

Central clearing of OTC derivatives: latest regulatory developments in the US and the EU

Foreign Exchange Contact Group

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DFA: schedule for mandatory clearing

- 30 July 2012: CFTC published a rule establishing a **schedule for compliance with the mandatory clearing requirement** for swaps under Title VII of the Dodd-Frank Act
- Phase-in compliance depends on the category the parties to the swap belong to:
 - Transactions between 2 **cat. I** entities (SD, MSP, active funds):
90 days after publication of mandatory clearing determination
 - Transactions between **cat. I** entity and **cat. II** entity (private funds, persons predominantly engaged in banking business) or 2 **cat. II** entities: **180 days**
 - Other combinations of types of counterparties: **270 days**
- Trade execution requirement: separate rulemaking



DFA: classes of assets subject to clearing

- 30 July 2012: CFTC also proposed the first determination of **classes of swaps that will be subject to mandatory clearing**
- Clearing requirement based on DCOs' submissions (LCH.Clearnet, CME, ICE)
- Following classes of assets are proposed to be subject to clearing requirement:
 - **2 classes of CDS contracts:** North American Untranchéd CDS Indices Class and European Untranchéd CDS Indices Class
 - **4 classes of IRS:** fixed-to-floating swap, floating-to-floating swap (basis swap), Forward Rate Agreement, overnight indexed swap



DFA: foreign exchange products

- 13 August 2012: CFTC and SEC jointly published a **final rule further defining ‘swap’ and ‘security-based swap’**
- **FX swaps** and **FX forwards** subject to the Treasury’s Secretary’s swap determination (*rule unchanged*):
 - Term ‘swap’ includes FX swaps and forwards, but:
 - FX swaps and forwards will no longer be considered swaps if the Secretary issues the written determination to exempt such products from the swap definition
 - FX swaps and forwards subject to continuing applicability of certain reporting requirements and business conduct standards
 - Timing for adoption of the Secretary's determination?
- **Cross-currency swaps** included in the ‘swap’ definition

DFA: foreign exchange products

- Additional interpretation concerning **FX spot transactions**
 - FX spots are not ‘swaps’ under the CEA
 - FX spots are not only those transactions typically settling within T+2
 - FX spots are all FX transactions that are settled on the **customary timeline of the relevant spot market** (usually T+2, but also longer maturities)
 - An FX transaction that is entered into solely to effect the purchase or sale of a foreign security will be considered an FX spot, under certain conditions:
 - Foreign currency’s amount equal to price of the foreign security
 - Simultaneous execution of both transactions in order to effect delivery by the relevant security settlement deadline
 - Actual delivery of foreign currency and foreign security by such deadline



DFA: status of foreign central banks (ECB)

- **Inclusion** of transactions entered into by foreign governments, foreign central banks and international financial institutions **in the definition of ‘swap’ confirmed** (unlike FED and US government)
- CFTC/SEC do not want to completely exclude those entities from the scope of the DFA
- **BUT**: in the CFTC final rule on the **end-user exception** to the clearing requirement for swaps (published on 19 July 2012), foreign governments, central banks and IFI are deemed to be **excluded from the clearing requirement** set forth in Section 2(h)(1) of the CEA.
- Still subject to reporting requirements
- Question of margin requirements for non-centrally cleared trades still pending (see BCBS-IOSCO consultative paper)

DFA: other relevant developments

- 12 July 2012: CFTC published a proposed interpretative guidance with respect to **cross-border application** of the DFA, mainly setting out a framework under which non-US swaps entities and foreign branches, affiliates and subsidiaries of US banks can apply foreign rules that are equivalent to the DFA
 - Errors and inconsistencies have been reported; technical corrections expected from the CFTC
- 27 August 2012: CFTC released final rule with respect to **confirmation and swap trading relationship documentation for SDs and MSPs**
 - Applies to swaps entered after compliance date with the rule (documentation must be in place by: 1 January 2013 / 1 April 2013 / 1 July 2013). Compliance date for confirmations (timing) depends on the asset classes

DFA: possible timeline

(source DavisPolk)

Date	Action
August 1, 2012 <i>(July 30, 2012)</i>	CFTC publishes proposed clearing determination for the proposed swaps
October 30, 2012	CFTC publishes final clearing determination for the proposed swaps.
January 28, 2013	Transactions between Category 1 entities in the proposed swaps must be cleared.
April 28, 2013	Transactions between Category 1 and Category 2 entities in the proposed swaps must be cleared.
July 27, 2013	All other transactions in the proposed swaps must be cleared, unless the end-user clearing exemption applies and is elected.

EU: state of play (EMIR)

- **EMIR** (Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories) **published** in the OJEU on **27 July 2012**
 - Entry into force: 16 August 2012
 - Likely implementation: early 2013 (at the soonest)
- **European Supervisory Authorities** to submit draft regulatory standards to the Commission **by 30 September 2012**

Commission expected to adopt regulatory standards by end 2012 (Commission entitled to adopt delegated acts to ensure harmonisation across Member States in implementing EMIR)

EU: state of play (EMIR)

- **ESMA:** Consultation on draft technical standards for EMIR dated 25 June 2012 (closed on 5 August 2012)
 - Indirect clearing arrangements
 - Procedures by which ESMA should determine that a class of derivatives should be subject to clearing
 - Clearing thresholds (per asset class)
 - Further requirements for CCPs, etc.

Did not cover: territorial scope, intra-group transactions, collateral for uncleared trades (cf. BCBS-IOSCO paper)
- **EBA:** Consultation of draft regulatory technical standards on capital requirements for CCPs dated 15 June 2012 (closed on 31 July 2012)

EU: state of play (MiFID II)

- 20 October 2011: Commission published **review of MiFID (MiFID II)**
 - proposed **Directive on markets in financial instruments repealing Directive 2004/39/EC**
 - proposed **Regulation on markets in financial instruments and amending EMIR, MiFIR**
 - All transactions in financial instruments to be reported to competent authorities
 - Trading in derivatives to occur only on eligible platforms: regulated markets, MTFs, OTFs
- Awaiting European Parliament first reading
- Council published a compromise text on 21 June 2012

EU: clearing obligation under EMIR and MiFIR

- **EMIR:**
 - **All OTC derivative contracts** pertaining to a class of derivative declared subject to the clearing obligation
- **MiFIR:**
 - **All transactions in derivatives** pertaining to a class of derivatives declared subject to the clearing obligation pursuant to EMIR that are **concluded on a regulated market** shall be cleared by a CCP.

EU: clearing obligation for FX transactions?

- **No explicit exemption** for FX in EMIR, which differs from the DFA
- Only reference to FX is in **Recital (19)** of EMIR: “In determining which classes of OTC derivative contracts are to be subject to the clearing obligation, due account should be taken of the specific nature of the relevant classes of OTC derivative contracts. The predominant risk for transactions in some classes of OTC derivative contracts may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes of OTC derivative contracts (such as **foreign exchange**) from other classes. **CCP clearing specifically addresses counterparty credit risk, and may not be the optimal solution for dealing with settlement risk.** The regime for such contracts should rely, in particular, on preliminary **international convergence** and mutual recognition of the relevant infrastructure.”

EU: What about FX spots?

- FX spots are **not** considered derivative contracts.
- Definition of '**derivative contract**' in **EMIR** refers to points (4) to (10) of Section C of Annex I to Directive 2004/39/EC [current MiFID]. FX spots not included in this definition.
- In **MiFIR**, definition of '**financial instruments**' refer to points (1) to (10) of the same Section C of Annex I to [new] MiFID.
- Amendment to definition in new MiFID relates only (so far) to the inclusion of spot emission allowances.
- FX spots not subject to clearing, reporting and trading requirements under EMIR and MiFIR.

EU: reporting obligation under EMIR and MiFiR

- **EMIR:**

- Reporting of **'any derivative contract'** to a trade repository (whether OTC or not, centrally cleared or not);
- Applies to contracts still outstanding on 16 August 2012 and to contracts entered into on or after 16 August 2012
- ESMA to specify the details and types of reports, as well as their frequency, for the different classes of derivatives.

- **MiFiR:**

- Investment firms which execute **transactions in financial instruments** shall report details of such transactions to the competent authority as quickly as possible, and no later than the close of the following working day.
- Transactions traded on a regulated market, an MTF or an OTF shall be reported by the operator of the platform.

EU: exchange trading under MiFIR

- **MiFIR** (Articles 24 to 27):
 - trading in certain **eligible OTC derivatives** moved to **regulated market, MTF or OTF**;
 - obligation imposed on both financial and non financial counterparties exceeding the clearing threshold laid down in EMIR;
 - Commission and ESMA have the task of defining the list of derivatives eligible to such obligation, taking into consideration the liquidity of the specific instruments.
 - Not all derivatives subject to clearing will necessarily be subject to exchange trading

EU: timeline

- **EMIR** entered into force on 16 August 2012 but:
 - As regards the **clearing obligation**:
 - ESMA shall conduct a public consultation and consult the ESRB before submitting to the Commission draft technical standards specifying the classes of OTC derivatives subject to clearing and date(s) from which the clearing obligation takes effect;
 - The dates from which the clearing obligation takes effect will depend on factors like e.g.
 - the expected volume of contracts to be cleared,
 - the ability of the CCP to handle such volume,
 - the number of market participants active within the market of the class of OTC derivatives subject to clearing, etc.

EU: timeline

- As regards the **reporting obligation**:
 - applies as from 16 August 2012 but effectively depends on the adoption of the technical standards by the Commission (specifying how reporting will have to be done)
- **MiFIR**: timeline for adoption uncertain. Sometime in 2013?
 - Cyprus Presidency of the Council (until 31.12.2012); in its 6 month-programme, the Presidency states that it “will work towards an agreement on the revised rules on markets in financial instruments (MiFID/MiFIR)”. However, the priority of the Presidency in the area of financial services is the finalisation of CRD IV.

=> EU schedule behind US schedule