EMIR : Regulation on OTC derivatives, Central Counterparties and Trade Repositories

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Background

At the G-20 Pittsburgh Summit in September 2009, the leaders of the 19 biggest economies in the world and the European Union agreed that *"all standard OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest"* and they acknowledged that *"OTC derivative contracts should be reported to trade repositories and that non-centrally cleared contracts should be subject to higher capital requirements".* The regulation of the OTC derivatives market has also been the subject of review by international regulatory organisations such as the International Organisation of Securities Commission (**IOSCO**) and the Financial Stability Board (**FSB**).

Both the US (Dodd Frank Act) and Japan (Financial Instruments and Exchange Act) passed OTC derivatives legislation earlier this year and the Hong Kong Monetary Authority and the Hong Kong Securities and Futures Commission are currently consulting on proposals to regulate the Hong Kong OTC derivatives market. The European Union's response in this area is contained in the Regulation on OTC derivatives, Central Counterparties and Trade Repositories ("**EMIR**") which was published in the Official Journal of the European Union on 27 July 2012. EMIR will implement the G20 commitments on OTC derivatives markets in the EU.

Although the overall approach in the EU and US is broadly similar, there are, however, certain differences of which market participants should be aware. These differences in approach may lead to the possibility of regulatory arbitrage.

EMIR came into force 20 days after its publication (i.e. on 16 August 2012). As EMIR is a Regulation it is directly applicable in all EU Member States. This means that no national measures are required to implement its requirements. However, as noted below, implementation will be gradual as there are a significant number of implementing measures required before EMIR will become fully operative.

Scope of EMIR

EMIR aims to improve the functioning of OTC derivative markets in the EU by (i) increasing transparency via trade repositories; (ii) reducing counterparty risks; and (iii) ensuring safe and resilient central counterparties ("**CCP**").

EMIR has the capacity to apply to anyone who trades derivatives, whether on an exchange or otherwise and whether within or outside the EU. It is likely to apply to banks, insurance companies, collective investment schemes (and their managers), alternative investment funds (and their managers) and MiFID authorised investment firms. It will also be relevant for those entities which may seek to be authorised as a trade repository or as a CCP. In particular, asset managers who use derivatives in their portfolios should be aware of the requirements relating to the mandatory reporting of OTC derivatives to trade repositories.

Technical Standards

On 25 June 2012, the European Securities and Markets Authority ("**ESMA**") published a consultation paper concerning the technical standards that it is required to produce under EMIR. The technical standards contain key information relating to how EMIR will apply in practice. ESMA must submit final technical standards to the European Commission (the "**Commission**") by 30 September 2012, after which the Commission will have three months to adopt the final technical standards. It is intended that the technical standards will be introduced by means of a number of Regulations to deal with the following matters:

(i) Technical Standards for OTC derivatives

These standards will include detailed requirements in relation to the criteria of classes of OTC derivatives which will be subject to clearing.

(ii) Technical Standard for central counterparties

These standards will include detailed requirements in relation to organisational requirements (such as governance arrangements, risk management and internal control mechanisms, internal compliance, remuneration policy, information technology systems, transaction recording, business continuity arrangements) and requirements in relation to other matters such as margins, haircuts, default fund, liquidity risk controls, default waterfall and stress testing and back testing of the risk processes.

(iii) Record Keeping Requirements for CCPs

These requirements will include the requirement to maintain data in a common format to facilitate the reconciliation of data across CCPs and in a format which is compatible with that in which data is retained by trade repositories.

(iv) Minimum Details of Data to be Reported to Trade Repositories

The regulations will set out the minimum level of detail which will need to be reported to trade repositories.

(v) Requirements in relation to the Application for the Registration as a Trade Repository

ESMA is responsible for the registration and supervision of trade repositories. These Regulations will set out details of the application process for registration as a trade repository which will include providing details of ownership, organisational, governance and internal compliance structures, financial resources and business plans as well as operational systems and procedures.

What does EMIR do?

EMIR aims to improve the functioning of OTC derivative markets in the EU by (i) increasing transparency via trade repositories; (ii) reducing counterparty risks; and (iii) ensuring safe and resilient CCPs.

Increasing transparency via trade repositories

The primary objective of the reporting obligation is to give regulators a complete picture of the derivative markets and to identify pockets of potential systemic risk at firm level and at product specific level.

Article 9 of EMIR applies a reporting requirement to (a) derivative contracts (whether OTC or exchange-traded) entered into before 16 August 2012 and which remain outstanding on that date and (b) derivative contracts entered into or after 16 August 2012. This means that detailed information on each derivative contract traded by a financial or a non-financial firm will need to be reported to trade repositories within one day of the execution of the contract.

As yet no trade repositories have been registered with ESMA, and in this regard EMIR sets out the information to be provided to ESMA for the authorisation and supervision of trade repositories. It is intended that the various trade repositories will provide certain information to the relevant authorities for analysis. ESMA may also recognise third country trade repositories if certain conditions are fulfilled.

The dates applicable for the reporting requirement are contained in a specific implementing technical standard, a draft of which can be found in Annex IV to the Consultation Paper which was issued by ESMA on 25 June 2012. The technical standards also specify the details and types of reports which must be reported to a trade repository. Article 6 of Aannex IV of the draft technical standards provides that derivative contracts shall be reported on the earlier of (i) 1 July 2012 where a trade repository for that particular derivative type has been registered; (ii) if no trade repository has been registered for a particular type of derivative contract on 1 May 2013, 60 days after the registration of such a trade repository in respect of that type of derivatives contract; or (iii) 1 July 2015.

Once the reporting requirements kick in, affected investment firms will need to back–report details of any trades from the 16 August 2012 start date. Therefore, from a practical perspective, investment firms should record details of such trades so that they can report them to a trade repository as and when required. Reporting may be delegated and CCPs "shall ensure that the details of their derivative contracts are reported without duplication". In this regard the technical standards provide that a "third entity is deemed appropriate if in the view of the delegating counterparty, it guarantees protection of the data and compliance with the reporting obligation under Article 9 of the Regulation".

Article 9 of EMIR imposes a new record keeping obligation such that records of derivative contracts plus any modification must be kept for at least five years after termination of the contract. Trade repositories also facilitate the reporting of some aggregate data to the public.

Reducing counterparty risks

Clearing Obligation

Article 4 of EMIR proposes to introduce significant changes to the OTC derivatives markets by requiring counterparties to clear standardised OTC derivative contracts (i.e. derivatives that have met predefined eligibility criteria) through an authorised CCP. In this regard the technical standards will specify the class of derivatives which are deemed to be sufficiently standardised and subject to clearing. Criteria for standardisation is likely to include: (a) common legal documentation (such as standard terms, confirmations and netting arrangements) (it is envisaged that this will be similar to ISDA type agreements; (b) operational processes for the relevant class of OTC contract which are managed in a common manner; (c) volume and liquidity of the relevant OTC class; and (d) availability of generally accepted and reliable pricing information for the relevant OTC class.

The clearing requirement will apply to all contracts in a class of OTC derivatives that has been declared subject to the clearing obligation. The Level 2 technical standards will specify the class of OTC derivatives that should be subject to the clearing obligation. The criteria is likely to include: (a) common legal documentation (such as standard terms, confirmations and netting arrangements) (it is envisaged that this will be similar to ISDA type agreements; (b) operational processes for the relevant class of OTC contract which are managed in a common manner; (c) volume and liquidity of the relevant OTC class; and (d) availability of generally accepted and reliable pricing information for the relevant OTC class.

The scope of the clearing obligation will apply to financial firms (banks, insurance companies, collective investment schemes and MiFID authorized investment firms) and non-financial firms (energy companies, airlines etc) who trade in OTC derivatives. There are some limited exemptions for non financial firms, pension schemes, and certain intra-group transactions.

The clearing obligation may also apply to transactions between two entities in one or more third countries that would be subject to the clearing obligation if they were established in the EU, provided that the contract has a direct, substantial and foreseeable effect within the EU or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of the Regulation. This is really an anti-avoidance provision to prevent market participants who would otherwise be caught by EMIR from deliberately structuring a contract outside the EU.

Risk mitigation obligation for OTC derivatives not cleared via a CCP

EMIR recognises that not all OTC derivatives are suitable for standardisation. In this regard Article 11 of EMIR provides that where OTC derivatives contracts are not cleared by a CCP, counterparties shall ensure that “appropriate procedures and arrangements are in place to measure, monitor and mitigate operational risk and counterparty credit risk”. This must include “timely confirmation, where available, by electronic means, of the terms of the relevant OTC derivative contract” and formalised processes for the reconciliation of portfolios, the segregated exchange of collateral and marking-to market on a daily basis of outstanding OTC derivative contracts.

It is likely that the most significant change will be the requirement for participants to exchange collateral on their non-cleared trades. In this regard the technical standards will specify amongst other things the levels and types of collateral required and segregation arrangements to comply with this requirement.

It is also important to note that CRD IV proposes to introduce higher capital requirements for non-centrally cleared trades, viewed by many as a punitive charge for trading non-cleared derivatives.

Ensuring safe and resilient CCPs

EMIR will impose requirements relating to authorisation, oraganisational arrangements, conduct of business (including segregation of client assets) and prudential arrangements on

CCPs. The prudential and conduct of business requirements applicable to CCPs apply to their activities in relation to derivatives as well as other types of financial instruments such as transferable securities and money market instruments.

A CCP will be required to be authorised in the Member State where it is established. EMIR provides that a CCP shall have a permanent and available initial capital of at least Euro7.5 million. The capital including retained earnings and reserves shall be proportionate to the risk stemming from the activities of the CCP. The recitals of EMIR provide that a CCPs “risk management strategies must be sufficiently sound so as to avoid risk for the tax payer”. It is likely that this provision was included due to industry concerns regarding the possibility that a CCP could be a source of systemic risk. The technical standards will specify requirements regarding the capital requirements of a CCP.

A relevant authority has up to 6 months to approve a completed application. Existing CCPs are required to apply for recognition within 6 months of the adoption of ESMA’s regulatory technical standards by the Commission. A CCP established in a third country may provide clearing services to clearing members or trading venues established in the EU only where that CCP is recognised by ESMA.

A CCP’s competent authority shall establish a regulatory college when considering an application to authorise a CCP. Each college shall consists of members representing ESMA, the national competent authority supervising the CCP and other Member States’ competent authorities supervising entities which might be impacted by that CCP’s operations. EMIR contains detailed measures to ensure that national protectionism does not affect the CCP authorisation process.

Other European Initiatives

The obligations contained in EMIR should be read alongside other EU regulatory developments which will also have an impact on the OTC derivatives market. These reforms include;

- Amendments to the MiFID Directive which includes wide ranging reforms to the regulation of derivatives in the EEA. The amendments proposed include the requirement that certain derivatives be traded on a Regulated Market, a Multi-lateral Trading Facility, Organised Trading Facility or on third country trading venues which the Commission has confirmed meet an equivalency test. ESMA will determine which classes of derivatives will be subject to the “on-exchange trading” requirement. The recitals to the Regulation explicitly provide that clearing eligibility and liquidity will be the criteria to be considered when determining whether a derivative will be subject to trading requirements.

- Amendments to the Capital Requirements Directive such that higher capital requirements will apply for non-cleared OTC derivative contracts.

- Amendments to the Market Abuse Directive such that its provisions will extend to OTC derivative contracts.

- UCITS VI – given the recent publication of a Consultation Paper regarding UCITS VI there is a question of whether counterparty limits that currently apply to OTC derivatives would no longer apply to centrally cleared derivatives or would need to be re-assessed.

Conclusion

It is clear that many important details have yet to be finalised in particular matters relating to the contents of reports which will have to be made to trade repositories, determining which class of derivatives will be subject to the clearing obligation, the values of the relevant clearing thresholds which will impose a clearing obligation on non-financial firms, collateral charges for non-cleared OTC derivative contracts and capital requirements for CCPs. It is likely that these measures will be finalised once the Level 2 technical standards are formally adopted by the Commission. In this regard, and as outlined above, ESMA has to submit final technical standards to the Commission by 30 September 2012, after which the Commission will have three months to adopt the final technical standards.

It is clear that EMIR will accelerate the existing trend towards the use of CCPs for clearing, impose new requirements on non-financial firms that participate in OTC derivatives markets (such as energy companies), increase costs for both cleared derivatives (e.g. through margin requirements and other CCP related costs) and for non-cleared derivatives (e.g. through collateral and/or capital requirements) as well as transaction reporting costs for all derivatives contracts and lastly will increase ESMA's powers within the European derivatives market.

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