



Are We There Yet? Progress on International OTC Derivatives Reform

On 11 October 2011, the Financial Stability Board (the “FSB”) published its second progress report (the “Report”)¹ and accompanying press release² on the implementation of reforms to the over-the-counter (“OTC”) derivatives market. This follows its initial progress report published on April 15, 2011,³ in which it expressed concern regarding many jurisdictions’ likelihood of meeting the end of 2012 deadline set by the G-20 and warned that to achieve this target, jurisdictions needed to take “substantial, concrete steps” toward implementation urgently. The Report, which comes out merely one year before the end of 2012 deadline, contains a more detailed review of progress towards meeting the commitments reached at the G-20 Pittsburgh summit in September 2009, to be enforced by end of 2012, including:

- all standardised OTC derivative contracts will be traded on exchanges or electronic trading platforms and cleared through central counterparties, where appropriate;
- OTC derivative contracts will be reported to trade repositories (“TRs”); and
- non-centrally-cleared contracts will be subject to higher capital requirements.

In the Report, the FSB analyses the progress made with respect to these commitments through the development of international standards, the adoption of legislative and regulatory frameworks, and actual implementation through changes in market practice. Although the FSB urges jurisdictions to “aggressively push forward” to comply with the G-20 commitments, it acknowledges that complexities are involved and states that measures must be developed with due care and analysis so as to follow the overall G-20 objectives of improving transparency in the derivatives markets, mitigating systemic risk and protecting against market abuse.

The Report also follows up on the first progress report where the FSB recognised that there would likely be a range of jurisdictional approaches taken to implementing the G-20 commitments, and recommended that the focus in assessing progress going forward should be on:

- the degree to which the commitments and objectives set by the G-20 are being met;
- highlighting areas where coordination of future steps toward achieving G-20 objectives are needed; and

¹ The report is available at: http://www.financialstabilityboard.org/publications/r_111011b.pdf.

² The press release is available at: http://www.financialstabilityboard.org/press/pr_111011b.pdf.

³ The report is available at: http://www.financialstabilityboard.org/publications/r_110415b.pdf; see also Morrison & Foerster client alert: International Reform of OTC Derivative Regulation: How Level Is the Playing Field? (15 July 2011), <http://www.mofo.com/files/Uploads/Images/110715-OTC-Derivative-Regulation.pdf>.

- flagging where differences in approaches may foster or facilitate opportunities for regulatory arbitrage, or subject market participants and infrastructures to conflicting regulatory requirements.

Central Clearing

The FSB states that there has been progress in this area, particularly in relation to interest rate and credit derivatives. It believes, however, that based on current progress, many jurisdictions are not on track to meet the G-20 requirement that all standardised derivatives be centrally cleared by the end of 2012.

The FSB states that Japan and the United States are the only jurisdictions that have adopted legislation mandating central clearing of standardised OTC derivatives, although such legislation does not apply to all standardised OTC derivatives, as required by the G-20 commitments. The FSB survey responses indicate that most jurisdictions, including the European Union, which expects legislation to be adopted by the end of 2011, intend to have a legislative and regulatory framework in place by the end of 2012. However, the FSB notes that for the legislation to be fully effective in many jurisdictions, further technical implementing measures are required to be taken that will further push back the effective date of the mandatory clearing requirements. Certain jurisdictions have indicated that for the sake of global consistency they are waiting for the frameworks in the US and the EU, the two largest OTC derivatives markets, to be finalised before they start work on their own systems. However, the FSB advises that they advance their systems as much as possible so as to be able to act quickly once the frameworks in the US and EU are established.

Notwithstanding the fact that most jurisdictions do not have legislation in place yet, the FSB has identified a number of potential inconsistencies across jurisdictions' implementation of central clearing. Although it acknowledges that complete consistency is unlikely due to the specific characteristics of particular markets, the FSB believes it is important to assess whether potential overlaps or conflicts create opportunities for regulatory arbitrage or otherwise compromise the objective of mitigating systemic risk. One such potential inconsistency relates to certain jurisdictions' doubts as to the applicability of the G-20 commitments concerning central clearing and reporting to TRs for standardised derivatives that are moved onto organised platforms (and are therefore no longer strictly "OTC"). The FSB emphatically reinforces the applicability of these commitments to all derivatives. It states that if the position were otherwise, it would be contrary to the spirit of the reforms, which are aimed at mitigating systemic risk and would also create the opportunity for regulatory arbitrage.

The FSB also notes that several jurisdictions only intend to mandate central clearing for certain asset classes and provide exemptions for others, and these exemptions may vary between jurisdictions. For example, the US Treasury proposes to exempt foreign exchange swaps and forwards from the central clearing and exchange trading requirements under Title VII of the Dodd-Frank Act on the basis that such markets operate with high levels of transparency and there are a number of unique factors that limit their risk profile compared to other derivatives. The US Treasury has also stated that mandatory clearing for such derivatives could actually jeopardise current market practices that help limit risk and ensure that the market functions effectively.

The FSB also states that certain jurisdictions plan to exempt qualifying intra-group transactions from the mandatory clearing requirement. The rationale for such exemption is that requiring clearing in such circumstances could increase capital and liquidity requirements for the firms involved, and increase operational complexity. It notes, however, that the proposed EU legislation will subject exempted intra-group transactions to bilateral collateralisation requirements unless it can be demonstrated that there is no impediment to the prompt transfer of funds and repayment of liabilities between the counterparties and the risk management procedures of the counterparties are adequate. There are also expected to be exemptions for transactions with non-financial counterparties/end-users in several jurisdictions. For example, non-financial end-users are expected to be exempted from mandatory clearing in most jurisdictions (including in the EU and the US) and the EU has proposed a temporary exemption for entities operating pension schemes to avoid a likely negative impact of a

mandatory clearing requirement on the retirement income of future pensioners. Central banks and certain other public sector entities are also proposed to be exempted under EU legislation from central clearing.

Recommendation 8 of the report of the FSB published in October 2010⁴ asks authorities not to grant exemptions to mandatory clearing where this could cause systemic risk. The FSB states that it will consider the International Organisation of Securities Commissions (“IOSCO”) report expected in January 2012 addressing the coordination of central clearing requirements across jurisdictions to assess whether the disparity between such exemptions may impact systemic risk.

Exchange and Electronic Platform Trading

The FSB notes that the progress made with respect to this commitment is markedly behind the progress made toward other commitments. This is despite efforts to set international policy standards for organised platform trading, including the IOSCO Report on Trading of OTC Derivatives, which was published in February 2011.⁵ The FSB notes that so far only the US has enacted legislation in this area and the EU does not anticipate having legislation in place before 2013 (although the draft Markets in Financial Instruments Regulation published on 20 October 2011 does contain proposals for requiring exchange trading of standardised derivatives). It expresses concern that most other jurisdictions have not yet made basic decisions about regulatory measures in this area, including whether any regulatory action will be taken. The FSB therefore expresses concern as to progress made toward this commitment and doubts whether the end of 2012 deadline will be met, and it therefore urges jurisdictions to accelerate their decision making in this area.

In terms of potential differences in the implementation of organised platform trading in different jurisdictions, the FSB identifies the issue of whether qualifying platforms will be required to provide for multiple dealers or if single dealer platforms are permitted. It also notes that differences are likely to arise with respect to pre- and post-trade transparency requirements with respect to transactions entered into on the platform that could lead to distortions in market operation or efficiency and give rise to opportunities for regulatory arbitrage.

Reporting to TRs

The FSB states that there remain a number of implementation issues to be resolved in connection with the G-20 commitment to achieve reporting to trade repositories by the end of 2012. It notes that there is progress in actual reporting of interest rate, credit and equity OTC derivatives but that TRs are not operational for commodity and fx derivatives (although infrastructure is under development). It notes that Brazil, Japan and the US already have legislation in place requiring reporting of OTC derivatives to a TR, and the EU expects to have legislation in place (under the European Market Infrastructure Regulation (“EMIR”)) by the end of 2011. Other jurisdictions, including Argentina, China and India, have rules in place requiring reporting of certain derivatives to a TR-like platform.

The FSB states that the Committee on Payment and Settlement Systems and IOSCO published their report on OTC derivatives data reporting and aggregation requirements for public consultation in August 2011 (the “Data Report”).⁶ The Data Report raised several issues, including the risk that TRs will not provide effective access to comprehensive OTC derivatives trade data that can be readily aggregated on a global basis unless further internationally coordinated action is taken. The FSB notes that the substitution in some jurisdictions of reporting to the central bank or other governmental authority instead of to a TR may lead to the development of multiple sources of data for a particular asset class. It states that data will need to be aggregated from the TRs, the central

⁴ The report is available at: http://www.financialstabilityboard.org/publications/r_101025.pdf.

⁵ The report is available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf>.

⁶ The Data Report is available at: <http://www.bis.org/publ/cpss96.htm> and <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD356.pdf>.

banks and other governmental authorities for the purposes of analysis on a global basis to ensure such potential fragmentation is not problematic.

The FSB identifies a lack of progress in some jurisdictions in addressing legal barriers to the collection and dissemination of data that it believes could seriously impact the usefulness of TR data. It therefore asks authorities to have ongoing discussions with their respective market participants to identify any challenges to comprehensive reporting, such as confidentiality restrictions or privacy law. It states jurisdictions should remove any barriers to comprehensive reporting, giving an example of the EU's draft EMIR proposal, which currently overrides privacy and confidentiality laws and requires that all relevant data must be reported. It also highlights the need to ensure practical and effective access to data, especially on a cross-border basis, to facilitate aggregation of data on an international basis and assist authorities in analysing potential systemic risks and risks to financial stability. In this regard, the FSB sets out its suggestions for setting up a body to recommend principles and guidance concerning public authorities' access to data. The FSB proposes a number of measures to address such issues, including setting up a small ad hoc expert group to analyse what data is needed to bridge data gaps, the coordination of the CPSS and IOSCO with national authorities and further work on the establishment of a legal entity identifier ("LEI").

Standardisation

The FSB states that standardisation is a core element for meeting the G-20 commitments relating to central clearing, organised trading, and reporting to TRs. It reports that coordinated industry action led by the OTC Derivatives Supervisors Group (the "ODSG") has been the main driver of increased standardisation through a series of quantitative and qualitative commitments. In this regard it notes that the industry's strategic roadmap delivered to the ODSG pursuant to a commitment letter published in March 2011⁷ establishes a framework for managing continued improvements in process and product standardisation.

The FSB states that most jurisdictions believe that the proportion of OTC derivatives that are standardised will have substantially increased by the end of 2012, but the FSB notes that in the absence of the development of any simple metrics or straightforward means to measure overall standardisation on a per-product basis it will be difficult to measure progress in standardisation. In this regard it welcomes the publication of the "Standardisation Matrix" by major international dealers and other market participants, which it describes in appendix III of the Report, and which it states may serve, together with supporting information and data, as a useful tool to evaluate how levels of standardisation evolve over time.

Capital Requirements

The FSB observes that the Basel III capital framework, which will strengthen the requirements for counterparty credit risk exposures, will take effect on 1 January 2013. Some aspects of the BCBS capital framework for counterparty credit risk exposures, in particular as it relates to banks' exposures to CCPs, are still being finalised. It notes that until this framework is finalised there will be uncertainties as to the capital incentives for derivatives to be cleared on CCPs rather than to be non-centrally cleared, as the latter will be subject to higher capital requirements. In this regard there is ongoing consultation between BCBS, CPSS and IOSCO to ensure that incentives are appropriately set. The FSB states that it currently lacks information on capital requirements for non-bank regulated entities and it intends to focus on gathering such information. Once the BCBS capital framework is closer to finalisation, and information has been gathered in relation to the capital requirements of non-bank regulated entities, the FSB states that it should be in a better position to assess progress in achieving the G-20 commitment to higher capital requirements for non-centrally cleared derivatives.

⁷ The commitment letter is available at: <http://www.newyorkfed.org/newsevents/news/markets/2011/an110405.htm>.

Are We There Yet?

The Report answers this firmly in the negative, and in fact suggests that we will not be there by the end of 2012 deadline. Therefore, the FSB states that the highest current priority in the implementation of OTC derivatives reforms is to increase the pace of legislative and regulatory action to ensure that frameworks are in place as soon as possible. The FSB also highlights the continuing risk of overlaps, gaps and conflicts in the international development of legislative and regulatory frameworks that would compromise achievement of the G-20 objectives. It therefore urges bilateral or multilateral discussions between jurisdictions to seek to address such issues, in particular by adherence to agreed international standards. Part of the work of the FSB's OTC Derivatives Working Group is to monitor the consistency of implementation and especially to alert the FSB as to any inconsistencies that may not be resolved through existing bilateral or multilateral channels.

The next progress report of the FSB is due in spring 2012, and until then the FSB has stated it will continue to maintain its "intense focus" on monitoring the developments in the implementation of derivatives reforms. In particular, it intends to focus on collecting relevant data, including seeking enhanced reporting from FSB members and other methods of retrieving data, such as contributions from market participants.

Although international consistency of implementation is important, especially to global enterprises such as banks and other financial institutions, who will, so far as possible, want to avoid having their operations subject to overlapping and inconsistent regulation, speed of implementation is also important if the end of 2012 deadline is to be met. In this battle between speed and consistency, it is infinitely preferable for these reforms to produce a coherent international framework, rather than have a rushed and fragmented approach established. At the recent G-20 meeting in Cannes, the G-20 leaders repeated their requirement that all standardised OTC derivatives be traded on exchanges or electronic platforms where appropriate and centrally cleared by the end of 2012. The G-20 leaders also agreed to cooperate further to avoid loopholes and overlapping regulations. However, there are clearly significant challenges in meeting the G-20 timetable and it seems likely that at this time next year when the G-20 is assembling for its 2012 meeting, one of the items for discussion will be to address the likelihood of many jurisdictions not being in a position to meet all their end of 2012 obligations with respect to OTC derivatives.

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