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Regulation of OTC derivatives markets A comparison of EU and US initiatives

On 15 September 2010 the European Commission published its formal legislative proposal for a Regulation on OTC derivatives, central counterparties and trade repositories. Like the US Dodd-Frank Wall Street Reform and Consumer Protection Act, the proposed EU Regulation aims to fulfil the G20 commitments that all standardised over-the-counter (OTC) derivatives should be cleared through central counterparties (CCPs) by end-2012 at the latest and that OTC derivatives contracts should be reported to trade repositories.

There is a significant commonality in the approaches adopted by the proposed EU Regulation and the Dodd-Frank Act in relation to the regulation of OTC derivatives markets, but there are also some significant differences. This paper summarises the way in which the two regimes treat different categories of counterparty and highlights certain other major differences between the proposed EU Regulation and the Dodd-Frank Act in relation to the trading and clearing of OTC derivatives.

The proposed EU Regulation is subject to amendment during the legislative process and both the proposed EU Regulation and the Dodd-Frank Act envisage that there will be extensive regulatory technical standards and implementing rules that will have a significant effect on how the two regimes operate in practice. In addition, the Dodd-Frank Act addresses issues relating to the trading and transparency of transactions in OTC derivatives that are not addressed by the proposed EU Regulation as they are being considered separately as part of the review of the EU Markets in Financial Instruments Directive (MiFID) currently under way in the EU.

This paper is not intended to be comprehensive or to provide legal or other advice.

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There is significant commonality of approach in the EU and the US but there are some important differences:

- Both the EU and the US regimes aim to impose clearing and reporting on a broadly defined class of OTC derivatives (with differences for some classes of derivatives) and give regulators the ultimate decision on when the clearing obligation applies.
- The EU clearing regime is potentially less burdensome for end-users. In the US, the clearing obligation falls on everyone who trades an eligible contract, with a narrow exemption when non-financial entities enter into certain hedging transactions. In the EU, the clearing obligation applies to financial counterparties when dealing with other financial counterparties and non-financial counterparties only become subject to the clearing obligation when their positions (excluding certain hedges) exceed a specified clearing threshold.
- The US regime imposes margin requirements on dealers and major swap participants entering into uncleared transactions, without any express exemption for transactions with end-users (although US legislators have indicated that margin requirements should not apply to end-users). The EU regime appears only to require financial counterparties (and non-financial counterparties subject to the clearing obligation) to have procedures requiring an appropriately segregated exchange of collateral or an appropriate and proportionate holding of capital for uncleared transactions.
- While both regimes envisage registration and conduct of business rules for dealers (the EU already had rules under MiFID), the US regime also extends registration, conduct of business and margin/capital rules to "major swap participants". The EU regime only imposes limited rules (albeit including margin/capital requirements) on non-financial counterparties subject to the clearing obligation.

- Both regimes seek to allow cross-border clearing by allowing the recognition/exemption of non-domestic CCPs. They are less flexible in relation to cross-border provision of trade repository services, with the US requiring compliance with full US requirements and the EU making recognition of non-EU repositories conditional on conclusion of a treaty.
- The US regime requires the execution of OTC derivatives subject to the clearing obligation on a swap execution facility or designated contract market, real time post-trade transparency for cleared derivatives trades and position limits. In the EU, these issues are being addressed separately as part of the MiFID review.
- The EU regime has no equivalent to the US "push out" rule restricting the derivatives trading activities of banks, the "Volcker rule" restricting the proprietary trading operations of bank groups or the provisions allowing regulators to restrict bank ownership of CCPs.
- The US regime probably provides the US regulators with more flexibility to address unintended consequences through rule-making and other powers.





Application of OTC derivatives rules to different categories of counterparty

	Clearing obligation applies to eligible OTC transactions?	Reporting obligation applies to OTC transactions?	Margin requirements apply to uncleared OTC transactions?	Capital requirements apply to uncleared OTC transactions?	Authorisation/registration and business conduct requirements apply?
OTC derivative dealers	EU: Yes	EU: Yes	EU: Yes†	EU: Yes†	EU: Yes (under MiFID)
	US: Yes*	US: Yes	US: Yes [‡]	US: Yes	US: Yes (and bank activities limited by "push-out" rule)
Other financial counterparties/entities	EU: Yes	EU: Yes	EU: Yes [†]	EU: Yes [†]	EU: No (except for existing sectoral rules)
	US: Yes*	US: Yes	US: Yes if major swap participant or if counterparty a dealer/major swap participant [‡]	US: No unless major swap participant	US: No unless major swap participant (but bank activities limited by "push-out" rule)
Non-financial counterparties/entities	EU: No except for non-financial counterparties whose positions (excluding certain hedges) exceed clearing threshold	EU: No except for non-financial counterparties whose positions exceed information threshold	EU: Yes if own positions (excluding certain hedges) exceed clearing threshold [†]	EU: No except for non-financial counterparties whose positions (excluding certain hedges) exceed clearing threshold [†]	EU: No
	US: Yes but non-financial entities may qualify for exemption for transactions hedging commercial risk*	US: Yes	US: Yes if major swap participant or if counterparty a dealer/major swap participant (possible exceptions for endusers) [‡]	US: No unless major swap participant	US: No unless major swap participant

Notes

- * Under the Dodd-Frank Act, derivatives subject to the clearing obligation must also be traded through a swap execution facility or designated contract market, unless one of the parties is a non-financial entity which opts for the clearing exemption, and mandatory real time public reporting will apply to all cleared trades whether or not subject to the mandatory clearing requirement. The Act also requires regulators to establish position limits for OTC derivatives. In the EU, trading and transparency issues are being addressed separately as part of the MiFID review.
- † The proposed EU Regulation imposes an obligation on financial counterparties (including dealers) and non-financial counterparties whose positions (excluding certain hedges) exceed the clearing threshold to have procedures requiring an appropriately segregated exchange of collateral or an appropriate and proportionate holding of capital for uncleared transactions. It also imposes other risk management obligations on them in relation to their uncleared transactions, including requirements for electronic confirmation, portfolio valuation and reconciliation and daily mark-to-market procedures.
- ‡ The Dodd-Frank Act requires the regulators to impose margin requirements on dealers and major swap participants for their uncleared transactions, without an express exemption for cases where the counterparty to the uncleared transaction is an enduser (but US legislators have indicated that margin requirements should not apply to end-users).



Major differences between the proposed EU Regulation and the Dodd-Frank Act

	EU: proposed Regulation	US: Dodd-Frank Act
Scope:	The proposed EU Regulation applies to a broad class of OTC derivatives but is limited to derivatives on specified underlyings. The EU definition does not cover spot foreign exchange transactions and the European Commission has interpreted the relevant EU definition to exclude commercial forward foreign exchange transactions. The EU definition also excludes some kinds of physically settled commodity transactions, although the exceptions differ from the US.	The Dodd-Frank Act applies to a broad class of OTC derivatives including any agreement, contract or transaction that is, or in the future becomes, commonly known to the trade as a swap. The US definition does not appear to cover spot foreign exchange transactions and the Act allows the Treasury Secretary to exempt both foreign exchange swaps and forwards from the clearing obligation (but not the reporting and business conduct standards) although it is not entirely clear whether this potential exemption applies to cash-settled trades. The US definition excludes some kinds of physically settled commodity transactions (and certain physically settled forward transactions in securities).
Other key definitions:	Financial counterparties are defined to cover banks, investment firms, insurance companies, registered funds (UCITS), pension funds and alternative investment fund managers.	Financial entities are defined to cover swap dealers, major swap participants, commodity pools, private funds, employee benefit plans and other entities predominantly engaged in banking business or financial activities (but regulators can exempt certain small banks, savings associations, etc.). Major swap participants are defined to cover (a) entities with substantial positions in any class of OTC derivatives (excluding positions hedging commercial or employee benefit plan risk), (b) entities whose outstanding OTC derivatives positions create counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or financial markets and (c) highly leveraged financial entities that maintain a substantial position in any class of outstanding OTC derivatives.
Authorisation requirements and business conduct rules for dealers/users:	MiFID already requires the authorisation of EU dealers in OTC derivatives (and imposes business conduct rules on authorised dealers), although it contains exemptions for certain categories of dealer (such as specialist commodity firms) for which there is no direct parallel in the US. The proposed EU Regulation does not extend the EU authorisation requirements (but see below as to the clearing and reporting obligations for non-financial counterparties).	The Dodd-Frank Act requires dealers in OTC derivatives and certain major swap participants to be registered and imposes business conduct rules on them (e.g. disclosure obligations and, for dealers, duties to act in the best interests of certain clients).

	EU: proposed Regulation	US: Dodd-Frank Act
Derivatives subject to mandatory clearing:	The proposed EU Regulation requires the European Securities and Markets Authority (ESMA) to make a determination as to which OTC derivatives are subject to the clearing obligation, although the evaluation criteria differ from the US. ESMA can also identify contracts for clearing even if no CCP currently clears the contract (but the proposed EU Regulation does not specify any related powers).	The Dodd-Frank Act requires regulators to make a determination as to which OTC derivatives are subject to the clearing obligation, although the evaluation criteria differ from the EU (e.g. the US regulators are required to take into account the effect on competition, including clearing costs). The US regulators can also take action even if no CCP currently clears the contract (e.g. to restrict trading in such a contract) and can also stay the application of the clearing obligation.
Scope of mandatory clearing:	The clearing obligation under the proposed EU Regulation applies to financial counterparties that enter into eligible derivatives contracts with other financial counterparties.	The clearing obligation under the Dodd-Frank Act applies to anyone who enters into a derivative subject to the clearing obligation (other than non-financial entities under the exemption described below).
Clearing by non-financial counterparties/entities:	Under the proposed EU Regulation, a non-financial counterparty may become subject to the mandatory clearing obligation (and have to notify the relevant regulator) if its positions (excluding certain hedges) exceed a clearing threshold (to be set by regulatory standards).	Under the Dodd-Frank Act, if one of the parties to the contract is a non-financial entity it can opt out of the clearing obligation if it is using the derivative for hedging or mitigating commercial risk and notifies the regulators how it will meet its obligations under non-cleared swaps. Certain affiliates can also rely on this exemption.
Reporting obligation:	Under the proposed EU Regulation, financial counterparties must report the details of all their OTC derivative contracts (even if subject to clearing) to a registered trade repository (failing which, to the regulator). Non-financial counterparties only have to report their OTC derivatives contracts if their positions exceed an information threshold to be set by regulatory standards (when they must also notify the relevant regulator and justify exceeding this threshold).	Under the Dodd-Frank Act, any swap must be reported to a registered trade repository (failing which to the relevant regulator). Additional reporting obligations will apply to market participants and other market utilities.

	EU: proposed Regulation	US: Dodd-Frank Act
Risk mitigation for uncleared trades:	The proposed EU Regulation requires financial counterparties (and non-financial counterparties that exceed the clearing threshold) that enter into uncleared derivatives transactions to have arrangements in place to measure, monitor and mitigate operational and credit risk, including requirements for electronic confirmation, portfolio valuation and reconciliation, daily mark-to-market, as well as an appropriately segregated exchange of collateral or an appropriate and proportionate holding of capital (to be set by regulatory standards). Therefore, it appears that a financial counterparty could choose to hold capital against an uncleared transaction with an end-user, instead of requiring margin.	The Dodd-Frank Act imposes capital and margin requirements on swap dealers and major swap participants that enter into uncleared swaps that are appropriate for the heightened risks posed by uncleared swaps. There is no express exception from the collateral requirements where the counterparty to the transaction is an end-user (even if the end-user is itself exempt from the clearing obligation) but US legislators have indicated that margin requirements should not apply to end-users. There are also provisions giving counterparties the right to require swap dealers or major swap participants to segregate initial (but not variation) margin on uncleared swaps. The US regulators are also given powers to make rules regulating swap dealers and major swap participants (including rules that would limit their activities).
Regulation of CCPs:	The proposed EU Regulation contains extensive provisions directly regulating the organisation and conduct of business of CCPs, including requirements as to access to liquidity and specifying that margins shall cover 99% of risk of exposure movements over an appropriate time horizon, with a relatively limited role for the adoption of delegated acts/technical standards to implement those requirements. The proposed EU Regulation includes provisions which aim to ensure the portability of client positions and collateral in the event of a clearing member's default. The proposed EU Regulation also has provisions permitting interoperability for CCPs in relation to cash securities clearing.	The Dodd-Frank Act gives regulators the primary role in developing organisational and business conduct standards for CCPs. The Dodd-Frank Act contains provisions requiring collateral for cleared swaps to be held with a futures commission merchant or a broker, dealer or securities swap dealer (but allows omnibus collateral accounts). The Dodd-Frank Act also specifically states that a registered CCP is not required to accept the credit risk of another CCP.
CCP ownership limits:	There are no provisions in the proposed EU Regulation equivalent to the US provisions, although holders of direct or indirect significant shareholdings in a registered CCP will require approval (and the proposed EU Regulation imposes requirements on CCPs and others to manage conflicts of interest).	The Dodd-Frank Act requires US regulators to determine whether to limit ownership of CCPs (and swap or futures exchanges) by large banks and non-bank financial holding companies supervised by the Federal Reserve. The Dodd-Frank Act imposes requirements on CCPs and others to manage conflicts of interest.





	EU: proposed Regulation	US: Dodd-Frank Act
Regulation of trade repositories:	The proposed EU Regulation sets out certain high level requirements for trade repositories but does not confer extensive powers to adopt delegated acts/technical standards to implement those requirements. While it contemplates that certain EU regulators and central banks will have access to information held by the repository, it does not directly address disclosure to other EU or non-EU regulators.	The Dodd-Frank Act gives US regulators extensive powers to regulate trade repositories. There are specific provisions allowing registered trade repositories to disclose information on request to domestic and foreign regulators, subject to certain confidentiality and indemnity requirements.
Territorial scope:	The proposed EU Regulation is unclear as to the territorial application of a number of its provisions. However, it does provide that the clearing obligation applies to financial counterparties (and non-financial counterparties which exceed the clearing threshold) which enter into eligible OTC derivatives with third country entities.	The provisions of the Dodd-Frank Act generally do not apply to derivatives activities outside the US, but the US regulators may make regulations to prevent evasion of US rules and may prohibit entities in countries whose regulations undermine US financial stability from participating in the US in derivatives activities.
Recognition arrangements:	The proposed EU Regulation prohibits non-EU CCPs and trade repositories from providing services in the EU (in the case of trade repositories for the purposes of satisfying the Regulation's trade reporting requirement) unless recognised by ESMA for this purpose. This requires a determination that there is equivalent home state regulation, home state authorisation and effective supervision and co-operation arrangements with ESMA (and, in the case of non-EU trade repositories, an international agreement governing mutual access to and exchange of information).	The Dodd-Frank Act provides that US regulators may exempt a non-US CCP from the relevant US regulation if the non-US CCP is subject to comparable, comprehensive regulation in its home country. Such an exempt CCP would be eligible to clear swaps. However, the Dodd-Frank Act does not contain any provisions allowing the recognition (or exemption) of non-US trade repositories, but such entities might be able to register under the Act if they can comply with its requirements.
Derivatives "push-out"/Volcker rule:	There are no equivalent provisions in the proposed EU Regulation effectively requiring EU banks to limit their OTC derivatives business.	The Dodd-Frank Act prohibits federal assistance to any swap dealer or major swap participant. Insured banks are exempt if they limit their derivatives activities to hedging and dealing in interest rate swaps, foreign exchange transactions and a limited class of other derivatives business (and can be part of a group of companies that includes a swap dealer or major swap participant). The Dodd-Frank Act also introduces a restriction on proprietary trading by banking groups (the "Volcker rule").



	EU: proposed Regulation	US: Dodd-Frank Act
Rulemaking powers:	The proposed EU Regulation envisages a less extensive role for delegated acts/technical standards.	In general, the Dodd-Frank Act gives a broader role to regulators to develop the requirements set out in the Act through rule-making (although it does limit their general exemptive authority).
Effective date:	The proposed EU Regulation would enter into force 20 days after official publication, but CCPs that have an existing national authorisation would have two years to obtain authorisation. It appears that some other provisions would not take effect until implementing regulatory standards are adopted (e.g. the information and clearing thresholds for non-financial counterparties). Other provisions have no transitional arrangements (e.g. to take account of delays in registering/recognising an initial group of trade repositories).	Under the Dodd-Frank Act, the effective date of most provisions is 360 days after enactment or (if rulemaking is required) 60 days after publication of the final rule. The Act specifically states that its enactment will not generally give rights to parties to terminate, amend or modify an existing swap and explicitly exempts contracts entered into before the clearing obligation becomes effective from the mandatory clearing obligation (so long as they are reported).
Backloading:	The proposed EU Regulation envisages that when a trade repository is registered by ESMA for reporting a particular type of OTC derivative, all those derivatives previously entered into shall be reported to that repository within 120 days (although the draft text is unclear).	Under the Dodd-Frank Act, uncleared derivatives existing at enactment generally must be reported to a registered trade repository or the relevant regulator, under rules that must be adopted by October 2011, within 30 days of the final rules or other time period specified in the rules.
Trading and post-trade transparency:	These issues are under consideration in the EU as part of the review of MiFID currently under way.	The Dodd-Frank Act imposes obligations requiring the execution of OTC derivatives that are subject to the clearing obligation on a swap execution facility or designated contract market, obligations for real-time reporting of cleared derivatives trades (i.e. post-trade transparency) and position limits.
Other OTC derivatives issues:	The corresponding EU rules on intra-group and external large exposures already include derivatives exposures.	The Dodd-Frank Act makes changes to the prudential rules for banks to include derivatives exposures in restrictions on banks' intra-group exposures and lending limits (large exposure rules).

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