

Update on proposed EU regulation as regards FX derivatives transactions

Foreign Exchange Contact Group

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Background of proposed European Regulation (formerly called “EMIR”)

- Pittsburgh G20 agreement (26 September 2009): all standardised OTC derivative contracts should be centrally cleared by end-2012 at the latest; OTC derivative contracts should be reported to trade repositories
- Conclusions of the European Council of 2 December 2009 on the need to substantially improve the mitigation of counterparty credit risk and with the importance of improving transparency, efficiency and integrity for derivative transactions
- European Parliament resolution of 15 June 2010 on “Derivatives markets: future policy actions” called for mandatory clearing and reporting of OTC derivatives
- Commission legislative proposal of 15 September 2010, which followed a public consultation and served as a basis for the draft EMIR
- NB: A “Regulation” is directly applicable in all Member States; no need for transposition; exactly the same terms apply throughout the Union

Overview of proposed EU regulation

- Hungary Presidency renamed EMIR as “Regulation on [OTC] derivatives transactions, central counterparties and trade repositories”; latest compromise proposal of 27 May 2011 is here: <http://register.consilium.europa.eu> (document No. 10811/11)
- The draft Regulation proposes:
 - *“Counterparties shall clear all [OTC] derivative contracts pertaining to a class of derivatives that has been declared subject to the clearing obligation...” (Art.3)*
 - *“Counterparties and CCPs shall ensure that the details of any derivative contract they have concluded and any modification, or termination of the contract is reported to a trade repository ...”(Art.7) (Reporting must be no later than the next working day.)*
 - *Tighter oversight and regulation of CCPs (authorised by MS where established but ESMA also involved)*
- The draft proposal is still work in progress

ECON Committee of European Parliament

- 24 May 2011, ECON Committee of the European Parliament agreed that
 - Scope: mandatory clearing applies to OTC derivatives; Reporting applies to all derivatives
 - Mandatory clearing only from entry into force BUT ESMA to consider if retroactive reporting should be required
 - Central role for ESMA, including on authorisation of new CCPs
 - Third country CCPs subject to similarly rigorous process as EU CCPs.
 - Interoperability provisions will only apply to cash equities (3-year period before CCPs can apply for inter-operability)
 - Special regime for pension funds
- European Parliament plenary vote on Regulation is expected in July (probably the first of two readings unless agreement is reached between Council and Parliament)
- Second reading must be within 3 months of Council agreeing its Common Position (implication: proposal could be delayed by a further 6 months)
- Regulation is nevertheless expected to be in force by end 2011

Treatment of FX derivatives

- The proposed EU Regulation covers FX derivatives (not FX spot)
- Mandatory clearing standards are not yet settled:
 - Article 4 of the draft Regulation: ESMA has to submit “implementing technical standards” to the Commission; Commission then adopts standards (i.e., determine whether a class of derivatives must be cleared centrally);
 - Recital 12b: “due account should be taken of the specific nature of the relevant classes of derivatives. The predominant risk for transactions in some classes of [OTC] derivatives may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes (e.g. foreign exchanges) of derivatives from other classes. CCP clearing specifically addresses counterparty risk, and may not be the optimal solution for dealing with settlement risk.”
- During the consultation phase, a number of market organisations argued for an exemption of FX swaps from the clearing obligation

Position in US

- **DFA brings the “unregulated” OTC derivatives market within the regulatory umbrella**
 - **DFA changed Commodity Exchange Act definitions to include within CFTC jurisdiction what had previously been statutorily excluded (by Commodity Futures Modernization Act)**
- **Foreign exchange swaps and forwards now in CFTC jurisdiction**
- **Treasury Secretary limited power to exempt**
- **Cannot exempt from:**
 - **Reporting to swap data repositories**
 - **Real time public reporting**
 - **Business conduct standards**

Proposed determination 27 April 2011

- **FX swaps and forwards would be exempted from central clearing requirement of DFA**
- **Key distinction: difference between settlement risk (addressed by market mechanisms and by CLS) and counterparty risk (considered now minor in FX, such that a cost benefit analysis could not justify requiring central clearing of FX swaps and forwards)**
- **Definition read restrictively; options and other FX derivatives will be subject to DFA**
- **Unknown if proposed determination will be adopted verbatim**

DFA and delegated legislation provisions applicable to FX products

- **Delegated legislation still pending. Three key areas of interest:**
 - **Swap data repositories**
 - **Business conduct standards (commercial counterparts required to implement DFA rules in their dealings)**
 - **Public reporting of information**
- **Key issue: public reporting means “real-time” reporting, i.e., as soon as “technologically practicable” and “executed”**
- **Information should not disclose “business transactions and market positions of any person” but**
 - **Effects on central bank currency interventions?**
 - **FED transactions are, by definition, not swaps and thus DFA is not applicable**

EMIR and Dodd-Frank Act compared

- G20 guidance to ensure consistency between European and US regulation
- Secretary Geithner “global minimum standards”
- The EU and US legislative processes are on different paths: the DFA entered into force July 2010, while the EU Regulation is not yet adopted
- CFTC and SEC are behind schedule for implementation, and will not meet the global time-line set by DFA
- Agriculture Committee hearing on US competitiveness after derivatives reform: <http://agriculture.house.gov/press/PRArticle.aspx?NewsID=1389>
- In the EU, once EMIR regulation will be adopted, ESMA will have to develop technical standards to be adopted by the Commission to implement the Regulation.
- As regards FX in particular, the DFA gives competence to the Secretary of the Treasury to exempt foreign exchange swaps and forwards from parts of DFA. In the draft EMIR Regulation there is no such explicit wording as regards FX, but an effective “exemption” remains possible