



**COUNCIL OF
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Derivatives: Council's position updated ahead of talks with EP

The Council today¹ adjusted its position in negotiations with the European Parliament on a draft regulation aimed at increasing transparency on all derivatives and reducing risk in the over-the-counter² (OTC) derivatives market.

This is designed to facilitate rapid agreement with the Parliament, so as to enable the regulation to be adopted in first reading.

The main change to a general approach agreed by the Council in October relates to the procedure for authorising central counterparties (CCPs)³, in particular to the powers of the CCP's "home" member state, i.e. the member state of establishment, versus those of the college of supervisors⁴ and the European Securities and Markets Authority (ESMA).

A general approach agreed in October specified that a CCP authorisation by a member state competent authority could only be blocked by a negative opinion of the college supported by a "unanimity minus one" vote (i.e. all the members of the college, excluding the authorities of the "home" member state). However, in order to facilitate agreement with the Parliament, which is pushing for a stronger role for the college and for ESMA, the Council today approved a proposal by the presidency which would introduce two additional safeguards, whereby:

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- ¹ The agreement was reached at a meeting of the Economic and Financial Affairs Council.
 - ² A derivative not traded on an exchange but instead privately negotiated between two counterparts.
 - ³ CCPs are entities that interpose themselves between the two counterparties to a transaction and thus become the 'buyer to every seller', as well as the 'seller to every buyer'.
 - ⁴ The college will consist of the competent authorities supervising the CCP as well as the entities which might be affected by its operations.

P R E S S

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- following a negative opinion of the college, with "unanimity minus one", the "home" member state can refer the matter to ESMA for binding mediation.
- when a "sufficient" majority in the college opposes authorisation of a CCP, this "sufficient majority" may then decide to put the issue to ESMA for binding mediation. The Council's position defines a "sufficient" majority as two-thirds of college members, with votes in the college limited to two per member state for colleges of up to and including 12 members and three for colleges above that size.

Negotiations over the past weeks also produced compromises on the following two issues:

- Pension schemes would be exempt from a clearing obligation for a period of three years, extendable by another two years plus one year, subject to reports justifying the deferrals.
- CCPs from third countries would only be recognised in the EU if the legal regime of the respective third country provides for an effective equivalent system for the recognition of CCPs authorised under foreign legal regimes. However, this approach would not constitute a precedent for other legislation on the supervision and oversight of financial market infrastructures.

Background

The draft regulation calls for:

- the *clearing* of standardised¹ OTC derivative contracts through CCPs in order to reduce counterparty risk (i.e. the risk of default by one party to the contract). This is aimed at preventing the default of one market participant causing the collapse of other market players, thereby putting the entire financial system at risk. To be authorised, a CCP would have to hold a minimum amount of capital. Specifically, the draft regulation requires a CCP to have a mutualised default fund to which members of the CCP would have to contribute.
- the *reporting* of all derivative contracts to trade repositories (i.e. central data centres). Trade repositories would have to publish aggregate positions by class of derivatives, thereby offering market participants a clearer view of the derivatives market. ESMA would be responsible for the surveillance of trade repositories and for granting and withdrawing their registration.

ESMA would also be responsible for the identification of contracts subject to the clearing obligation, while national competent authorities, in coordination with a college of supervisors, would be responsible for authorisation and supervision of CCPs, except in the case of CCPs from third countries, which would have to be recognised by ESMA, provided they meet certain conditions.

¹ Those that have met predefined eligibility criteria.

If a contract is not eligible for clearing by a CCP, the draft regulation would require the application of different risk management techniques, including the holding of additional capital.

The obligation to clear OTC derivatives contracts through a CCP and report them to trade repositories would apply to financial firms, while non-financial firms would only be subject to the clearing obligation, provided their OTC derivatives positions reach specified clearing thresholds, to be set by ESMA and the Commission, and are considered to be systemically important.

The compromise proposal provides for venues of execution, such as multilateral trading platforms or exchanges, to have access to any CCP to clear OTC derivatives transactions, and vice versa, subject to technical and safety requirements.

The regulation, which will apply from the end of 2012, is intended to implement commitments made by G-20 leaders in September 2009. One year after the collapse of Lehman Brothers, a major player in OTC derivatives markets, G-20 leaders agreed in Pittsburgh that all standardised OTC derivative contracts should be cleared through CCPs by the end of 2012, while non-centrally cleared contracts should be subject to higher capital requirements. They also resolved that OTC derivative contracts should be reported to trade repositories.

Based on article 114 of the Treaty on the Functioning of the European Union, the regulation allows for adoption by qualified majority by the Council, in agreement with the European Parliament.