EU, and that the CCP is authorised by, and subject to effective supervision in, that third country. This will ensure that EU market participants do not attempt to clear contracts through CCPs outside the EU which have lower standards than those set within the EU.

Once approval has been granted by the Commission, ESMA will be required to establish co-operation arrangements with the third country competent authorities. A third country CCP will not be granted permission to perform activities and services in the EU if these stringent conditions are not met.

The process for recognising a third country trade repository outside the EU will be subject to similar conditions as for CCPs in terms of equivalent legal regime and supervision. In addition, such regulation will be subject to an international agreement being in place between the Commission and the third country within which the particular trade repository is located. The international agreement must deal with mutual access to data and exchange of information on OTC derivative contracts held in trade repositories.

Timetable for implementation

The Commission proposals are intended to be implemented by the end of 2012 and would enter into force 20 days after publication in the Official Journal. CCPs with existing national authorisation would have two years to be authorised by ESMA. It appears that some other provisions of the Commission proposals will not be effective until the adoption of regulatory standards (for example, the publication by ESMA of information and clearing thresholds for non-financial counterparties). Other provisions have no transitional arrange-

Glossary

Collateralisation. The provision of security by counterparties by way of cash or guarantee, before entering into a transaction.

Forward contract. A non-standardised contract between two parties to buy or sell a commodity at a specified future time, up to a year in advance, at a price agreed on the day the contract is entered into.

Positions. A derivative position sets out the details of the derivative transaction(s) entered into.

Spot contract. An agreement to buy or sell a commodity for two working days ahead, which is then settled on the second working day.

Swap. A derivative contract between two parties to exchange a series of cash flows for a stated period of time to hedge or mitigate commercial risk.

Trade repository. A trade repository is a body that centrally collects and maintains records of OTC (over-the-counter) derivatives.

ments (for example, to take account of delays in registering/recognising an initial group of trade repositories). However, over the course of the next 18 months, the Commission is expected to publish more concrete guidelines on implementation.

The Dodd-Frank Act, which was enacted in July 2010, expressly provides that, unless otherwise specified, it will not take effect until 360 days after enactment or, to the extent that any provision requires a rulemaking, 60 days after the final rule is promulgated, whichever is later.

Due to the differences between the timetables for implementation of the Dodd-Frank Act and the Commission proposals, companies operating on a cross-border level will need to monitor the implementation of the two pieces of legislation closely. For periods when a particular provision of the Dodd-Frank Act is in force, but the corresponding Commission proposal is not yet in force, it would be recommended that the company follows the provision as under the Dodd-Frank Act, which means changing its trade practices before the Commission proposals come into force.

Recent developments

At the end of October 2010, the Technical Committee of the International Organisation of Securities Commissions (IOSCO) formed a task force on OTC derivatives regulation to co-ordinate the work of securities and futures regulators to create a co-ordinated supervisory and oversight structure relating to OTC derivatives markets.

The task force's aim is threefold; namely, to:

- Develop consistent international standards related to OTC derivatives regulation for clearing, trading, trade data collection and reporting, and the overseeing of certain market participants.
- Co-ordinate international programmes relating to OTC derivatives regulation.
- Serve as a focal point within IOSCO through which IOSCO members can consult and co-ordinate generally on issues relating to OTC derivatives regulation.

The task force received support from Commissioner Barnier and Chairman

Gensler in November 2010, when the two met in Chicago to discuss issues concerning the oversights of the commodity markets.

Meanwhile, the European Banking Federation (EBF) has criticised the Commission for going “too far” in its approach to attempting to regulate the OTC derivative market (www.ebf-fbe.eu/uploads/D1105E-2010.pdf). It questioned whether imposing clearing obligations over a class of derivatives for which no CCP has received clearing authorisation would contribute to reducing instability in the system (see “Mandatory clearing obligations” above). The EBF was also of the view that exemptions for “smaller financial counterparties” should have been tabled in the Commission proposals.

PHYSICAL COMMODITY REFORMS

French President Nicholas Sarkozy has said that when he takes to the helm of the G-20 in 2011, one of his priorities will be the introduction of increased regulation of the market in physical commodities (including metals, oil, gas, raw agricultural products and CO₂ quotas); that is, one element of derivatives trading. Commissioner Barnier’s and President Sarkozy’s views reflect a widely-held opinion that the need for increased regulation in the commodities market has been triggered by increased food (in particular, wheat) prices, rather than energy prices.

Christine Lagarde, France’s finance minister, believes it necessary to go a step further than the Commission proposals, focusing specifically on commodity derivatives, rather than simply packaging them together with the terms of the proposed legislation for OTC derivatives.

Unique system

Rather than just adopting the US model of financial commodity markets regulation, the Commission wants to adopt a unique system of regulation. This will reflect the distinct needs and make-up of the US and European markets and suit the historical and cultural specificities of the participants using the two

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different markets. It will also be an opportunity for the Commission to improve on anything it feels that its US counterparts have not successfully implemented in the Dodd-Frank Act.

No mandatory cap

Preliminary views suggest there would be no introduction of a mandatory cap on the number of contracts that financial investors can hold in a specific commodity at any one time. This contrasts with the US legislation in which Wall Street bankers and hedge funds have prescribed limits on how many speculative commodity contracts can be held.

Instead, EU regulators will regulate traders’ positions in a more flexible way. Such a move is unlikely to meet strong resistance from exchanges or bankers in the EU, although it could result in an increased number of US bankers transacting from the EU. It has been noted that most EU watchdogs do not have the power to monitor speculative positions.

More relaxed regime?

The reform of the physical commodities market is being closely observed

by Washington market participants. The CFTC is concerned that financiers from the US could go to the EU seeking a laxer regime, curtailing their trading activities on the New York and Chicago markets. Washington lawmakers have regularly referred to the “London loophole”, demonstrating the less stringent regulation of commodities in Europe.

The FSA has already stated that it is unlikely to back an overhaul of reforms due to the widely-held belief in the London-based financial world that increased prices in commodity markets have been caused primarily by basic supply and demand fundamentals, as opposed to market speculation. The UK, along with Denmark and The Netherlands, has suggested that if reforms do go through, they should be limited.

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