from

- Reform of OTC derivatives regulation is part of a global effort to reduce systemic risk in a $707 trillion market.
- The general focus of regulatory changes has been agreed
- There is concern regarding extra-territoriality implications from reforms in the EU and US
- The G20 want implementation of reforms completed by end-2012, though certain jurisdictions look set to miss this target

Concern has been expressed by some regulators about the impact of foreign jurisdictions reforms to domestic firms…

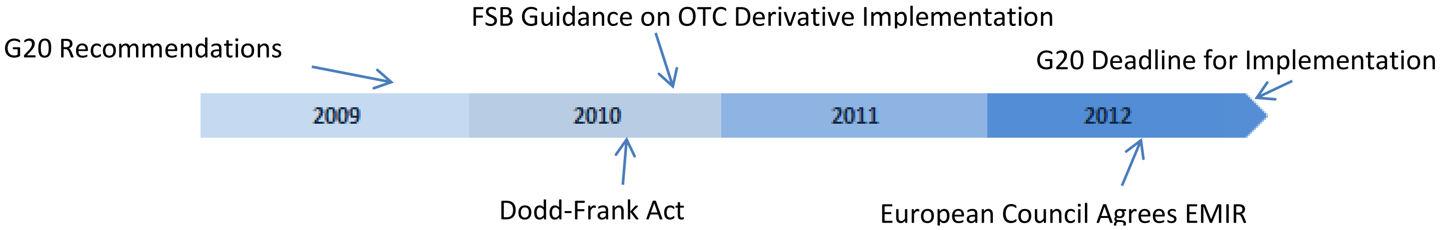
Industry is divided on specific aspects of the regulation but is looking for a level playing field internationally…

While some academics have supported reforms, others have questioned the need for new regulation or the balance between private and public sector approaches…

The term OTC derivatives refer to transactions between two counterparties where the terms are freely negotiated. These derivatives cover a range of products including: credit, equity, foreign exchange, interest rates and other structured products. Official estimates suggest that OTC products make up around 95% of the derivatives market, with the notional value of outstanding derivatives around $707 trillion.

By the end of 2012, the G20 advised that: all standardised OTC derivatives contracts should be cleared through central counterparties; all OTC derivatives should be reported to trade repositories and; non-centrally cleared contracts should be subject to higher capital requirements to recognise the higher risk inherent in those products.

With the upcoming deadline, the FSB has noted that while there has been progress in the major derivatives markets of the US, EU and Japan, there has been slower progress in other countries. There are discussions currently taking place about what carve-outs there should be for smaller firms and other types of derivatives. Another area of concern at the current time is the overlap in regulation between countries, with the US being seen as particularly severe in their treatment on swap dealer registration, amongst other areas.



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Prior to the crisis, OTC derivative markets were seen to be vulnerable to two key weaknesses: counterparty credit risk and lack of transparency.

The G20's recommendations were aimed at tackling these two weaknesses. First, by clearing contracts through central counterparties (CCPs) the notional exposures are reduced substantially. Second, CCPs can enforce standardised rules for initial and variation margins to ensure contracts are collateralised. Third, by pushing standardised OTC contracts onto CCPs there is greater access to data, allowing more effective risk monitoring from regulators and supervisors. There has also been work undertaken by the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions to ensure that CCPs have adequate liquidity, capital and oversight to ensure that new regulation does not create new systemic risks.

, Chairman of the Commodity Futures Trading Commission

"I believe that swaps market reform should cover transactions not only with persons or entities operating in the U.S., but also with their overseas branches."

The requirement that all OTC derivatives be reported to trade repositories is another effort to address the second weakness. By creating an effective record of OTC derivatives transactions, it is hoped that both market participants and regulators will be more aware of systemic risks being built up in the system.

Policymakers have argued that higher capital requirements are needed for non-centrally cleared derivatives, to reflect the continuing weakness they are prone to. The Basel Committee on Banking Supervision is currently consulting on the level of capital requirements for non-centrally cleared OTC contracts.

The most recent report on the progress of the implementation of the G20 recommendations showed that only Japan and the United States had adopted the legislation needed to enforce central clearing, while the EU has only reached a political arrangement on the issue. Most authorities are only confident about meeting the deadline for central clearing of interest rate derivatives, but not other asset classes. Alongside this there are significant delays in the implementation of trade repository reporting and the movement of standardised OTC contracts on to exchange or electronic trading platforms

The deadline for transposing the international requirements into domestic law is not the only problem facing the global regulation of OTC derivatives. There are also issues raised as to the consistency of implementation and interaction between national frameworks. A number of institutions have raised concerns about the possibility of conflicting regulatory requirements between their domestic jurisdictions and the major derivative markets.

Under the legislation passed in the US and EU on OTC derivatives (covered by Dodd Frank and the European Markets Infrastructure Regulation (EMIR) respectively), there are cross-border implications for other jurisdictions. For example, EU rules will extend to non-EU counterparties for non-centrally cleared transactions to prevent firms from basing themselves outside the EU for the purposes of avoiding EMIR. There are similar cross-border impacts from the US with foreign firms being required to register and comply with regulations as swap dealers.

A further difficulty is the scope of exemptions to central clearing requirements. These vary across the types of products and counterparties in the legislation. For example, the US is planning to exempt foreign exchange swaps and forwards. While there is not the same exemption under EMIR, the EU proposals allow the European Securities and Markets Authority (ESMA) the flexibility to take the same approach. This has the potential to increase opportunities for regulatory arbitrage between major derivative markets.

It remains to be seen how exemptions and extra-territorial requirements will affect those countries that have yet to finalise their regulation of OTC derivatives. Some regulators have expressed concern that the lack of agreed standards between major markets makes it difficult to know which framework to converge toward.

There is broad agreement amongst regulators to address the four categories identified in the G20 recommendations.

Nevertheless, regulators are clashing on the cross-border implications of their rules particularly with regard to the registration requirements for firms. For example, Michael Barnier, EU Commissioner for the Internal Market, wrote in the Financial Times that when undertaking transactions with American entities "the danger is that many of the requirements would apply to companies in the EU and to trades between the EU and US clients. American rules would take primacy over those in Europe." ESMA Chairman, Steven Maijoor, also commented "we should avoid breaking up a global market into a number of local ones for the simple purpose of applying our domestic rules."

However, Gary Gensler, Chairman of the Commodity Futures Trading Commission, has challenged this view, saying "particularly in times of crisis, the risks would come back to affect our economy." These clashes have caused a number of jurisdictions to hold back on finalising the details of their OTC derivative regulations until further information from Europe and the US is made available.

There are also concerns about location requirements of centrally cleared counterparties. This is related to the difficulty in effectively managing the relationship between the determining authority (an authority with the power to mandate central clearing in its jurisdiction) and the supervisory authority (the authority supervising the CCP) for CCPs. This again will impact smaller jurisdictions as the largest central counterparties are generally based outside their jurisdictions. Edmund Lau of the Hong Kong Markets Authority has said "we will allow some flexibility" on location requirements.

There are a number of different industry groups which will be affected by changes to OTC regulation. These include companies which manage the clearing infrastructure, and users of the infrastructure like financial and non-financial corporates. There are also questions as to the impact of regulation on central banks which use OTC derivatives for monetary policy and financial stability purposes.

The rules around the implementation of clearing requirements and the scale of exemptions have worried some groups. For example, the non-financial corporate sector has significant concerns about being caught up in OTC derivatives regulation

There is support from the academic community for the approach which regulators have taken. Acharya, Philippon, Richardson and Roubini argued in 2009 for bringing standardised instruments, like CDS and related indexes, onto centralised clearing houses or exchanges. They also recommended that smaller less standardised markets should have a central clearing mechanism available to the regulator.

However, Lynn Stout of UCLA Law School has argued that new regulation is not necessary to cope with the risk posed by OTC derivatives. She outlines an approach in which public resources would not be devoted to enforcing OTC derivative contracts unless at least one of the parties to the contract either owned, or was legally obligated to take ownership, of the asset underlying the contract. It is stated that this would separate useful hedging contracts from speculation and address the underlying concern of policymakers.

There are also calls from some academics for a more balanced approach to OTC derivatives than the potentially false dichotomy of regulation vs. 'laissez-faire'. This approach is referred to in one paper as 'coerced' self-regulation, which uses the regulator to oversee a private regulatory structure with a view to using the private framework to achieve public objectives. Under such an approach regulators would issue a set of 'core principles', but the primary responsibility for promulgating, monitoring and enforcing technical regulation to further the core principles would rest with private sector agents. This approach would effectively delegate responsibility for determining which instruments are 'standardised' and therefore eligible for central clearing.

While the broad framework has been devised and the major jurisdictions have put in place legislation, or planned legislation, there are a number of outstanding issues for stakeholders to address.

One of the first points is how smaller markets will harmonise their legislation if differences remain between key derivative markets. The contrast in US and EU legislation is likely to impact counterparties operating in those jurisdictions. There are also further questions as to whether international policymakers are able to create a more effective mechanism to recognise substituted compliance (the act of compliance with the applicable home country regulation rather than foreign regulation, when a firm takes part in a transaction with an entity in a foreign market). If these factors are not addressed then the global scope of the derivatives market is likely to be curtailed.

Regulators also need to finalise rules for margin requirements on non-centrally cleared derivatives. According to FSB reports, most jurisdictions state that they are waiting to follow the guidance of the Basel Committee on Banking Supervision, which is currently out for consultation. While some jurisdictions, such as Singapore, already require higher margining requirements for non-centrally cleared derivatives, the final rules are likely to lead to pressure to converge toward an international norm, particular for smaller markets which stand at a disadvantage to central markets.

There are also outstanding issues as to the exemptions for certain activities in the OTC derivatives market. For example, whether central banks should be covered by derivative regulations. Europe has exempted its own central banks, but is unclear whether non-EU central banks will receive a similar exemption. In some jurisdictions policymakers must also decide which instruments or users will be covered by central clearing requirements and which will not. There is also work to be done on the size at which central clearing requirements will kick in.

The on-going delay to reform is another area that needs to be addressed. International bodies estimate while a significant proportion of interest rate derivatives will be centrally cleared by end-2012, there is significantly less confidence on the progress for other asset classes. These same delays can be seen in exchange and electronic platform trading and trade repository reporting, where international guidelines have been issued but continued delays remain.

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