Ready or not, EMIR I come...

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William Yonge, Partner in the Business & Finance Practice at the London Office of Global Law Firm Morgan Lewis, reminds readers of EMIR's scope and key obligations.

EU regulations on over-the-counter (OTC) derivatives, central counterparties and trade repositories, known as the European Market Infrastructure Regulation (EMIR), came into force on 16 August 2012, as part of the G20 commitment to reduce counterparty and operational risk and enhance transparency in the OTC market. That date is misleading, since EMIR's set of clearing, risk mitigation and reporting obligations are to take effect on a phased basis, pending introduction of a range of regulatory technical standards. The first of these came into force on 15th March 2013.

EMIR sets out the framework for the introduction of:

- Central clearing of derivatives transactions;
- Risk mitigation techniques for 'uncleared' OTC trades;
- Trade reporting of OTC derivatives and exchange traded derivatives to authorised trade repositories.

These requirements apply to a range of financial and non-financial counterparties to derivative contracts, defined by reference to the definition of derivatives under the Markets in Financial Instruments Directive (known as MiFID), which includes options, interest rate swaps, credit default swaps and forward rate agreements relating to underlying such as securities, currencies, interest rates, commodities, emissions allowances and weather derivatives. Whilst it is clear that spot FX transactions are not caught, it is unclear whether FX derivatives are caught by EMIR. There is no consistent pan-EU understanding of which FX contracts are considered derivatives under MiFID.

Who is impacted?

EMIR applies to financial counterparties (FCs) and non-financial counterparties (NFCs). An FC is any investment firm, bank, insurer, UCITS fund, pension fund or an alternative investment fund managed by an AIFMD-authorised manager. An NFC is an EU entity other than an FC. EMIR further distinguishes between NFCs+ and NFCs-. An NFC becomes an NFC+ because it takes positions in OTC derivatives, which exceed any relevant clearing threshold. The thresholds are:

OTC credit derivatives	**€1 billion in gross notional value**
OTC equity derivatives	**€1 billion in gross notional value**
OTC interest rate derivatives	**€3 billion in gross notional value**
OTC FX derivatives	**€3 billion in gross notional value**
Other OTC derivatives (including commodities)	**€3 billion in gross notional value**

EMIR also applies to third country counterparties which would be subject to the clearing obligation if they were established in the EU (TCC). A TCC will be subject to the clearing obligation if it enters into either of the following types of trade:

- A trade with an FC or an NFC+;
- A trade with another TCC if:
  - the contract has a direct, substantial and foreseeable effect within the EU; or
  - the obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR.

Similarly, EMIR's risk mitigation techniques apply to third country entities which would be subject to those obligations if they were established in the EU, provided the contract has such effect or the obligation is as described above.

On 15th November 2013, the European Securities and Markets Authority (ESMA) issued draft regulatory standards, clarifying that OTC derivative contracts entered into by two counterparties established in one or more non-EU countries, for which a decision on equivalence of the jurisdiction's regulatory regime has not been adopted by the European Commission, will be subject to EMIR where one of the following conditions are met:

- One of the two non-EU counterparties to the OTC derivative contract is guaranteed by an EU FC for a total gross notional amount of at least €8bn, and for an amount of at least 5% of the OTC derivatives exposures of the EU FC guarantor; or
- The two non-EU counterparties execute their transactions via their EU branches and would qualify as FCs if established in the EU.

ESMA has so far delivered advice to the Commission on the equivalence of the legal and supervisory frameworks of Australia, Canada, Hong Kong, India, Japan, Singapore, South Korea, Switzerland and the US. Formal equivalence determination by the Commission is expected by the end of this year. ESMA'S standards also specify cases of transactions aimed at evading EMIR's regulatory requirements.

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Next steps

In August 2013, ESMA proposed that reporting of OTC derivatives and exchange-traded derivatives begin on 1st January 2014 and 1st January 2015 respectively. However, the Commission overruled ESMA, decreeing in November that reporting for all derivative asset classes would begin on 12th February 2014. ESMA simultaneously announced it had approved registrations of four trade repositories under EMIR (DTCC Derivatives Repository Ltd. (UK), Krakow Deposit Papierów Wartosciowych S.A., (Poland); Regis-TR S.A. (Luxembourg); and UnaVista Ltd (UK)). These TRs can now be used to fulfil EMIR trade reporting obligations. US derivatives exchanges CME Group and IntercontinentalExchange have applied. Regulators have raised concerns that data may be fragmented between repositories and jurisdictions due to rival services.

EU counterparties have less than three months to arrange to report details of concluded, modified or terminated derivative contracts to registered trade

What are the new obligations under EMIR?

Obligation	Application	Key dates
Record-keeping of any derivative contract and any modification	• FCs, NFC+, NFC-	16th August 2012
Risk mitigation • Timely confirmation	• FC, NFC+ and NFC – irrespective of counterparty. • TCCs*	15th March 2013
Risk mitigation • Daily valuation	• FC and NFC+ irrespective of counterparty • TCCs*	15th March 2013
NFC+ notification to its local regulator	• NFC+	15th March 2013
Risk mitigation • Portfolio reconciliation • Portfolio compression • Dispute resolution mechanisms	• FC, NFC+ and NFC- irrespective of counterparty • TCCs*	15th September 2013
Reporting to registered trade repositories of all derivative contracts (whether OTC or exchange-traded, cleared or non-cleared) outstanding on 16 August 2012 or entered into on or after that date	• FC, NFC+ and NFC- irrespective of counterparty • Reporting may be delegated but responsibility may not. • OTC and listed derivatives	12th February 2014 for both OTC and exchange-traded derivatives including outstanding derivative contracts entered into on or after 16th August 2012.
Mandatory clearing	• FC and NFC+ • TCCs*	Estimated Q4 2013 – March 2014 for first CCP authorisation and commencement of front-loading period. Estimated April – September 2014 for first clearing obligations.
Risk mitigation • Margining	• FC; NFC+	Estimated April - September 2014.
Risk mitigation • Capital	• FC	TBC

* Uncertain timing for extra-territorial clearing and risk mitigation obligations.

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repositories. They will need to obtain a pre-legal entity identifier code from a pre-local operating unit, and have arrangements in place to generate a unique trade identifier code for each derivative transaction.

NFCs face particular challenges in complying; they are likely to find it challenging to meet obligations on portfolio reconciliation, dispute resolution and portfolio compression if trading with non-EU firms unaware of EMIR. However, many NFCs have already started planning for trade reporting, identifying EMIR trade repositories and/or exploring the option of delegating reporting to their counterparty or a service provider. NFCs may need to develop their own reporting systems to report internal intra-group back-to-back derivative transactions.

The UK's Financial Conduct Authority (FCA) recently reviewed challenges for market compliance by FCs, determining:

- FCs using electronic platforms found that electronic confirmation helped them to comply with timely confirmation timeframes;
- A certain proportion of OTC derivatives remain confirmed on paper due to their bespoke nature;
- Products for which no standardised industry documentation is available pose a challenge to timely confirmation;
- FCs are reviewing operational processes to ensure compliance with timely confirmation and bilateral risk mitigation requirements;
- FCs are working on including intra-group trades in timely confirmation and risk mitigation processes, as required by EMIR.

The FCA also reviewed how NFCs are defining hedging activity and monitoring status against the clearing threshold, finding that NFCs are accurately classifying hedging and non-hedging transactions. However, some NFCs are unaware that all OTC transactions entered into by group non-financial entities (whether EU or non-EU) must be included in the calculation.

Get in touch...

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