



Partnership

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E X P E C T E X C E L L E N C E

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Financial Regulatory Group Briefing

Future Regulation of Derivatives Markets

On 20 October 2009, the European Commission (the “**Commission**”) issued a communication outlining the policy actions which it intends to take in 2010 relating to the future regulation of derivatives markets. The Commission believes that there is a need for regulation in this area as, in its view, derivatives have contributed to the recent financial turmoil by allowing leverage to increase and by interconnecting market participants. In the Commission’s view this went unnoticed because of the lack of market transparency which arose as a result of the predominantly OTC market structure in respect of derivatives.

OTC derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. Products such as swaps, forward rate agreements and exotic options are almost always traded in this way. The OTC derivative market is largely unregulated with respect to disclosure of information between the parties, since it is almost exclusively made up of banks and other highly sophisticated parties, such as hedge funds.

The Commission has identified four complementary tools to reduce the impact of OTC derivatives markets on financial stability:

- (a) increase standardisation;
- (b) use of trade repositories;
- (c) strengthen the use of central counterparty clearing houses (“CCPs”); and
- (d) increase the use of organised trading venues, such as exchanges.

Approach of the Commission

The Former Internal Market and Services Commissioner, Charlie McCreevy, said that a “paradigm shift” must take place away from the traditional view that derivatives are financial instruments for professional use, for which light-handed regulation was thought sufficient, towards an approach where legislation allows markets to price risks properly.

This document contains a general summary of developments and is not a complete or definitive statement of the law. Specific legal advice should be obtained where appropriate.

The Commission also believes that a comprehensive policy on OTC derivatives is necessary in order to avoid regulatory arbitrage. As the markets for derivatives are global, and in order to ensure a robust and convergent international regulatory outcome, the suggested policies of the Commission are in line with the objectives outlined in the third G20 summit in Pittsburgh on 25 September 2009. In order to minimize the risk of regulatory arbitrage, the Commission has signalled that it will continue to engage with the G20, and in particular the United States, in developing technical details of derivative regulation. The Commission has indicated that, as a matter of policy, the cost of strengthening the market infrastructure for OTC derivatives should not be carried by taxpayers but rather by those who directly enjoy economic benefit from using derivatives. Whilst the larger part of the cost will fall to financial firms, some cost will fall to non-financial institutions that use OTC derivatives as a means of hedging the risks that result from normal business operations.

Counterparty Credit Risk and Central Clearing

The international financial crisis has demonstrated that market participants did not price counterparty credit risk correctly. The Commission has identified clearing by means of CCPs as the way by which counterparty credit risk is mitigated.

Although some CCPs currently provide services on a Europe-wide basis, they remain regulated only at national level. There is no EU legislation covering CCPs (with the limited exception of the Settlement Finality Directive (1998/26/EC), which allows for crisis management of CCPs). The Commission has identified CCPs as being of systemic importance and intends to propose legislation to remove national differences and ensure the safety, stability and proper governance of CCPs in Europe. The Commission has indicated that the following key requirements will be addressed in the forthcoming legislation:

- (a) conduct of business and governance rules;
- (b) rules to ensure that CCPs employ minimum risk management standards;
- (c) legal protection to collateral and positions which ensure segregation of assets and portability of client assets and positions;
- (d) passporting of CCPs with on-going supervision by the home member state authority; and
- (e) recognition of third country CCPs that are subject to comparable levels of regulation.

Very importantly, the Commission intends to bring forward proposals to make it mandatory to clear standardised derivatives through CCPs and will work with the US and the rest of the G20 to implement these requirements.

This is likely to lead to an increase in the number of CCPs in Europe. First drafts of the relevant EU Legislation are expected in 2010.

Changes to Bilateral Clearing

As noted above, the Commission intends to propose legislation which will provide incentives to firms to use central clearing instead of bilateral clearing. In the Commission's view, the current system of bilateral clearing with counterparties exchanging collateral to cover exposure does not accurately reflect the risk that bilaterally-cleared derivatives trades pose to the financial system as collateral levels are too low.

The Commission acknowledges that not all derivatives contracts can be centrally cleared (e.g. some may be too customised or not liquid enough) and intends to retain mechanisms to allow firms to use derivatives for transferring risk, especially in the case of non-financial firms whose use of derivatives is below a given threshold.

The Commission, the G20 and the Basel Committee on Banking Supervision have all accepted the concept that non-centrally cleared contracts should be subject to higher capital requirements to reflect the higher risk that these contracts pose to the financial system.

Transparency

The Commission's view is that the lack of transparency in relation to prices, transactions and positions on OTC derivatives markets has hindered regulators from properly supervising the markets, both in terms of systemic risk and market abuse.

For market participants, the lack of transparency has created uncertainty around pricing, risk, valuing positions and checking best execution.

To combat the current lack of transparency, the Commission is planning to propose legislation governing trade repositories as well as imposing new reporting obligations on market participants. All trades that remain outside CCPs should be reported to trade repositories.

Further measures being considered by the Commission to strengthen regulation in this area include:

- (a) trading of standardised OTC derivative contracts on exchanges or electronic trading platforms;
- (b) harmonising pre- and post-trade transparency requirements for the publication of trades and associated process and volumes across the various organised venues; and
- (c) taking specific measures in relation to various EU commodity derivative markets.

Additional Regulation

In addition to the direct measures discussed above, the following measures are already also being taken by the Commission to establish and enhance the regulation of derivatives:

- (a) the 2010 review of the Market Abuse Directive will extend relevant provisions in order to cover derivatives markets in a comprehensive fashion;
- (b) the 2010 review of MiFID being undertaken is examining the exemptions available for certain firms dealing in commodity derivatives; and

- (c) the Commission intends to propose rules to give regulators the authority to set position limits to counter excessive price movements or excessive concentration of speculative positions.

Proposed Timeline

The Commission has published the following table indicating the proposed timeline for the actions discussed above.

Objective	Proposed actions	Time line
Reduce counterparty credit risk - strengthen clearing	(1) Propose legislation on CCP requirements, governing: safety requirements (e.g. conduct of business, governance, risk management, legal protection of collateral and positions); authorisation/withdrawal of CCP; and mandating of CCP clearing of standardised derivatives.	Mid-2010
	(2) Amend CRD in order to: mandate financial firms supplying initial and variation margin; and substantially differentiate capital charges between CCP-cleared and non-CCP cleared contracts in CR.	End-2010
Reduce operational risks - standardisation	Assess whether to re-shape the operational risk approach in the CRD to prompt standardisation of contracts and electronic processing.	End-2010
	Work with industry to increase standardisation of legal regimes and processes;	On-going
Increase transparency - trade repositories	Propose Community Legislation to: regulate trade repositories; and mandate reporting of OTC derivatives transactions to trade repositories;	Mid-2010
Increase transparency - trading	Amend MiFID to require transaction and position reporting to be developed in conjunction with CCPs and trade repositories; ensure trading of standardised contracts on organised trading venues under MiFID; enhanced trade and price transparency across venues; and conclude review of exemptions from MiFID for commodity firms.	End-2010
Improve market integrity	Extend MAD to OTC derivatives; and give regulators the power to set position limits.	End-2010

Key Contacts

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