

# OTC Derivatives Regulatory Update

September 2010

## OTC CLEARING

On September 15, 2010, the European Commission published two legislative proposals that will influence the future direction of OTC derivatives markets. The proposed EU legislation is, in principle, similar to the Dodd-Frank Act in relation to the regulation of OTC derivatives markets, but there are differences of which investors need to be aware.

### OTC derivatives, central counterparties and trade repositories

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The proposal for new regulation related to OTC derivatives, central counterparties and trade repositories, often referred to as the European Markets Infrastructure Regulation (EMIR), has many elements that are consistent with the recently enacted Dodd-Frank Act in the U.S., specifically:

- A broad set of OTC derivatives will be mandated for clearing through a clearinghouse (often referred to as a central counterparty, or CCP).
- Most investors, with the exception of certain corporate users, will be subject to the mandatory clearing requirement.
- Both cleared and non-cleared OTC derivative trades are required to be reported to a trade repository.
- Non-cleared trades are subject to additional monitoring of operational and counterparty risk measures, including increased capital charges as compared to cleared trades.

### Short-selling and certain aspects of Credit Default Swaps

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In addition to EMIR, draft legislation was proposed for short selling and certain aspects of Credit Default Swaps (CDS), including:

- Increased transparency on short positions in shares and sovereign bonds where the principal trading venue is in the EU, including disclosure thresholds for reporting net short positions to regulators / public and disclosure obligations to regulators for net short positions in sovereign debt.
- Regulators will have the ability to impose restrictions, require disclosure and ban trading on any financial instrument in exceptional circumstances.
- Exemptions will be adopted for market-making activities.
- There are restrictions for uncovered / naked short sales.

In this bulletin, we focus on the EMIR legislation and its impact on investors.

### The process and timeline from legislation to enactment

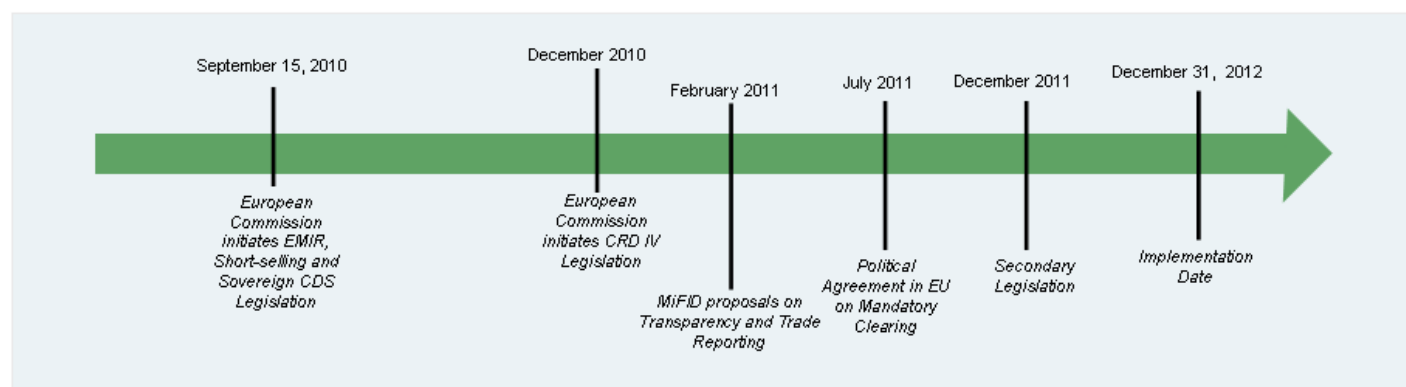
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As noted above, EMIR was adopted by the European Commission on September 15, 2010. The proposal now moves into the “co-decision” phase in the European Parliament and European Council, where each body will separately negotiate and finalize its own text. Political agreement on the regulation is not expected until at least June 2011. As EMIR is currently drafted, the European Commission proposes that secondary legislation should be finalized by the EU Securities and Markets Authority (ESMA) before December 31, 2012, suggesting effective implementation of the regulation could be the first half of 2013. In his speech of September 15, EU Internal Market Commissioner Barnier highlighted the importance of international co-operation and the implementation of the G20 recommendations, which include an end of 2012 date for a completion of financial regulatory reform, which includes mandatory clearing.

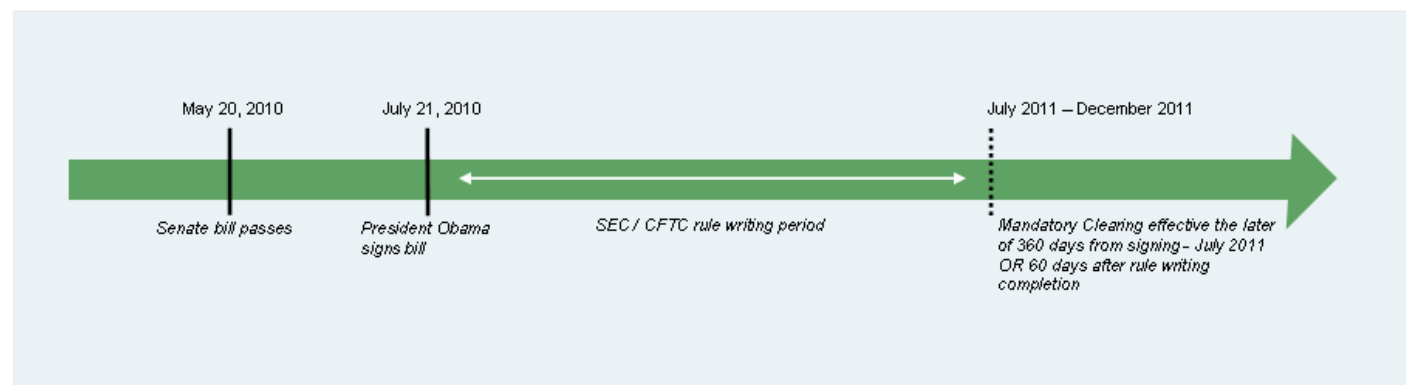
In addition to EMIR, there are several other pieces of forthcoming legislation that will impact investors in OTC derivatives. These include:

- Capital Requirements Directive (“CRD IV”), targeted for publication by the European Commission by the end of 2010. This will likely include higher capital requirements for non-CCP cleared transactions.
- Updated MiFID review targeted for publication by the European Commission by early 2011, and will likely include additional transparency rules and guidance for trading venues and position limits for derivatives.

The following depicts the expected timeline for the key dates of the various pieces of legislation:



In contrast, the Dodd-Frank Act was signed into law in July 2010, and regulators (the CFTC and the SEC) were provided with at least 360 days to enact the required rules to adopt the legislation. It is therefore conceivable that certain provisions of the Dodd-Frank Act, such as mandatory clearing of certain OTC derivatives, could be implemented as soon as July 2011.



## A side-by-side comparison of the EU and U.S. OTC derivatives legislation

While the approaches adopted by both the proposed EU legislation and the Dodd-Frank Act in relation to the regulation of OTC derivatives markets are broadly similar, there are also some significant differences of which investors need to be aware. In the table below we summarise how both the proposed EU legislation and the Dodd-Frank Act consider different categories of counterparties and highlights certain other differences between both texts in relation to the trading and clearing of OTC derivatives.

	EU (EMIR)	U.S. (Dodd-Frank Act)
<b>Product scope</b>	All categories of OTC derivatives, including interest rate, credit, foreign exchange, equities and commodities, but limited to derivatives on specified underlyings. Spot foreign exchange (FX) transactions appear to be excluded, as are commercial forward foreign exchange transactions and some kinds of physically settled commodities.	A broad class of OTC derivatives that are commonly known as swaps. Spot FX does not appear to be included, and the Treasury Secretary has the ability to exempt both FX swaps and forwards from the clearing obligation (but not other obligations within the Act). Certain physically settled commodity transactions (but different from the EU exclusions) and certain physically settled forward transactions in securities are also excluded.
<b>Products subject to mandatory clearing requirement</b>	The EU Securities and Markets Authority (ESMA) determines which OTC derivatives are subject to mandatory clearing. This may be on its own initiative, in consultation with the European Systemic Risk Board (ESRB), known as the “top-down” approach, or pursuant to a CCP, after receiving authorization from its primary regulator, requesting an approval, known as the “bottom-up” approach. ESMA shall base its decision on the following criteria: <ul style="list-style-type: none"> <li>Reduction of systematic risk in the financial system</li> <li>Liquidity of contracts</li> <li>Availability of pricing information</li> <li>Ability of CCPs to handle the volume of contracts</li> <li>Level of client protection provided by the CCPs</li> </ul>	Regulators (eg, the CFTC and the SEC) make a determination as to which OTC derivatives are subject to mandatory clearing, while clearinghouses submit lists of proposed categories of clearable swaps for review. The evaluation criteria differ from the EU, and include: <ul style="list-style-type: none"> <li>The outstanding notional exposures</li> <li>Trading liquidity</li> <li>Adequate pricing data</li> <li>Available infrastructure needed for clearing</li> <li>The effect on competition, including appropriate fees and charges applied to clearing</li> </ul> <p>The US regulators can also take action if no CCP currently clears a contract; this provision requires further clarification in the rule-making stages.</p>
<b>End-users required to clear</b>	The clearing obligation applies to financial counterparties, which includes banks, investment firms, insurance companies, registered funds (UCITS), pension funds and alternative investment fund managers.	The clearing obligation applies to anyone who enters into a derivative subject to the clearing obligation, other than those end-users who are exempt (as described below).
<b>Scope of end-user exemption</b>	Corporate end-users are not required to clear if it is using the derivative for hedging or mitigating commercial risk. These users could become subject to the mandatory clearing obligation (and have to notify the relevant regulators) if its positions that are not commercial hedges exceed a certain clearing threshold, which will be set by the regulators.	If one of the parties to the trade 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. Parties opting out are required to notify the regulators of their intention to do so. The definition of financial entity covers swap dealers, major swap participants (covers certain users of derivatives, other than dealers, with potentially systematically important positions), commodity pools, private funds, employee benefit plans and other entities predominantly engaged in business or financial activities.
<b>Reporting obligations</b>	Financial counterparties must report the details of all their OTC derivative contracts to a registered trade repository.	Any swap must be reported to a registered trade repository.
<b>Risk mitigation for non-cleared trades</b>	Products not required to be cleared carry new obligations, in addition to reporting, including: <ul style="list-style-type: none"> <li>Electronic confirmation</li> <li>Tracking of valuations</li> <li>Reconciliation of portfolios</li> <li>Proactively manage collateral</li> <li>Link to capital requirements where applicable</li> </ul>	Imposes capital and market requirements on swap dealers and major swap participants that enter into uncleared swap transactions. There are also provisions giving counterparties the right to require swap dealers or major swap participants to segregate initial margin on uncleared swaps.
<b>Territorial scope</b>	The clearing obligation applies to any transaction where one leg of the trade is in the EU.	Because many of the key elements of the Act are subject to pending regulatory rule-making, the territorial reach of the Act outside of the U.S. is uncertain.
<b>Backloading</b>	Required to submit to trade repositories.	No clearing requirement, but required to submit to trade repositories.
<b>Mandatory electronic trading</b>	No equivalent provisions in the proposed EU Regulation, but due to be addressed in a MiFID review in Q1 2011.	The Bill requires that swaps eligible for clearing must be traded on an exchange or executed through a swap (or security-based swap) execution facility (“SEF”), if the relevant instrument is listed by an Exchange or traded on a SEF. The Bill defines a SEF as, generally, a trading system or platform in which multiple participants have the ability to execute or trade derivatives by accepting bids and offers made by other participants, including a facility that facilitates the execution of security-based swaps in particular. Swap Execution Facilities must be registered as such (or as a “designated contract market” under either the Commodity Exchange Act or the Securities Exchange Act) and comply with certain core principles (including timely publication of trade data to the extent prescribed by the relevant commission).

<b>Effective date</b>	The proposed EU Regulation would enter into force 20 days after official publication, but CCPs that have an existing national authorization would have two years to obtain authorization. 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).	The Bill sets timelines for the relevant regulators to craft implementing regulations - the default effective date is 360 days after enactment, or where rule making is required, 60 days after publication of the rule. Many provisions include additional transition periods for compliance by affected institutions. For example, the swaps push-out rule provides for a 24 month implementation window (plus an extension right).
<b>Regulation of CCPs</b>	CCPs will be regulated by their local authorities, while ESMA will have some supervisory, review and approval powers.	Dodd-Frank gives the US regulators powers to regulate CCPs.
<b>CCP ownership limits</b>	No provisions in the proposed EU Regulation equivalent to Dodd-Frank, although holders of direct or indirect significant shareholdings in a registered CCP will require approval. Like Dodd-Frank, the EU Regulation also imposes requirements on CCPs and others to manage conflicts of interest.	Dodd-Frank provides US regulators with the authority to determine whether to limit ownership of CCPs. The Act also imposes requirements on CCPs and others to manage conflicts of interest.
<b>Regulation of trade repositories</b>	The proposed EU Regulation sets out certain high level requirements for trade repositories but does not confer powers to adopt acts/standards to implement those requirements. The text contemplates that certain EU regulators and central banks will have access to information, but does not directly address disclosure to other EU or non-EU regulators.	Dodd-Frank gives the US regulators powers to regulate trade repositories. Specific provisions allow repositories to disclose information on request to domestic and foreign regulators, subject to certain requirements.
<b>Derivatives “push out” / Volcker rule</b>	No equivalent provisions in the proposed EU Regulation.	The swap push-out rule prohibits “Federal assistance” to any “swaps entity” “with respect to any swap, security-based swap or other activity of such swaps entity” “Federal assistance” includes access to the Fed discount window and FDIC insurance. Consequently, subject to specific exceptions, the rule requires FDIC insured banks engaging in substantial covered derivatives activity within a captive investment banking business unit to spin that activity out of the bank entity into a different, separately capitalized entity. The Dodd-Frank Act also introduces a restriction on proprietary trading by banking groups (the “Volcker rule”).
<b>Business conduct</b>	No equivalent provisions in the proposed EU Regulation.	The bill prescribes a high code of conduct covering anti-fraud and manipulation, conflicts of interest, documentation and back office standards and compliance with position limits. Special requirements apply to trades with governmental entities, pension plans and endowments, including requiring these entities to have independent advisors.

As we mention earlier, the proposed EU legislation is subject to amendment during the legislative process. We anticipate further work to be done on the text of the proposed legislation - for example, the proposed text does not deal with many of the issues related to the territorial application of the rules or the transitional arrangements.

Similar to Dodd-Frank, the proposed EU legislation envisages that there will be extensive regulatory technical standards and rule implementations to follow that will have a significant effect on how the regime will operate in practice. We expect to share further guidance on both legislations as the rule-making takes shape over the coming quarters.

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