McDermott Will & Emery

On the Subject

Energy and Derivatives Markets

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Recent EC proposals are likely to lead to the increased regulation of OTC derivatives markets in the European Union by the end of 2012.

EU Financial Reform

European Commission (EC) announcements in the last week presage substantial changes to the structure and regulation of EU commodities markets. The first development came in the form of legislative proposals published by the EC, designed to regulate the over-the-counter (OTC) derivatives markets, including the establishment of central counterparty clearing and trade repositories, and restricting short-selling (EC Proposals). These proposals target derivatives traded OTC which have hitherto escaped formal regulation and are scheduled to be implemented by December 2012.

The EC Proposals were supplemented this week with pronouncements from Michel Barnier, the European Commissioner leading the EC Proposals, at the opening speech of the conference on the revision of the Market in Financial Instruments Directive (MiFID). He sees revisions as necessary to address the deep changes that have occurred in the financial world since MiFID was originally drafted and transposed into local law throughout the European Union in 2007 and 2008. Significantly for commodity market participants, Commissioner Barnier has stated that changes are required to reinforce regulatory control over the currently volatile commodity market, and views revisions to MiFID as being "one of the key elements of an ambitious reform of the raw materials markets".

The EC Proposals

The EC's approach to reforming the OTC derivatives markets is threefold:

- Greater transparency
- Reducing counterparty risks
- Reducing operational risks

Several requirements are similar to those adopted in the United States under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These and other key elements are explored below.

Greater Transparency

Currently, regulators do not feel they can get a comprehensive "snapshot" of the OTC derivatives markets. The EC, therefore, wants mandatory reporting of OTC derivative trades to central data centres (trade repositories). The newly-created European Securities and Markets Authority will be tasked with supervising trade repositories. Positions and derivative classes will be published by trade repositories, thus providing a clearer and more transparent view of the OTC market.

Reducing Counterparty Risk

The EC concluded that counterparty credit risk currently is not sufficiently mitigated and therefore intends to require the clearing of standardised OTC derivatives through central clearing counterparties (CCPs). The intention is that CCPs, by acting as an intermediary between buyer and seller, will help to prevent the collapse of one market participant leading to the automatic collapse of other market participants.

Reducing Operational Risk

The use of electronic facilities to confirm OTC derivative contract terms will be encouraged, replacing the current system of complex, bespoke contracts, which increase the risk of human error. Reducing manual intervention should decrease the operational risk surrounding derivatives trading.

The EC Proposals are aimed at OTC market traders, with a view to standardising the market as a whole and presenting a coordinated approach on an EU-wide level. Non-financial firms using OTC derivatives to mitigate risk arising out of their principal business activities would be exempt from the CCP clearing and reporting requirements, until the positions "reach a threshold and are considered to be systemically important".

Comparison with US Legislation

The Dodd-Frank Act, which came into force in July 2010, affects every financial institution operating in the United States and, potentially, non-financial companies participating in the OTC derivatives markets. It marks the most significant legislative change to the financial sector since the Great Depression, establishing new regulatory frameworks for, *inter alia*, derivatives, securities, consumer protection, executive compensation and corporate governance.

The scope of the EC Proposals and the Dodd-Frank Act is very similar, with both applying to a broad class of OTC derivatives, but excluding spot foreign exchange transactions and certain physically-settled commodity transactions. A brief comparison of the EC Proposals and the Dodd-Frank Act is set out below.

Clearing and Reporting Obligations

Under the Dodd-Frank Act, if one party to an OTC contract is a non-financial entity, the party can opt out of the clearing obligation if the derivative is used solely for hedging or mitigating commercial risks. EU-based non-financial entities will only be required to fulfil the clearing obligation if certain thresholds are exceeded. Under the EC Proposals, non-financial counterparties will only report OTC derivative contracts if certain limits are exceeded. In the United States, all swap transactions must be reported to registered trade repositories.

Conduct of Business

The Commodity Futures Trading Commission (CFTC) will establish new business conduct rules. In the European Union, certain issues concerning trading and transparency of OTC derivatives will be dealt with separately under the aforementioned EC review of MiFID. Likewise, the registration of dealers and certain swap participants, along with other conduct of business rules, are also intended to be dealt with under the revised MiFID.

Regulation of CCPs

The EC Proposals deal with the regulation of CCPs, including how they conduct business and their organisational structure. Similarily, in the United States, regulators set the standards for the organisational and business conduct of CCPs. Furthermore, the Dodd-Frank Act requires regulators to determine whether banks and financial holding companies supervised by the Federal Reserve should be prevented from owning CCPs, thereby pointing to a clear “separation of powers”. There is no equivalent provision in the EC Proposals.

Territorial Scope and Cross-Border Cooperation

The Volcker Rule and “push-out” provision of the Dodd-Frank Act are not replicated in the EC Proposals. The Dodd-Frank Act does not apply to derivatives traded outside the United States, although regulators can impose regulations on entities in countries whose regulations may affect the financial stability of the United States and prevent them from participating in US derivative activities. The EC Proposals provide for cooperation with third countries, ensuring exchange of information.

Physical Commodity Derivative Reforms

The EC has been under increased pressure to tighten commodity market regulation as the United States is preparing to put in place legislation to tame speculative activity. One of the ways the EC proposes to do this is by reviewing the Market Abuse Directive and extending its scope, to cover the control and supervision of raw materials markets. Moreover, prescribed position limits, designed to counter excessive movements, may be imposed on futures markets. The intention behind these proposals is clear, but Commissioner Barnier has also warned that the EC is “ready to go further” and “will not hesitate to consider further measures.”

Commissioner Barnier’s comments at the MiFID Review Conference come in the wake of a French-led initiative to subject commodity derivatives traders to increased control. Increasing transparency at a national level could convince France’s European counterparts to put forward a joint proposal for reform at the G20. Although not as far-reaching as US commodity legislation, the purported aim is the same: greater transparency.

The United Kingdom’s Financial Services Authority is unlikely to back the French initiative, due to the widely-held belief in the London market that the increased price in commodity derivatives has primarily been caused by basic supply and demand fundamentals, as opposed to market speculation. This differs considerably from the view held by French Agriculture Minister Bruno Le Maire, who has stated that speculators may have inflated the future price of commodity derivatives in the European Union by up to a third.

Langen Report

The EC Proposals follow the European Parliament’s adoption of the Langen Report on OTC derivatives in June 2010 (see *On the Subject*, 4 June 2010). The Langen Report called on the EC to secure internationally coordinated and consistent regulation of derivatives, as well as a tightening of the cooperation between the United States and all other G20 countries to stabilise the volatile derivatives market.

Conclusion

The EC Proposals will have to be approved by the European Parliament and Council of Ministers before becoming law by the end of 2012. Thus there are still some legislative hurdles that have to be overcome, and time for possible amendments, before the EC Proposals come into force. Despite the opposition from traders and hedge funds, the EC Proposals are not as drastic as some market commentators were expecting.

Given the increased focus on commodity markets, it seems certain that some form of (likely substantive) changes will be made to how the market operates. Commissioner Barnier’s views on the physical commodity markets further underline the EC's determination to "increase controls on the activity of the various players in these markets". Whilst this clearly indicates a change in strategy, until formal legislative proposals are put in place regarding commodities, it is difficult to know how comprehensive a change the market will be forced to make.

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