Regulatory

June 2013

MAJOR NEW DERIVATIVES REGULATION – THE SCIENCE OF COMPLIANCE

Around the world, new derivatives laws and regulations are being adopted and now implemented to give effect to a 2009 agreement among G20 leaders on measures to increase transparency and reduce risk in the huge global derivatives business.

This Briefing summarises the key rules, especially those that impact end-users, and looks also at some of the resulting changes to the documentation of derivatives transactions. The Briefing focuses on EU and US regulation, but regulations with similar basic principles are being introduced in many other jurisdictions (particularly G20 countries, including for example Australia, China, Hong Kong, Japan, Saudi Arabia, Singapore and Switzerland).

Overview of the EU and US regimes

The new derivatives laws and regulations aim to implement a global (G20) agreement to the effect that:

- All standard derivatives contracts should be cleared through central counter-parties (CCPs) – regulators will decide which types of swaps must be cleared.
- They should be traded on exchanges or electronic trading platforms, where appropriate (e.g. if sufficiently liquid) – again regulators will decide.
- OTC derivative contracts should be reported to trade repositories.
- Non-centrally cleared contracts should be subject to requirements for higher capital and other risk mitigation.

The principles are being implemented in different ways in the different G20 nations. However, the US, EU, Australia and Singapore, for example, have all passed laws addressing at least the clearing and reporting points, though implementation is at different stages (and is most advanced in the US).

The nature of the obligations imposed tends to

depend on the categorisation of the person concerned – for example, as a financial firm, or a non-financial firm that is a large-scale participant in OTC derivatives markets, or an end-user that basically uses derivatives markets only to hedge, and other market participants. The definitions vary and the obligations on each category, and available exemptions vary from one jurisdiction to another.

The US and EU laws and perhaps others purport to have substantial extra-territorial effect – and there have been regulatory pronouncements about this, and further regulations and guidance on this subject are expected later in the year. For example, the definition of "US Person" remains uncertain and has yet to be finalised and the European Securities and Markets Authority (ESMA) is scheduled to produce by mid-September, for adoption by the European Commission, draft regulations on what derivatives are considered to have a "direct, substantial and foreseeable effect within the EU" and other cross-border issues.

Indeed, even as the regimes are, stage by stage, coming into force, many details remain uncertain. Further rules and guidance are anticipated, but especially in the EU much will depend in practice on regulators' interpretation.

The primary legislation is:

- In the EU, a regulation commonly referred to as the European Market Infrastructure Regulation (EMIR), adopted in July 2012.
- In the US, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in July 2010 and commonly referred to as the Dodd-Frank Act.

The primary legislation requires numerous regulations and rules to be adopted to elaborate or give effect to certain requirements. However, some provisions take effect without any secondary legislation or rule-making.

Many of the new rules apply to the sell-side – banks and other swap providers, and the more active participants in the OTC derivatives markets. These are defined in varying and quite complex terms, but include (in the US) "swap dealers", "major swap participants", "financial entity" and "end-users" and (in the EU) "financial counterparties" and "non-financial counterparties".

There are numerous defined terms: you cannot assume that any word or phrase bears its normal meaning when used in these regulations! The US regime relies on the term "swap", which has been defined by regulators in very wide terms (including some options and forward contracts) while EMIR refers to "OTC derivatives" (defined in quite different terms), though the two concepts overlap substantially, especially in relation to most types of OTC financial and commodity derivative. And EMIR's reporting requirements and provisions regulating central counterparties generally apply to exchange-traded derivatives, too.

In both the US and EU there are safe harbours designed for corporate end-users, for example taking into account hedging activity. However, both the scope of these and the procedures to take advantage of them differ between the US and EU.

There are six main types of obligation applicable to end-users:

- OTC derivatives must be reported to a trade repository registered/recognised in the jurisdiction concerned:
  - In the EU this obligation can be delegated/outsourced (e.g. to the sell-side counterparty), and will apply also to exchange-traded derivatives such as futures.
  - In addition, the implementation of the Regulation on Energy Market Transparency and Integrity (REMIT) will require reporting of physical and derivatives transactions in gas, power and LNG markets from late 2013, which should be managed to avoid duplication with EMIR.
  - In the US, we understand that typically the sell-side will report and, while in theory not all swaps are reportable, in practice they will be, unless exchange-traded and cleared.
  - All counterparties will need to obtain a unique Legal Entity Identifier (LEI): a global system is being developed, but meanwhile regional or individual jurisdiction solutions are being implemented, and already a CFTC Interim Compliant Identifier (CICI) is generally required to deal with US counterparties.
- OTC derivatives may need to be cleared through a central counterparty (CCP) that is

authorised/recognised/registered/designated (the terminology varies) in the jurisdiction concerned, if the relevant regulator has designated the particular type of swap for clearing:

- In the EU, the obligation will apply only to non-financial counterparties (NFCs) exceeding a specified threshold (currently expressed in terms of gross notional amount). Such counterparties are referred to as "NFC+". Not all OTC derivative contracts count towards the clearing threshold: in calculating whether a counterparty is an NFC+, OTC derivatives entered into to reduce risks relating to the commercial or treasury financing activity of the NFC (or of NFCs in its corporate group) are excluded.

- In the US, there is a safe harbour from the obligation for end-users that are non-financial entities and are using the swap to hedge or mitigate risk.

- In each case there are procedural requirements.

• OTC derivatives that are required to be cleared may require also to be executed on a regulated trading facility:

  - We understand this is generally the case in the US, where a designated contract market (such as a traditional futures exchange) or a swap execution facility (SEF) may be used, but the rules are not yet fully in force.

  - In the EU, this requirement will be imposed as a result of reforms to the 2004 MiFID Directive, which will require some classes of liquid clearing-eligible derivatives to be traded on a "regulated market", multilateral trading facility (MTF) or a proposed new breed of regulated venue, organised trading facility (OTF).

• Risk mitigation techniques must be applied to uncleared derivatives: these will have an impact on documentation and processes. Examples of requirements include:

  - Prompt trade confirmation (within specified deadlines).

  - Collateral (of course margin/collateral must also be provided if a transaction is cleared, but this will typically be at a lower level than if the swap is uncleared).

  - Dispute resolution procedures.

  - Portfolio reconciliation and compression where there is a large number of transactions outstanding with a particular counterparty.

  - Increased capital requirements for regulated entities (such as banks and brokers) carrying exposures to clients and counterparties in respect of uncleared swaps).

• Many of these requirements will lead to significant changes in transaction documentation (including to master agreements and terms of business):

  - Changes to ISDA documentation and to documents required for clearing are already required by most swap dealers registered with the CFTC in order to comply with CFTC rules.

  - Documentary changes for EMIR compliance are underway.

  - See below for further information of documentation changes.

• Recordkeeping requirements.

Among additional points to note are:

• Intra-group transactions are generally exempt from reporting requirements. Even if they satisfy the conditions for an exemption/safe harbour from the clearing obligation, they may be subject to collateralisation and other risk mitigation requirements.

• There may be a need to apply these new requirements to existing transactions: for example, the EU reporting requirements will apply to all OTC derivatives that were outstanding August 16, 2012, when EMIR formally came into force.

• EMIR will apply also in the countries of the European Economic Area (EEA) that are not part of the EU (namely Iceland,

Norway and Liechtenstein) and we understand that Switzerland is likely to be similar to and compatible with EMIR.

- New rules applicable to banks and certain other financial institutions will impose additional capital requirements in respect of their exposures to counterparties on uncleared derivatives, and their exposures to CCPs on any business.
- The regimes also set standards and rules for trade repositories.
- As mentioned above, the US and EU regimes are extra-territorial in many respects. Even though regulators have yet to issue final interpretations in relation to this, many sell-side firms and others are assuming extensive extra-territorial application and engaging with counterparties on this basis. There are inconsistencies and there could be conflicts between the requirements of different jurisdictions, though regulators have been coordinating in an attempt to minimise these.

Documentation initiatives

It is apparent even from the summary above that the status, processes and other requirements applicable to many transactions depend on a variety of factors, including the nature and status of a counterparty, its derivatives portfolio/history and actions it has taken or will take (e.g. to qualify for a safe harbour). Counterparties need assurances about these matters in order to ensure they comply with the requirements applicable to each trade. Accordingly, the EU and US regimes increase the "know your client/counterparty" obligations and the need to obtain representations from counterparties, undertakings to notify changes in relevant facts, changes to existing agreements and agreements about how compliance with certain requirements is to be performed.

The International Swaps and Derivatives Association (ISDA), which produced the standard swap master agreement and various other documents used around the globe in OTC derivatives dealing, has taken the initiative to consider how these matters can best be dealt with in documentation. Although parties are free to agree with each other on these matters (subject to that agreement meeting the requirements), ISDA has concluded that many of the issues can be more efficiently addressed through a centralised and to some extent automated approach.

Because the US is ahead of the EU in implementing its regime, ISDA started first with Dodd-Frank Act requirements. In August 2012, it launched the first of what it expects to be a series of protocols to simplify documentation changes for CFTC and SEC rules, as well as changes under EMIR and further EU legislation (such as the reform of the EU's 2004 MiFID Directive, which will require some classes of derivatives to be traded on an exchange or other organised venue). In March 2013, ISDA published a second Dodd-Frank Protocol and the first EMIR Protocol for adherence by master agreement counterparties, and this month (May 2013) a generic protocol was launched to facilitate compliance with reporting requirements across many jurisdictions. Whilst the requirements that are addressed in ISDA's Dodd-Frank Protocols can be met through bilateral agreement with each counterparty, the Protocol represents a more efficient approach to the process, especially if a party deals with many counterparties in deals that are (or potentially are) subject to Dodd-Frank Act requirements.

In addition, ISDA has published the texts of amendments, disclosures and annexes parties are free to adopt bilaterally, and has been working with trade associations (particularly the Futures Industry Association in the US and the Futures and Options Association in the UK) to develop documentation in respect of swaps clearing. Many of these will require some adaptation to meet parties' specific needs, and experience in the US shows that some parties are considering how best to manage their OTC and exchange-traded documentation in a consistent manner that achieves efficiencies and mitigates legal, operational and credit risks.

Key actions required

Participants in derivatives markets are at various stages of preparation for the new regime, and to some extent the pace has been forced by US regulation, which is more advanced in terms of implementation and affecting transactions with US parties and with some non-US institutions (especially those which have registered with the CFTC as swap dealers). Many non-US counterparties have already adhered to ISDA Dodd-Frank protocols and obtained a CICI.

All participants need to act now to ensure compliance with the US, EU and other regimes which may apply to them in their dealings in OTC or exchange-traded derivatives.

HFW suggests actions in the following twelve areas:

1. Assess your derivatives business, to identify the following, for example:
    - What types of transactions do you enter into, with what underlyings and in what markets?
    - Who are your counterparties, e.g. affiliates, investment banks, others?
    - What is the scale of the business in each area?
2. What is your status under applicable regulation?
    - For example under EMIR, as a financial counterparty, non-financial counterparty, third country (non-EU) entity.
3. Develop and implement procedures to confirm OTC derivatives promptly:
    - And to ensure your counterparties do so, too.
4. Mark-to-market uncleared derivatives (if this requirement applies to you):
    - Consider whether you need a model in case of market disruption.
5. Obtain LEI(s):
    - Initially you might need separate LEIs in different jurisdictions.
6. Report (or prepare to report) your derivatives transactions to a trade repository:
    - Unless you have delegated this, or it is clearly the other party's responsibility:
        - In which case ensure these arrangements will apply to all your transactions.
    - Obtain LEI(s) – initially you might need separate LEIs in different jurisdictions.
    - Consider which trade repositories you will use.
7. Plan for the likely collateralisation requirements:
    - Including potential changes to margin credit availability, if you have been relying on such finance.
8. Address new documentation requirements:
    - Consider adhering to ISDA protocols that are open for adherence.
    - Consider what other documentation you now or will need, and the extent to which industry standards will work for you.
    - Open discussions with counterparties about this.
9. Ensure your trading and operations are monitored and controlled to ensure compliance with new rules (on an ongoing basis):
    - Substantial preparation will be required by many parties, including new policies, procedures and processes (and related IT changes).
10. Clearing - ensure you are set-up for mandatory clearing when and where this applies:
    - Clearing obligations are already coming into force in the US, and are expected in the EU from mid-2014.
    - Documentation and process changes are required.
    - Many questions need to be considered, including for example:
      Will you need/want to clear?
      Which CCPs are relevant to your business?
      Have you the right broker (and back-up broker) relationships in place?
      What type of segregation will you require?
11. Cross-border issues: understand them and plan.
12. Monitor for change:
    - Rules and guidance are still being issued to flesh out details of the new derivatives regulations.
    - Other regulator changes may have a significant impact on the requirements and costs of derivatives business:
        - For example, in Europe, the CRDIV package (on capital requirements), MiFID II (introducing mandatory trading of some derivatives on organised venues), and possibly the European financial transaction tax.

How HFW can help

As is clear from this summary, there is much to consider, and implementation is already unfolding.

HFW can help your business in a number of ways, including in the twelve areas mentioned above, to meet the challenge of the new requirements for derivatives, such as:

- Advising you on the detailed requirements of the legislation and rules, including collating advice from our offices and correspondent firms in relevant jurisdictions – for example, we have been working with US counsel to assist clients on their Dodd-Frank Act compliance.
- Assistance in assessing your status under the rules, and planning your strategy to manage compliance.
- Advice on the applicability of the rules to existing transactions.
- Guiding you in relation to ISDA protocols and other documentation initiatives designed to facilitate compliance.
- Assistance with new documentation requirements, such as in relation to margin and collateral, where this becomes necessary.
- Advice on safe-harbours/exemptions for intra-group transactions, from clearing etc. and particularly on satisfying hedging criteria.

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