



Procedure file

Basic information		
INI - Own-initiative procedure	2010/2008(INI)	Procedure completed
Derivatives markets: future policy actions		
Subject 2.50.03 Securities and financial markets, stock exchange, CIUTS, investments		

Key players			
European Parliament	Committee responsible	Rapporteur	Appointed
	ECON Economic and Monetary Affairs		20/10/2009
		PPE LANGEN Werner	
	Committee for opinion	Rapporteur for opinion	Appointed
	DEVE Development		17/03/2010
		Verts/ALE JOLY Eva	
	JURI Legal Affairs	The committee decided not to give an opinion.	
Council of the European Union	Council configuration	Meeting	Date
	Economic and Financial Affairs ECOFIN	3015	18/05/2010
European Commission	Commission DG	Commissioner	
	Financial Stability, Financial Services and Capital Markets Union	BARNIER Michel	

Key events			
20/10/2009	Non-legislative basic document published	COM(2009)0563	Summary
21/01/2010	Committee referral announced in Parliament		
18/05/2010	Debate in Council	3015	Summary
02/06/2010	Vote in committee		Summary
07/06/2010	Committee report tabled for plenary	A7-0187/2010	
14/06/2010	Debate in Parliament		
15/06/2010	Results of vote in Parliament		
15/06/2010	Decision by Parliament	T7-0206/2010	Summary
15/06/2010	End of procedure in Parliament		

Technical information	
Procedure reference	2010/2008(INI)
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Stage reached in procedure	Procedure completed
Committee dossier	ECON/7/01724

Documentation gateway

Non-legislative basic document		COM(2009)0563	20/10/2009	EC	Summary
Committee draft report		PE438.493	11/02/2010	EP	
Amendments tabled in committee		PE440.018	13/04/2010	EP	
Committee opinion	DEVE	PE440.100	28/04/2010	EP	
Committee report tabled for plenary, single reading		A7-0187/2010	07/06/2010	EP	
Text adopted by Parliament, single reading		T7-0206/2010	15/06/2010	EP	Summary
Commission response to text adopted in plenary		SP(2010)6508	27/10/2010	EC	

Derivatives markets: future policy actions

PURPOSE: to set out future actions to strengthen the safety of derivatives markets.

BACKGROUND: derivatives play a useful role in the economy: they can be used to transfer (all or part of) the risks inherent to economic activity from economic agents who are not willing to bear them to those who are. However, they also contributed to the financial turmoil by allowing leverage to increase and by interconnecting market participants, a fact which went unnoticed because of the lack of market transparency, resulting from the predominant over-the-counter (OTC) market structure.

Already in July this year, the Commission identified four complementary tools to reduce the negative impact of OTC derivatives markets on financial stability: (i) increase standardisation, (ii) use trade repositories, (iii) strengthen the use of Central Counter-party clearing houses (CCPs), and (iv) increase the use of organised trading venues (see [COM\(2009\)0332](#)). The proposed tools have been the subject of a stakeholder consultation and were debated at a high-level conference on 25 September 2009.

The Commission believes that a paradigm shift must take place away from the traditional view that derivatives are financial instruments for professional use, for which light-handed regulation was thought sufficient, towards an approach where legislation allows markets to price risks properly.

CONTENT: this Communication examines the main shortcomings of the current derivatives market organisation as concerns both OTC and derivatives traded on organised trading venues. It outlines the policy actions the Commission intends to take in 2010 to address these problems and thus meet the need for greater stability and transparency in these markets as recognised by the De Larosière report, the June 2009 European Council conclusions and the G20. All legislative and other proposals to give effect to the policy orientations will be subject to appropriate impact assessment. The proposed measures will shift derivative markets from predominantly OTC bilateral to more centralised clearing and trading.

The Communication notes that the various derivatives market segments differ in their characteristics, namely in terms of risk, operational arrangements and market participants. In principle, the Commission believes that a comprehensive policy on derivatives is necessary in order to avoid market participants exploiting differences in rules, i.e. regulatory arbitrage. However, where justified, the policy proposals take into account the specificities of the asset class and contracts involved as well the specificities of the market participants, also striking the right balance between financial and non-financial institutions. At the same time the Commission will take into account the specificities of certain commodity markets, e.g. electricity and gas markets, which are particular in their underlying physical market structure.

The future policy actions set out in the Communication aim to do the following:

Reduce counterparty risk: the crisis has shown, inter alia, that market participants did not price counterparty credit risk correctly. Clearing is the way by which this risk is mitigated. Clearing can either occur bilaterally between the two counterparties or at central market level, by means of a central counterparty (CCP), thus involving appropriate collateralisation. The Commission aims to strengthen the clearing of derivatives both at central and bilateral level. It will reduce counterparty risk by proposing legislation on CCP requirements, governing: (a) safety requirements (e.g. conduct of business, governance, risk management, legal protection of collateral and positions); (b) authorisation/withdrawal of authorisation and supervision of CCP; (c) mandating of CCP clearing of standardised derivatives. It will also amend Directive 2006/48/EC (the [Capital Requirements Directive](#) (CRD)) in order to: (a) mandate financial firms supplying initial and variation margin; (b) substantially differentiate capital charges between CCP cleared and non-CCP cleared contracts in CRD.

Reduce operational risk: operational risk relates to losses resulting from inadequate or failed internal processes, or from external events, and includes legal risk. The market has been making efforts to reduce operational risk. For example, market practice has generated standard legal

documentation for a considerable part of the derivatives market. Moreover, market participants have gradually moved to electronic processing of trades. These efforts are likely to be boosted by the mandatory use of data repositories and the widening use of central clearing. They will result in more standardisation of contracts in terms of electronic processing and standard legal terms (without affecting the economic terms of the contracts), which will also facilitate central clearing. However, the Commission considers that ongoing industry efforts to reduce operational risks should be reinforced. It proposes to assess whether to re-shape the operational risk approach in the CRD to prompt standardisation of contracts and electronic processing, and to work with industry to increase standardisation of legal regimes and processes.

Increase transparency: OTC derivatives markets have clearly suffered from a lack of transparency of prices, transactions and positions. The lack of transparency to regulators and the market has varied with time and across products, but has overall hindered regulators from efficiently supervising derivatives markets in terms of systemic risk and market abuse. For market participants, it has created difficulties in accessing reliable prices, assessing risks, valuing positions, and checking best execution. Accordingly the Commission will propose legislation on trade repositories: (a) to regulate trade repositories; (b) to mandate reporting of OTC derivatives transactions to trade repositories. With regard to trading on organised markets, it will (a) amend MiFID to require transaction and position reporting to be developed in conjunction with CCPs and trade repositories; and (b) ensure trading of standardised contracts on organised trading venues under MiFID.

Enhance market integrity and oversight: the review of the [Market Abuse Directive in 2010](#) will extend relevant provisions in order to cover derivatives markets in a comprehensive fashion. In the context of efforts to align the rules applicable to physical and financial energy markets, a tailor-made proposal for the EU level oversight of electricity and gas spot markets is envisaged ensuring transparency and market integrity. Similarly, the Commission is to examine by end-2010 whether the market for emission allowances is sufficiently protected from insider dealing and market manipulation and, if appropriate, bring forward proposals to ensure it. Lastly, the Commission intends to propose rules to give regulators the possibility of setting position limits to counter disproportionate price movements or concentrations of speculative positions.

The Commission concludes that its general approach will limit the potential for loopholes and regulatory arbitrage. It will begin the process of drafting legislation, notably by launching impact assessments, in order to come forward with ambitious legislation to regulate derivatives in 2010. When finalising these proposals, the Commission will work closely with all stakeholders in the EU as well as with its global partners.

Derivatives markets: future policy actions

The Council took note of a presentation by commissioner Michel Barnier of the Commission's work programme for financial services.

It held a brief exchange of views on the approach to be followed.

At an extraordinary meeting on 9 May 2010, the Council underscored the need to make rapid progress on financial market regulation and supervision, in particular with regard to derivative markets and the role of rating agencies. It also emphasised the need to work on a "stability fee" to ensure that in future, in the event of a crisis, the financial sector bears its share of the burden incurred.

Derivatives markets: future policy actions

The Committee on Economic and Monetary Affairs adopted the own-initiative report drafted by Werner LANGEN (EPP, DE) in response to the Commission's communication entitled "Ensuring efficient, safe and sound derivatives markets: Future policy actions".

Noting that the lack of transparency and regulation in the derivatives market played an exacerbating role in the financial crises, Members welcome the Commission's initiative for better regulation of derivatives, and in particular over-the-counter (OTC) derivatives with a view to reducing the impact of the risks in the OTC derivatives markets for the stability of financial markets as a whole.

In particular, they back the calls for legal standardisation of derivatives, the use and strengthening of central clearing houses and the use of organised trading venues.

Pre-trade transactions: the report calls for more transparency on pre-trade transactions for all instruments that qualify for the extensive use of organised

trading venues as well as for increased post-trade trade transparency through reporting of all transactions to repositories, to the benefit of both regulators and investors.

Strengthening CCPs (central counterparty clearing facilities): Members back the call for the compulsory introduction of CCP clearing between financial institutions for all eligible derivative products with a view to ensuring better assessment of counterparty credit risk, and support the objective that as many eligible derivative products as possible should be traded on organised markets. They call for provision of incentives that encourage the trading of eligible derivative products on trading venues regulated by the Markets in Financial Instruments Directive (MiFID), i.e. on regulated markets and multilateral trading facilities (MTFs). They note that one criterion for clearing eligibility must be liquidity.

Members insist that, in future, derivative prices must better reflect risk and that the costs of the future market infrastructure must be borne by market participants and not by taxpayers.

They consider that individually negotiated derivatives are required to hedge special risks and therefore oppose the compulsory standardisation of all derivatives.

The report calls on the Commission to look into ways of significantly reducing the overall volume of derivatives so that the volume is proportionate to the underlying securities in order to avoid a distortion of price signals, to reduce the risk to market integrity and to cut down systemic risk.

The Commission is called upon to give a strong role in the authorisation of European clearing houses to the European Securities and Markets Authority (ESMA).

Adjusting capital requirements: Members consider that, through clearing, collateral by adjusting capital requirements and through other regulatory tools counterparty credit risk can be reduced. They support the Commission in proposing higher capital requirements for financial institutions in the case of bilateral derivative contracts that are ineligible for central clearing, based on a risk-proportionate approach and taking

into account the effects of netting, collateral, initial margin, daily portfolio reconciliations, daily margining, automated collateral movements and other bilateral counterparty risk management techniques in counterparty risk reduction.

Competition: Members insist that CCPs must not be organised wholly by users, that their risk management systems must not be in competition with each other, and that regulatory arrangements for clearing costs must be envisaged. They call on the Commission to address these concerns in its legislative proposal and to set governance and ownership rules for clearing houses, with regard inter alia to the independence of directors, membership and close supervision by regulators. The Commission must pay close attention to the possible development of technological differences, discriminatory practices and work-flow barriers which are harmful to competition. In this context, Members call for conduct-of-business and access rules governing CCPs to ensure non-discriminatory access by trading venues.

Members call for binding procedural rules to be established to prevent distortions of competition and to ensure equal interpretation in the Member States and, furthermore, for ESMA to have supreme decision-making authority in disputes. The Commission is called upon to draw up reporting standards for all derivative products consistent with standards being elaborated at an international level. Measures should also be developed to ensure that regulators are able to set position limits to counter disproportionate price movements and speculative bubbles.

The report considers careful clarification of all technical details to be necessary, in close cooperation with national regulators, in particular as regards standards and the distinction between financial-market products and non-financial-market products.

The Commission is backed in its plan to establish CCPs under agreed European standards, overseen by ESMA. Members demand that key market participants should not have a controlling influence on the governance and risk management of the CCPs but should be included in the risk management board. They insist on the need to have regulatory standards to ensure that CCPs remain resilient to a broader set of risks, including multiple participant failures, sudden sales of financial resources and rapid reduction in market liquidity.

They call, therefore, for clear rules of conduct and the necessary compulsory standards as regards the setting-up of CCPs (involvement of users) and the decision-making procedures and risk management systems used by them. They support the Commission in its intention to propose a regulation governing clearing houses.

Credit default swaps: Members call, as a matter of priority, for credit default swaps (CDS) to be made subject to independent central clearing and for as many derivatives as possible to be settled centrally by CCPs. They believe that individual types of derivative with cumulative risks should, if necessary, be authorised only conditionally or even, on a case-by-case basis, prohibited. The Commission should come forward with appropriate legislative proposals to regulate financial transactions involving naked selling of derivatives in order to ensure financial stability and transparency of prices. It takes the view that, pending that, credit-default swaps (CDSs) should be processed through a European CCP in order to mitigate counterparty risks, increase transparency and reduce the overall risks.

Members are of the opinion that all financial derivatives that concern public finances in the EU (including sovereign debt of Member States and local administration balance sheets) must be standardised and traded on exchange or other regulated trading platforms in order to promote transparency of derivatives markets for the public.

They call for a ban on CDS transactions with no underlying credit which are purely speculative transactions involving bets on credit defaults, thereby leading to an artificial rise in the cost of credit default insurance and, consequently, to increased systemic risks through actual credit defaults. They call on the Commission to consider upper risk limits for derivatives, particularly CDSs, and to agree on them with international partners.

Members call for the planned regulation of derivatives to include rules relating to the banning of purely speculative trading in commodities and agricultural products, and the imposition of strict position limits especially with regard to their possible impact on the price of essential food commodities in developing countries and greenhouse gas emission allowances.

Lastly, the committee welcomes the Commission's intention to submit legislative proposals on clearing houses and trade repositories as early as mid-2010 and to discuss the technical details with all institutions at national and EU level, in particular the Council-Parliament legislative authority, at an early stage.

Derivatives markets: future policy actions

The European Parliament adopted a resolution on derivatives markets (future policy actions) in response to the Commission's communication on the same subject.

Parliament welcomes the Commission's initiative for better regulation of derivatives, and in particular OTC derivatives with a view to reducing the impact of the risks in the OTC derivatives markets for the stability of financial markets as a whole, and backs the calls for legal standardisation of derivatives contracts (inter alia through regulatory incentives in the Capital Requirements Directive (CRD) regarding operational risk), the use of trade repositories and centralised data storage, the use and strengthening of central clearing houses and the use of organised trading venues.

Increasing transparency: Parliament welcomes the Commission's paradigm shift towards greater regulation of OTC derivatives markets, abandoning the prevailing view that derivatives need no further regulation, chiefly because they are used by experts and specialists. It calls, therefore, for future legislation to secure not only transparency in the derivatives markets but also sound regulation. The resolution calls for more transparency on pre-trade transactions for all instruments that qualify for the extensive use of organised trading venues as well as for increased post-trade transparency through reporting of all transactions to repositories, to the benefit of both regulators and investors.

Strengthening CCPs (central counterparty clearing facilities): Members back the call for the compulsory introduction of CCP clearing between financial institutions for all eligible derivative products with a view to ensuring better assessment of counterparty credit risk, and support the objective that as many eligible derivative products as possible should be traded on organised markets. They call for provision of incentives that encourage the trading of eligible derivative products on trading venues regulated by the Markets in Financial Instruments Directive (MiFID), i.e. on regulated markets and multilateral trading facilities (MTFs). They note that one criterion for clearing eligibility must be liquidity.

Members insist that, in future, derivative prices must better reflect risk and that the costs of the future market infrastructure must be borne by market participants and not by taxpayers.

They consider that individually negotiated derivatives are required to hedge special risks and therefore oppose the compulsory standardisation

of all derivatives.

The resolution calls on the Commission to look into ways of significantly reducing the overall volume of derivatives so that the volume is proportionate to the underlying securities in order to avoid a distortion of price signals, to reduce the risk to market integrity and to cut down systemic risk. The Commission is called upon to give a strong role in the authorisation of European clearing houses to the European Securities and Markets Authority (ESMA).

Reducing counterparty risk: Parliament considers that, through clearing, collateral by adjusting capital requirements and through other regulatory tools counterparty credit risk can be reduced. It supports the Commission in proposing higher capital requirements for financial institutions in the case of bilateral derivative contracts that are ineligible for central clearing, based on a risk-proportionate approach and taking into account the effects of netting, collateral, initial margin, daily portfolio reconciliations, daily margining, automated collateral movements and other bilateral counterparty risk management techniques in counterparty risk reduction.

Members insist that CCPs must not be organised wholly by users, that their risk management systems must not be in competition with each other, and that regulatory arrangements for clearing costs must be envisaged. They call on the Commission to address these concerns in its legislative proposal and to set governance and ownership rules for clearing houses, with regard inter alia to the independence of directors, membership and close supervision by regulators. The Commission must pay close attention to the possible development of technological differences, discriminatory practices and work-flow barriers which are harmful to competition.

Members call for conduct-of-business and access rules governing CCPs to ensure non-discriminatory access by trading venues, with the issues to be addressed including discriminatory pricing practices.

Repositories: Parliament backs the introduction of repositories for all derivatives positions, ideally distinguished by asset class and regulated and supervised under ESMA direction. It calls for binding procedural rules to be established to prevent distortions of competition and to ensure equal interpretation in the Member States and, furthermore, for ESMA to have supreme decision-making authority in disputes. It calls for the Commission to ensure that national supervisory authorities have real-time access to granular data in repositories that relate to market participants based within their jurisdiction and to data that relate to potential systemic risk that might be built up in their jurisdiction, as well as access to aggregate data from all repositories including those held in repositories based in third countries.

The Commission is called upon to draw up reporting standards for all derivative products consistent with standards being elaborated at an international level. Measures should also be developed to ensure that regulators are able to set position limits to counter disproportionate price movements and speculative bubbles. Parliament asks the Commission to ensure in particular that the valuation of all derivatives that are not traded on exchange is conducted in an independent and transparent way, avoiding conflicts of interest.

The resolution considers careful clarification of all technical details to be necessary, in close cooperation with national regulators, in particular as regards standards and the distinction between financial-market products and non-financial-market products.

The Commission is backed in its plan to establish CCPs under agreed European standards, overseen by ESMA. Members demand that key market participants should not have a controlling influence on the governance and risk management of the CCPs but should be included in the risk management board. They insist on the need to have regulatory standards to ensure that CCPs remain resilient to a broader set of risks, including multiple participant failures, sudden sales of financial resources and rapid reduction in market liquidity.

The resolution calls, therefore, for clear rules of conduct and the necessary compulsory standards as regards the setting-up of CCPs (involvement of users) and the decision-making procedures and risk management systems used by them.

Credit default swaps: Members recall that the recent events involving sovereign credit default swaps used by financial speculators led to unjustified high levels of several national spreads. Those events and practices highlighted the need for further market transparency and for enhanced European regulation vis-à-vis trading of credit default swaps, in particular those connected to sovereign debts.

Parliament calls, as a matter of priority, for credit default swaps (CDS) to be made subject to independent central clearing and for as many derivatives as possible to be settled centrally by CCPs. It believes that individual types of derivative with cumulative risks should, if necessary, be authorised only conditionally or even, on a case-by-case basis, prohibited. The Commission should come forward with appropriate legislative proposals to regulate financial transactions involving naked selling of derivatives in order to ensure financial stability and transparency of prices. It takes the view that, pending that, credit-default swaps (CDSs) should be processed through a European CCP in order to mitigate counterparty risks, increase transparency and reduce the overall risks. Parliament demands that CDS protection should be payable only upon production and proof of an underlying bond exposure and be limited to the amount of this exposure.

Members are of the opinion that all financial derivatives that concern public finances in the EU (including sovereign debt of Member States and local administration balance sheets) must be standardised and traded on exchange or other regulated trading platforms in order to promote transparency of derivatives markets for the public.

They call for a ban on CDS transactions with no underlying credit which are purely speculative transactions involving bets on credit defaults, thereby leading to an artificial rise in the cost of credit default insurance and, consequently, to increased systemic risks through actual credit defaults. They call on the Commission to consider upper risk limits for derivatives, particularly CDSs, and to agree on them with international partners.

The resolution calls for the planned regulation of derivatives to include rules relating to the banning of purely speculative trading in commodities and agricultural products, and the imposition of strict position limits especially with regard to their possible impact on the price of essential food commodities in developing countries and greenhouse gas emission allowances.

Lastly, Members welcome the Commission's intention to submit legislative proposals on clearing houses and trade repositories as early as mid-2010 and to submit legislative proposals on CDSs.