

## CCPs: building a safer financial system

Editorial

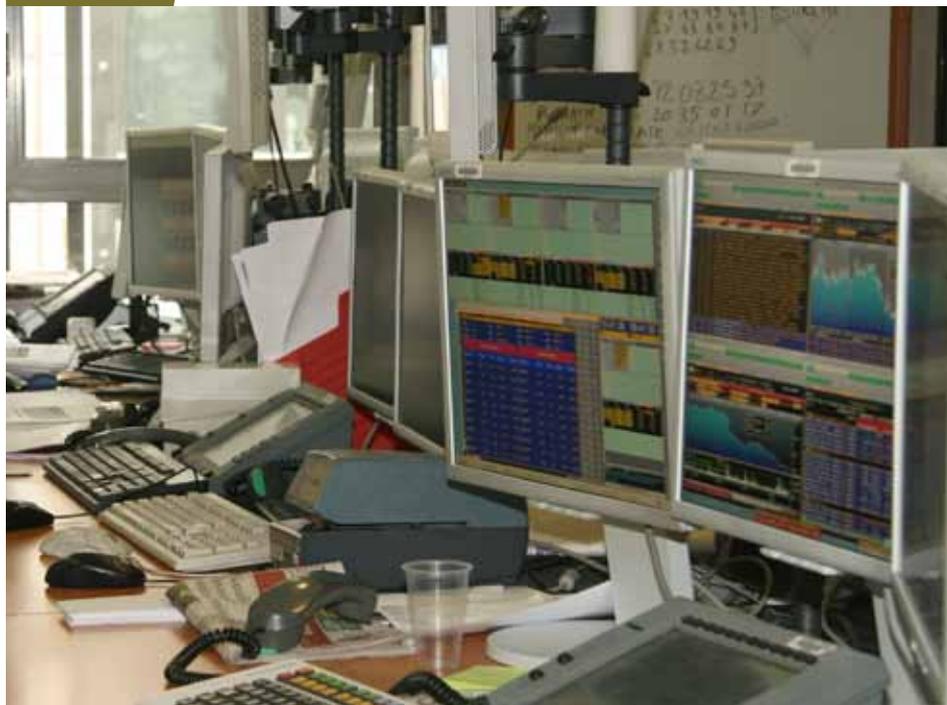
AMAFI has always stressed the need for robust regulation to foster the confidence that enables financial markets to operate properly. At present, public opinion is deeply suspicious of markets, overlooking the central role they play in financing economic activity, allocating savings efficiently and hedging against risks. In consequence, we believe that a number of the regulatory initiatives currently underway are vital.

With this in mind, AMAFI recently published its contribution to the G20's work on the organisation of commodity derivatives markets (News p 4). It has set out twelve action guidelines for overseeing these markets, which have a highly specific profile because of their strong ties to underlying physical markets.

In the same vein, we recently responded to the European Commission consultation on the MiFID review (News p 5). With many investors and issuers exercised about the organisation of Europe's equity markets, a number of critically important structural issues need to be decided upon. AMAFI has therefore called on the Commission to focus solely on these issues, paying particular attention to the type of competitive model that should be advocated.

**Pierre de Lauzun**  
Chief Executive, AMAFI

### Feature



**The US and Europe have decided to regulate derivatives, which are seen to be one of the main causes of the financial crisis. Central counterparties (CCPs) are set to play a big role in the new safety mechanism.**

**I**t is widely believed that if certain derivatives had been more tightly regulated, there would have been no financial crisis. Regulators and authorities across the globe, including the European Commission, have turned their attention to these products, following recommendations that came out of the G20 meeting

in Pittsburgh. The aim is to strengthen the safety and soundness of the financial system and ward off another meltdown.

### Of derivatives and underlyings

Derivatives are so called because their prices are linked to the value of an underlying interest, which can be shares, currencies, commodities, mortgages or another asset. The most common derivatives are futures, options and swaps.

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► Structured products, among them the infamous collateralised debt obligation (CDO), have joined the ranks more recently. Derivatives are essentially designed to “hedge” – or protect against – risk. But they have also attracted speculators, resulting in excesses that triggered the crisis. Not all derivatives are under the spotlight, however, because not all of them are considered to be “financial weapons of mass destruction,” to quote Warren Buffet. Many of them, futures and options included, are traded on organised markets. It is the others, the ones that are traded bilaterally or over the counter (OTC), that remain below regulators’ radar screens. These trades involve massive amounts that escape oversight, making it impossible to spot impending systemic risk.

In Europe, Brussels has set its sights on OTC derivatives and wants to create a regulatory framework for them. In its draft European Market Infrastructure Regulation (Emir), the European Commission is proposing, in line with G20 recommendations, that all standardised derivatives – instruments that meet certain general characteristics – should be centrally cleared to ensure transparency and safety and allow financial supervisors to measure potential systemic risks. The US introduced similar legislation in July 2010 with the aptly named Wall Street Reform and Consumer Protection Act, better known as the Dodd-Frank Act, under which standardised derivatives will have to be traded on open platforms and submitted for clear-

ing to central counterparties, or CCPs. In theory, Europe’s system should be in place by 2012. The basic idea behind Emir is that all standardised derivatives traded by investment services providers should be subject to clearing. The proposed system would exclude bespoke contracts created for firms with special hedging requirements, as well as non-financial firms

## “Safety : CCPs will play a major strategic role”

that use OTC derivatives to protect against risks connected with their core business. Electronic trade confirmation and reconciliation procedures will be in place for contracts that are ineligible for clearing. CCPs are to be subject to special oversight. And all transactions in standardised contracts will have to be registered in a centralised database, known as a trade repository, and reported to regulators.

### A major strategic role

CCPs will play a major strategic role because, by virtue of their function, they guarantee soundness and safety. For one thing, they check that their members are solvent. They also ensure trade transparency by performing multilateral netting, which involves tallying all the trades made by an institution during the course of the day to determine its net position. By standing between counterparties, CCPs shoulder a large portion of the risk. Moreover, the system of margin deposits and calls, which requires participants to deposit a percentage of the value of their trades, means that risk exposures are reassessed daily according to asset price movements. Says

Bruno Biass, Research Director at TSE-CNRS: “The crisis showed that some participants had built up huge risk positions without anyone noticing, because OTC markets are unsupervised. At the very least, regulators must be in position to know what the risk exposure is. CCPs provide a natural way to report and calculate net positions. If we want to avoid a repeat of the last crisis, we must make sure that derivatives trades are routed through clearing houses”.

### Why CCPs should be registered as banks

While Europe and the US may have established the principle of clearing standardised derivatives, some issues still have to be resolved. Systemic risk is not going to go away: it will simply be shifted to CCPs, where it will be mitigated but not totally eradicated. After all, if they transfer their risk, members may be tempted to take bigger and bolder bets on financial markets. So the status of CCPs is a key issue. “The requirement to clear most OTC trades will mean that central counterparties have to manage a considerable amount of additional risk. For that reason, their status should be standardised within Europe,” points out Yvon Lucas, head of Payment Systems and Market Infrastructure at the Banque de France. “France is calling for CCPs to be registered as banks. This would give them access to central bank facilities and see them adopt the safest possible liquidity management approach – an appreciable advantage during a crisis of confidence like the one we experienced in 2008”. Brussels does not seem inclined to follow France on this, but France is not giving up yet. ►

▶ Two firms already clear derivatives in Europe: ICE in London and LCH.Clearnet SA in Paris. Significantly, LCH.Clearnet SA is chartered as a bank. Its CEO, Christophe Hemon, says: "The Emir project marks a step forward by introducing the principle that clearing should be mandatory for standardised derivatives. But unless all CCPs are required to register as banks, some will be able to continue operating under lighter, more flexible risk management rules". This raises the problem of competition between clearing houses based on regulatory undercutting. As Hémon points out, "Quite apart from the distortions that this would introduce within the EU, it is also a risk in the event of a crisis. Because LCH.Clearnet SA has a bank charter, it is obliged to comply with relatively burdensome constraints in terms of capital requirements and risk management systems. To give just one example, we have 30 people in our risk management department, whereas other institutions have just a couple. Customers are sensitive to this, though. And we find that, more and more, they are quizzing us on our safety systems so that they can adjust their own levels of risk on structured products". Since it began clearing OTC derivatives in March 2010, LCH Clearnet SA has cleared 27.8 billion trades in 744 standardised contracts.

## Q&A with...



**Michel Pébereau, Chairman of BNP Paribas**

➤ **What are the likely benefits of clearing for OTC derivatives?**

Reduced counterparty risk and improved market transparency will be the two big advantages.

➤ **Couldn't the concentration of trades engender new risks?**

It is true that CCPs will, by definition, bring all counterparty risks under one roof, especially if clearing becomes mandatory. This means that CCPs will have to be robust, well regulated, and meticulously supervised to prevent any risk of failure, which would be fatal to everyone. Each CCP will have to apply a standardised risk management policy, including transparent methods for calculating margin deposits and calls that can be replicated by members and checked by regulators. They will also need a well-defined procedure for dealing with member defaults and a risk management approach that must not be used as a competitive tool. CCPs should be regulated as banks or investment services providers and subject to the same supervision, with stiff capital requirements. They need access to central bank money to prevent any liquidity risk over and above the counterparty risk that they have to manage. Finally, they will have to be extremely selective when it comes to admitting members, who will be required to demonstrate their financial and operational soundness.

➤ **In your view, what is the best way to organise clearing in Europe?**

There are those who believe that the concentration risk created by clearing could be mitigated by having several CCPs "interoperate" in a competitive environment. These new risks can be managed only through strict harmonisation of rules and procedures, which would ultimately lead to the creation of a single virtual clearing house. I do not think interoperability is the right solution. The most effective approach would be to have a small number of CCPs that are subject to careful supervision. Given that these CCPs should have access to central bank money, they will probably be organised on a regional basis by major currency area.

### Converging on greater safety

Markets on both sides of the Atlantic are eagerly awaiting the outcome of the new proposals, and the stakes are high. In the US, regulators have 12 months from the passage of Dodd-Frank to draft and vote on the rules. The European Parliament will examine the draft of Emir in March 2011, and the new legislation is due to come into force by 2012. The Euro-

pean Securities and Markets Authority, the new watchdog set up on 1 January, will then be responsible for determining which derivatives are eligible for clearing. Despite differences between the two pieces of legislation – among other things, Europe's is more tightly focused than America's – the ultimate goal is promote converge and build a safer, sounder financial system.

**Olivia Dufour and Anthony Bulger**

## International

### ➤ Commodity derivatives – AMAFI proposals for the G20

The AMAFI working group responsible for submitting proposals for regulating commodity derivatives markets, in connection with the French presidency of the G20, has submitted its findings (*AMAFI 11-04*). Based on an analysis of factors that set these markets apart from financial markets, twelve action guidelines have been adopted, seven for priority implementation and five for the medium term.

Close attention has been paid to the concerns raised by the growing involvement of financial investors.

There is no conclusive evidence that commodity markets have been disrupted by this phenomenon, especially in terms of volatility.

On the contrary, there are indications that it may be a positive factor because investors can act as counterparties to industrial firms, traders and agricultural producers seeking hedging opportunities. In this context, the guidelines identified by AMAFI seek to ensure that the regulators in charge of commodity derivatives have the information and tools needed to take targeted action

and allow these markets to operate smoothly.

The report has been forwarded to the French authorities for use in preparing the G20 meetings and will shortly be made public (in English and French). Work will now continue at European level, since the European Commission intends to include commodity derivatives regulation in the ongoing review of the Markets in Financial Instruments Directive.

**Bertrand de Saint Mars and  
Dominique Depras**

## Europe

### ➤ Short selling

In connection with the draft European regulation on short selling and credit default swaps, AMAFI published an outline paper in December 2010 describing its position on these issues (*AMAFI / 10-70*).

It believes that a regulation is highly desirable and should focus on three main areas:

- Continue to permit short sales that contribute to the orderly operation of the market, and ban those that interfere with it.
- Identify and punish disruptive behaviour.
- Deal efficiently with exceptional market situations

AMAFI considers that in normal market circumstances, the main requirement is to comply with the settlement period agreed

upon at the time of the transaction. The regulator should be informed of any deficiencies so that it can sanction those not caused by an unforeseeable event.

Buy-in procedures are key in this respect, and AMAFI has made several proposals on this issue.

The outline paper was forwarded to several MEPs, along with a series of amendments comparing and contrasting the Commission's draft with AMAFI's positions.

The ECON Commission is scheduled to debate the draft regulation in the second week of February.

**Emmanuel de Fournoux**

### ➤ AML/CFT

AMAFI made an active contribution to ICSA's response to the consultation on the review of FATF standards. The response stressed that:

- The FATF's proposal to extend the definition of politically exposed persons to domestic persons should concern only political functions carried on at national level, in contrast with those at local level.
- The risk-based approach should be applicable to identifying and verifying the identity of beneficial owners and to non-face-to-face relationships.
- Countries should provide entities subject to AML/CTF obligations with the information needed to identify and verify the identity of beneficial owners.
- An Interpretative Note on the risk-based approach for FATF supervisors is welcome but it should be published in collaboration with the private sector and should not call into question the flexibility inherent in the approach.

**Stéphanie Hubert**

## Europe

### ➤ **MiFID review**

The European Commission published a consultation paper on 8 December 2010 concerning the review of the Markets in Financial Instruments Directive (MiFID). The paper contains 147 questions relating to all the areas covered by MiFID, with two main thrusts: market structure and investor protection.

For AMAFI, the Commission's initiative is crucial. Structural issues need to be addressed in light of the concerns felt by many investors and firms as a result of recent happenings in markets. Unfortunately, given the importance of these issues, the Commission has not based its consultation on an overall discussion of the objectives to be achieved in terms of market organisation. Such a discussion is especially important since Europe must keep control of the consequences of creating a regulatory framework for its markets. AMAFI also believes that including client protection in the review needlessly diverts it from its primary goal, especially since the MiFID-based protective framework weathered the crisis successfully. So although certain aspects of investor protection are certainly worth examining at

this level, they are not nearly as urgent or important as issues of market structure.

AMAFI's key recommendations are:

- Focus Level 1 action on high-level principles and objectives, to be translated into regulatory measures at Levels 2 and 3 based on the results of vital additional research in a number of areas;
- Hold in-depth discussions on the underlying competitive model, in light of recent developments;
- Deal with commodity derivatives markets in a separate directive, taking into account the specific issues raised by the way they operate;
- Consider reporting issues in terms of efficient use of data by regulators;
- Place less emphasis on the legislative approach, since the critical issue at present is to harmonise oversight and sanction practices.

AMAFI sent its highly detailed response to the consultation to the European Commission in early February (*AMAFI / 11-05*).

**Emmanuel de Fournoux, Dominique Depras, Sylvie Dariosecq, Stéphanie Hubert**

### ➤ **Remuneration**

At the beginning of December 2010, the industry was still awaiting a number of publications ahead of the entry into force of new rules on remuneration on 1 January 2011. It had to wait until the middle of the month for the release of CEBS guidelines on remuneration policies under the third Capital Requirements Directive, as well as the directive itself and, in France, the executive order amending CRBF Regulation 97-02 and implementing the remuneration provisions of the CRD 3 in domestic law. In light of these publications, AMAFI is now revising its professional standard and guidelines on remuneration, first released in November 2009. In particular it

is taking into account the extensive recommendations made by CEBS. These issues are vitally important for investment firms because the new arrangements will raise many practical problems of implementation.

AMAFI is also calling on the authorities to transpose the CRD 3 exemption for investment firms that do not hold client funds or securities and that supply only investment advice and order transmission reception services, either singly or together. Furthermore, CESR is currently preparing special guidelines applicable to investment services.

**Stéphanie Hubert**

### ➤ **Harmonisation of securities law**

The European Commission is holding a consultation on the harmonisation of securities law. This initiative builds on work underway for several years, including a previous consultation in 2009 (*AMAFI / 09-35*). In connection with collective discussions within the French financial industry, AMAFI expressed strong disagreement with some of the Commission's orientations (*AMAFI / 11-02*). It emphasised in particular that it was opposed to any attempt – especially in the aftermath of the crisis – to challenge the securities ownership rights that final investors enjoy under the laws of France and many other European countries. AMAFI also stressed that, in any case, the new arrangements should ensure the integrity of securities issuance and maintain the existing body of EU legislation with regard to choice of law.

**Emmanuel de Fournoux, Sylvie Dariosecq, Marie Thévenot**

## France

### ➤ Regulation of carbon markets

The AMF held a consultation in December on amending its general regulations in order to strengthen regulation of the market in greenhouse gas emission allowances, in light of measures recently laid down in the Banking and Financial Regulation Act. The timeframe for the consultation was extremely short, so AMAFI's contribution centred on a handful of issues that need to be factored into the schedule for organising carbon allowance auctions in Europe (*AMAFI / 10-72*). At the same time AMAFI called for more extensive discussions with the regulator in the coming months on various issues that had been insufficiently analysed due to the urgency of the matter at hand.

**Dominique Depras, Sylvie Dariosecq**

### ➤ Major shareholding notifications – Cash-settled instruments

Prompted by LVMH's recent stakebuilding in Hermès, AMAFI's Major Holdings Group drafted an industry proposal on transparency rules for purely cash-settled equity derivatives. The proposal was approved by the national association of joint-stock companies, ANSA, and by the French Banking Federation, and was then submitted by all three organisations to the finance minister and the chairman of the AMF.

The proposal significantly increases the transparency of these instruments, but it stops short of total assimilation, i.e. counting them along with the instruments already taken into account to compute a notification threshold. Doing so would have undermined the clarity of the information given to the market and to issuers; it could also have had a seriously negative impact on the mandatory bid regime and hence on the activities of publicly traded companies. Based on the principle of making a separate, independent notification for cash-settled instruments, the proposed mechanism achieves the same degree of transparency as total assimilation while avoiding the pitfalls.

### ➤ AMF sanction procedure

The AMF recently published a long-awaited guide to its disciplinary measures. Titled the "Sanction Charter", the document finalises the overhaul of the regulator's investigation and sanction procedures undertaken by the government and the legislature. Most of the measures stemming from the reform have already been implemented through the Banking and Financial Regulation Act of October 2010.

The Sanction Charter responds to a pressing need identified by AMAFI in its 2009 report on the AMF's disciplinary powers (*AMAFI / 09-48*). It also supplements the regulatory provisions adopted in December 2010 that emphasised use of the adversarial process, not only in the phase that culminates in Enforcement Committee decisions but also in the decisions taken by the AMF's Board to issue statements of complaint.

### ➤ Investor compensation

The working group set up by the AMF to examine how investors could be compensated for their losses has finalised its recommendations. Its draft report gave rise to much discussion between the group's members. After an initial review by the AMF Board, the report was amended and has been put out to public consultation until 28 February. AMAFI is working on formalising its position before responding to the consultation.

**Sylvie Dariosecq, Marie Thévenot**

**Sylvie Dariosecq, Marie Thévenot**

**Sylvie Dariosecq**



## New Member

➤ **Sélection R** is an investment firm offering fund order-reception and transmission services for third parties and insurance brokerage solutions for retail and institutional clients.

Its senior officers are Jean-Louis Laurens (Chairman) and Philippe Chevrier (Chairman of the Supervisory Board).

**Director of Publication:** Bertrand de Saint Mars

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AMAFI documents quoted in this Newsletter and flagged with a reference number are on our website at

**www.amafi.fr**

Most of them, notably AMAFI's responses to public consultations, are freely available, but some are restricted to members only.

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