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What's over the horizon for OTC derivatives?

Proposed European and US legislation will have a significant impact on the OTC derivatives market. Journalist Brian Thompson listens to Clifford Chance specialists identify the key challenges and discuss the likely outcomes.

European and US market participants are having to prepare for the introduction of OTC derivatives legislation and clearing reforms, despite continuing uncertainty about the exact nature of significant elements of the new rules. Jeremy Walter, partner in Clifford Chance's Derivatives and Financial Regulation group in London, believes that given the 'sea of change' engulfing the sector it's important "to focus on the practical effects of new regulation from a clearing member or market participant perspective".

Mapping the 'sea of change'

Before going into any detail on individual areas of concern, it is worth very briefly sketching out the regulatory framework. In the US, the mechanism for implementing OTC derivatives regulations and clearing reforms is contained in the Dodd-Frank Act, while in Europe, the main legislation is the European Market Infrastructure Regulation (EMIR – as below), supported by further reforms in the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive 4 (CRD4). These changes are in response to the financial crisis, which highlighted a lack of information on positions and exposures of individual firms in OTC derivatives. This issue was seen to have prevented regulators from getting a clear view of the inherent risks building up in the system. It was also judged to have impeded accurate assessment of the consequences of a default and, as described by a recent European Commission impact assessment, "helped fuel suspicion and uncertainty among market participants during a crisis".

In an attempt to combat this problem, the regulatory measures share a certain amount of common ground. Put simply, they aim to improve transparency by requiring participants to disclose more information about the positions they hold. They also aim to reduce risk through changes to clearing and collateral requirements. Specific measures in the proposed regulation include reporting and clearing obligations for eligible OTC derivatives, measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives, common rules for central counterparties (CCPs) and for trade repositories, and rules on the establishment of interoperability between CCPs.

The devil is in the detail

Behind these broad brush strokes lie a number of details that present real problems for market participants. Sometimes this is because of a lack of clarity, sometimes because they raise cost and competitiveness issues, and sometimes because of a fear that the regulations will have unintended consequences.

Sitting alongside these uncertainties is the variability of the implementation timetable. As David Felsenthal, partner in Clifford Chance's Capital Markets practice in New York, says, "With respect to the US, we are not that much further on than six months ago, with little in the way of solid implementation dates." He believes that the regulations on mandatory clearing will be the first to be implemented, "but this looks to have shifted back to mid-2012 and that can still only be a guess". This would bring them into the same proposed implementation timescale as new rules under Volcker requirements (discussed later) which are scheduled for July 2012.

It's a similar story in Europe as the extended 'trialogue' between European Council,

Commission and Parliament means that the European Securities and Markets Authority's (ESMA) 'fleshing out' of the EMIR framework is being held back. The prospect of implementation by the end of 2012 looks challenging. In addition, CRD4 and MiFID II have their own timetables, with the former expected to apply from January 2013 and the latter currently likely to apply from the end of 2014 following a two-year transposition period.

Extraterritoriality

When it comes to extraterritoriality, US and EU regulators want to ensure the same things: that domestic markets do not face 'risk contagion' by engaging with less strictly regulated 'foreign' counterparties; and that domestic institutions do not lose business to foreign entities that face a less onerous regulatory framework. The obvious way to achieve a level playing field is by requiring all foreign entities doing business within the regulators' territory to play by the same rules, while at the same time keeping a close eye out for any activity taking place 'offshore' that looks like a way of avoiding the regulators' reach. But details on how authorities will define 'foreign entities', police extraterritorial activities and manage the overlap between different regulatory jurisdictions remain elusive.

"What is clear is that any non-US entity that enters into swaps with a US counterparty must meet US regulatory requirements, covering everything from registration to clearing and Volcker," explains David. But what is meant by a 'US counterparty'? Does it include, for example, a fund whose agent is in the US but is managed offshore? Or a non-US branch of a US bank? And how will the overlap between the US and EU regulatory frameworks work? "To take one example, you can't clear the same swap twice, so how will a trader fulfil requirements of both EU and US regulators?" asks David.

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>
> **Jeremy Walter**, Partner, Clifford Chance London

In terms of the EU take on this, Caroline Dawson, associate in the Derivatives and Financial Regulation group in London, believes that "EMIR has the potential to have a huge impact on the ability of EU firms to carry on business with third-country entities". In this case, both the clearing obligation and the risk mitigation obligation also extend to third-country entities trading with EU entities. However, there is also a clear attempt to extend the clearing obligation to cover trading between third-country entities "provided that the contract has substantial and foreseeable effect within the EU". This would also be invoked if regulators felt that such transactions between third-country entities were an attempt to evade EMIR provisions.

Managing the overlap

EMIR also restricts the ability of third-country providers to offer services to EU firms. For example, a CCP established in a third country would not be permitted to provide clearing services to EU-established entities unless it had been recognised by ESMA. In addition, there are concerns that regulation could lead to a distortion of competition. One example would be where an EU firm has to comply with clearing and risk mitigation requirements when dealing with counterparties in a particular jurisdiction, but a local firm does not have to do so.

"These issues are not being ignored," explains Caroline. "The latest Council compromise text includes provisions aimed at requiring the Commission to cooperate with third-country authorities to ensure consistency and avoid overlaps." There are also international initiatives underway to monitor and harmonise OTC derivatives regimes. For example, the OTC Derivatives Working Group within the Financial Stability Board (FSB) will monitor the consistency of implementation and bring any overlaps, gaps or conflicts to the attention of the FSB. In the US, a further release is expected by the end of the year, which will give more clarity on extraterritoriality and other issues.

Documentation and collateral segregation

Central clearing brings with it a documentary burden that clients need to address now in order to be ready for implementation next year. In terms of clearing agreements for end users, there is a trend in the US towards the use of existing futures brokerage documentation, but with an OTC addendum. However, as David Felsenthal explains, some are questioning whether this method, though relatively straightforward, is appropriate. "Many in the dealer community are used to the bilateral agreement so it seems the obvious route, but isn't the whole point of the cleared world that you don't take risk on your counterparty? In which case, do you need this sort of agreement with them?"

Perhaps the most contentious issue is the segregation of collateral. In the US, client collateral is traditionally held on an omnibus basis by the futures brokerages, with some scope for them to reinvest. The collapse of MF Global has further heightened calls for client collateral to be kept separate and transparent for each customer – although it could lead to increased cost for end users.

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David Felsenthal, Partner, Clifford Chance New York

As for the EU position on the above issues, there is likely to be a move away from ISDA dealer/client documentation towards customer terms agreements. In terms of collateral, there is a question over what rights of use the CCP will have, and a nervousness about the systemic risk that such rights may introduce. With CCPs likely to be required to hold only very liquid collateral such as cash and government securities, there is also a concern that end clients may not have this type of collateral to post. In such a situation dealers may be expected to step in to provide a service that, at a cost, 'swaps' client collateral for that required by the CCP. "In terms of collateral segregation, early movers are insisting upon it, but it will be interesting to see how this develops as the market may resist the higher costs involved," explains Jeremy Walter. With questions already being raised about potential CCP credit risks, there is a view that, rather than removing systemic risk, regulators have simply moved it into a different space.

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Associate, Clifford Chance London

Uncleared trades in the US

For non-standardised swaps that are exempt from central clearing, there are new documentary and margin requirements. Wider requirements for both initial and variation margins will necessitate new documentation. However, because few of the rules on uncleared swap documentation have been finalised, uncertainty remains about specific details.

EU round-up

Although negotiations continue between the European Parliament, EU Council of Ministers and European Commission, a clearer picture is developing on some of the outstanding issues concerning clients.

These issues include front-loading: the proposal that counterparties will, in effect, be required to clear 'pre-existing contracts' that were entered into after the effective date of the regulation but before the date of the clearing obligation. Until recently, this looked very much on the cards but it now appears the battle may be won and the clearing obligation will be prospective only.

Similarly, movement seems evident on intra-group trading. While the original Commission text did not provide for any intra-group exemptions, and the latest Parliament text only permitted exemption from the clearing obligation, it now seems likely that the final text will contain exemptions from the clearing and risk mitigation obligations for intra-group transactions.

Given the complexities of these and many other issues, it is perhaps not surprising that trialogue participants are reportedly finding it challenging to make progress. As a result, although there is a great deal of political will to reach agreement on the text before the end of this year, it is possible that negotiations may continue under the new Danish Presidency.

As mentioned earlier, EMIR is only part of the story for EU OTC regulation, and the current text of the revised MiFID also includes provisions that will have an impact on OTC derivatives business.

Key points here include: a platform trading obligation, whereby contracts that are eligible for clearing must be traded through qualifying trading platforms (if determined to be sufficiently liquid); the creation of a new category of trading platform, the Organised Trading Facility; and an obligation for systematic internalisers to provide firm quotes in derivatives. Under revised post-trade transparency requirements, investment firms will have to make public the volume and price of derivatives transactions. This increased emphasis on transparency is also reflected in the new short selling regulation, which will require disclosure of net short positions in shares and sovereign debt.

Volcker rules?

A recent regulatory release on the Volcker rule, the part of the Dodd-Frank Act that bars banks from proprietary trading, has provided much greater detail on how it will

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work and who will be affected by it. The essential point for OTC derivatives is that it will apply widely, covering not only US banks, but any bank with a US branch or subsidiary. It will also extend to almost any transaction with a tangible US connection. Although there is a 'carve out' which provides exemptions for deals between non-US counterparties, some uncertainty remains on just who will or will not qualify for exemption. For example, the exemption would not apply to a transaction between non-US parties that was executed on a US exchange.

The definition of proprietary trading is also a grey area. When does market making become proprietary trading? When does 'legitimate' hedging become taking a proprietary position? The proof, for regulators, appears to be in the detail. Extensive reporting and documentation requirements will help authorities to monitor the nature of flows over time and make decisions. Market participants will, as with other similar transparency objectives, bear the burden and will need to put systems in place to record and produce the required information effectively.

Outlook

While uncertainties remain about some details and definitions, market participants should not expect the major tenets of regulation to change. The clearing, collateral, transparency and territorial obligations are unlikely to be relaxed to any great extent. As a result, both end users and dealers should expect increased costs and a heavier administrative burden. While the narrower effect on day-to-day transactions may be relatively easy to foresee, the wider market impact will take time to evolve and participants should keep a close eye on developments to maintain competitiveness and spot opportunities.

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