



The European CDS and OTC Derivatives Seminar Market Regulatory Overview

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28 March 2011



Market Regulatory Overview

- Reforming the UK's Regulatory Architecture

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- Overview of key European developments for regulation of derivatives

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Back to the Future meets *Twin Peaks*
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Origins of the crisis

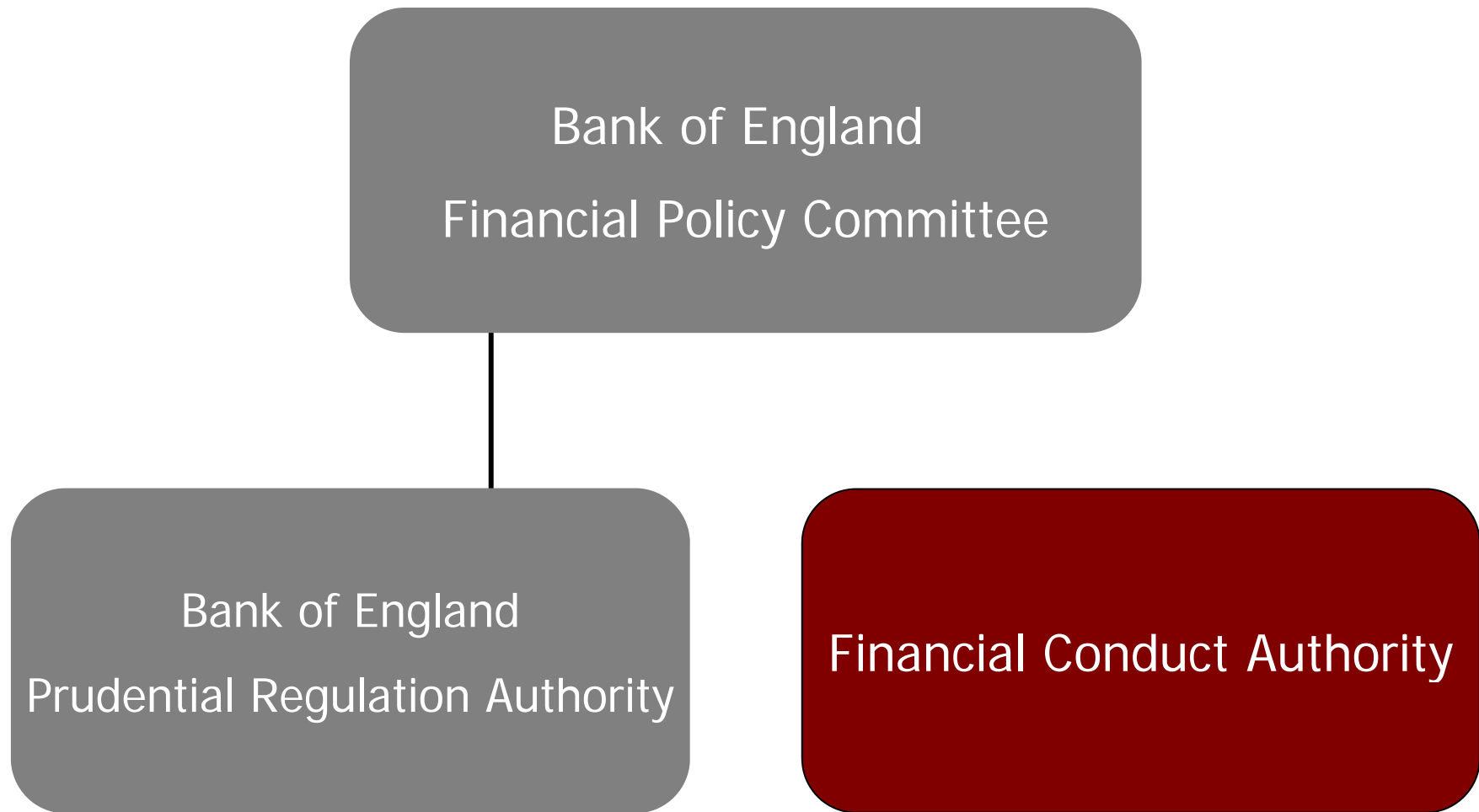
- Government failed to understand deep links between macroeconomic policy and financial stability
- Banks and other financial institutions failed to understand risks and engaged in improper conduct
- Regulation of financial institutions was weak

Source: Conservative Party White Paper – “From Crisis to Confidence: Plan for Sound Banking”, July 2009

“The Conservative solution”

- Abolish the fragmented and confused tripartite system
- Make the BofE responsible for financial stability
- Replace the FSA with two new bodies:
 - **Consumer Protection Agency**
 - **Financial Regulation Division** of the BofE
 - Micro-prudential regulation of all banks, insurances companies and other significant institutions

Proposed New Regulatory Architecture



Financial Policy Committee

- New Committee to be established within the BoF E
- Responsible for 'macro-prudential' regulation
- Primary statutory responsibility for maintaining financial stability
- Identify and respond to developing risks across the financial system as a whole
- Will work closely with the other bodies:
 - G20 Financial Stability Board
 - European Systemic Risk Board

Prudential Regulation Authority

A much narrower remit than the FSA...

- **Prudential supervision** of some **1,700 firms**:
 - banks
 - investment banks
 - building societies
 - insurers
 - friendly societies
 - credit unions
 - Lloyd's of London and its managing agents
- Introducing Solvency II for insurers will be a major focus

Financial Conduct Authority

- Conduct of Business regulator for all authorised firms
- Prudential regulator for approx 25,000 firms
- UK Listing Authority
- Recognised Investment Exchanges
- Civil and criminal Market Abuse regime



Financial Conduct Authority

- Conduct of business regulator for all **20,000 firms** currently authorised by the FSA
- FSA's historic strategy focusing on high-level systems and controls and information disclosure has not proved effective. It remains *"too easy for firms to exploit consumers"*.
- Build on the more interventionist and pre-emptive approach to regulating conduct begun in March 2010
 - more proactive identification and prevention of consumer detriment
 - earlier intervention in the value chain

Wholesale conduct regulation

- Alongside its consumer protection role, the FCA will be responsible for the regulation of conduct in wholesale markets
 - FCA needs to develop a clearly articulated **wholesale conduct strategy** and to give more attention to this area than the FSA
 - FSA's efforts in this area overshadowed by focus on market abuse
 - Many systems and controls weaknesses relate to failures to manage **conflicts of interest** in various forms
- FCA should be prepared to **intervene early** to deal with emerging wholesale conduct issues that threaten market integrity, particularly where these have a link to retail markets and consumers
- Where necessary, FCA will develop **additional regulatory requirements** for wholesale market participants

Some concerns

- HMT recognises there are difficult boundary issues
 - Unclear dividing line between prudential and conduct matters
- Possible extension of supervisory powers to cover unregulated holding companies and other group entities
- Requirement to consult before making prudential rules?
- Removal of existing safeguards?
- Mechanism for challenging decisions by regulators
 - Firms may wish to challenge decision of PRA e.g. regarding capital add-ons
 - HMT favours judicial review

Some more concerns

- How will dual authorisation process work?
- Enhanced OIVOP powers?
- PRA/FPC relationship: how will the micro/macro relationship work in practice?
- Scope of PRA regulation
 - which firms are systemic?
 - spectrum of intensive supervision with focus on the biggest firms
 - how will groups be supervised?
- Co-ordination with the FCA

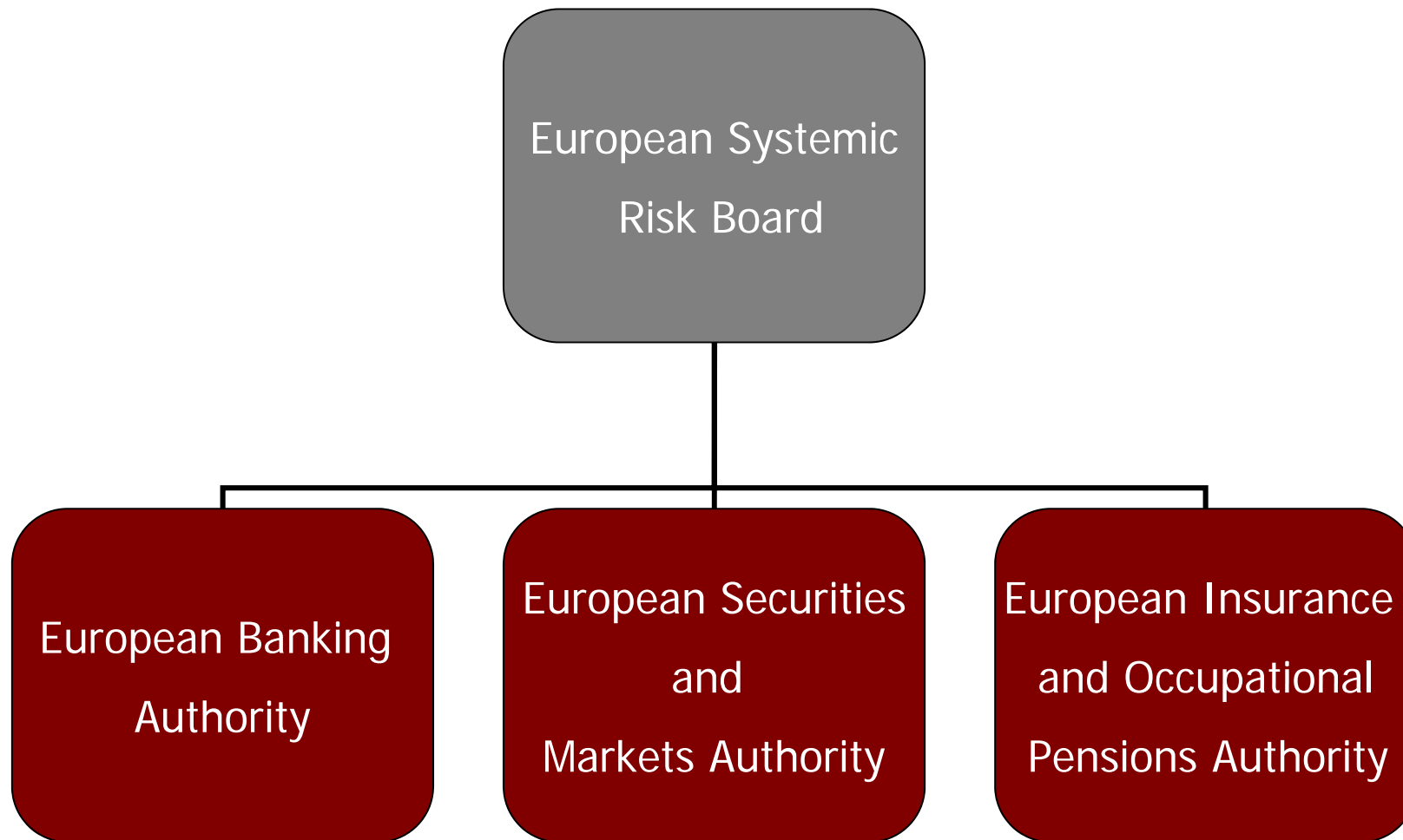
Breaking up is hard to do...

- Draft Bill to be published by the end of June
- FSMA will be amended
- Aiming for Royal Assent by mid-2012
- Cut-over to new regime in late 2012?

Transition to new structure

- Internal FSA reorganisation on 4 April 2011
- First step on the road to becoming two regulators
- Supervision and Risk business units to go
- Replaced by two new business units
 - Prudential Business Unit (PBU)
 - Consumer & Markets Business Unit (CMBU)

European Supervisory Authorities



Policy set at EU level

The role and mandate of the new European Insurance and Occupational Pensions Authority (EIOPA) means that “going forward, the FSA and successor authorities will thus essentially be a supervisory arm of an EU policy setting body.”

Hector Sants



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Overview of key European developments for regulation of derivatives

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Objectives

Overview and status of:

- EU Regulation on OTC derivatives, central counterparties and trade repositories (European Market Infrastructure Regulation – EMIR)
- Markets in Financial Instruments Directive (MiFID) review
- Proposed regulation on short selling and certain aspects of credit default swaps

European Market Infrastructure Regulation

- Proposed regulation published on 15 September 2010
- When enacted will be directly applicable in all EU member states
- Member States undertook to conclude negotiations relating to G20 commitments on financial reform by end 2011
- In line with G20 commitments, the new rules should be fully in place and operational during 2012.
- Currently in draft only and being discussed and debated

European Market Infrastructure Regulation

Clearing Obligation:

- Duty on financial counterparties to clear “eligible” OTC derivatives through a central counterparty (CCP)
- Financial counterparty definition is broad capturing banks, investment firms, insurance companies, registered UCITS funds, pension funds and alternative investment fund managers
- Non-financial counterparties will be subject to clearing obligation where take positions that exceed a clearing threshold (to be specified)
- Eligibility derivatives for clearing to be determined by “bottom up” and “top down” approach

European Market Infrastructure Regulation

Risk management for non-cleared contracts:

- For non-cleared contracts, financial counterparties and non-financial counterparties subject to a clearing obligation are obliged to adopt appropriate procedures to measure, monitor and mitigate risk (e.g. by electronic confirmations, margining and marking to market)

Reporting:

- Financial counterparties required to report all OTC transactions (whether cleared or not) to trade repository or, if cannot report to repository, to home state regulator
- Non-financial counterparties required to report where take positions that exceed information threshold (to be specified)
- Information held by repository to be available to regulatory authorities

European Market Infrastructure Regulation

Regulation of CCPs:

- Framework of common requirements to be imposed on CCPs regarding systems and resources to ensure consistent regulation
- e.g. non-discriminatory access to CCPs, rules on supervision and authorisation, and rules on segregation and prudential requirements

European Market Infrastructure Regulation

Comparison with Dodd-Frank:

- EMIR is broadly similar in many respects to US reforms under Dodd-Frank Wall Street Reform and Consumer Protection Act
- There are, however, a number of important differences. This may lead to the possibility of regulatory arbitrage
- There is also the possibility that some participants may be caught by conflicting requirements
- Ultimate scope will also depend on implementing rules and regulations

MiFID Review

- MiFID came into force on 1 November 2007
- Now under review in light of market events and developments since 2007
- The proposed amendments cover a number of areas
- Consultation closed on 2 February 2011 and legislative proposals expected in spring 2011

MiFID Review

In respect of derivatives, key developments include:

- Mandatory requirement for all clearing eligible and sufficiently liquid derivative contracts, as determined by the European Securities and Markets Authority, to be traded on a regulated market, multi-lateral trading facility or an organised trading facility
- Application of pre-and post-trade transparency regime to derivative contracts
- Position reporting obligation on commodity derivative exchanges and narrowing of exemptions available to commodity derivative firms.

Proposed Regulation on Short Selling

- In September 2010, the EU Commission published a proposal for a regulation on short selling and credit default swaps
- In part a response to suggestions that speculative trading and short selling had increased volatility of European sovereign debt markets
- Regulation intended to be operational in 2012
- Regulation in draft only and subject to discussion and debate. e.g. recent debates amongst members states and European parliament over whether to ban “uncovered” sovereign CDS

Proposed Regulation on Short Selling

Key proposals relate to:

Transparency

- Disclosure to competent authorities and to the market of net short positions in shares traded on an EU trading venue and at or above certain thresholds
- Flagging of short sales of shares executed on an EU trading venue
- Private disclosure of net short positions in EU sovereign debt and uncovered CDS referencing EU sovereign debt above certain thresholds

Proposed Regulation on Short Selling

Uncovered short selling

- Restriction on uncovered short sales of shares and EU sovereign debt instruments unless borrowed financial instrument or made other arrangements to settle.
- Includes proposals for buy-ins, cash compensation, fines and prohibitions on further short selling to deter settlement failures

Powers of Intervention

- Powers for competent authorities to impose additional transparency requirements and restrict certain activities including preventing persons entering into sovereign CDS or limiting the value of uncovered CDS that may be entered into

Others

- These measures are part of other broader regulatory changes and initiatives. For example:
- Changes in regulatory architecture
- Capital Requirements Directive and counterparty credit risk