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EMIR Regulations Continue to Impact Derivatives Markets in 2014

PATRICK BRANDT

The author examines the implications of the EU Regulation on OTC derivatives, central counterparties and trade repositories, which implements part of the EU's G20 commitments, on over-the-counter derivative market participants.

The financial crisis highlighted a number of problems in global OTC derivatives markets, including transparency, counterparty credit risk and a consequent removal of market liquidity. International concerns about these problems led to the 2009 G20 Pittsburgh agreement, which included provisions that all standardized OTC derivative contracts should be cleared through a central counterparty ("CCP") and reported to trade repositories ("TRs"), and counterparties to nonstandardized derivatives should take steps to mitigate the risks of their positions.[1]

The EU Regulation on OTC derivatives, central counterparties and trade repositories ("EMIR")[2] implements part of the EU's G20 commitments, and although enacted in 2012, its provisions have only recently started to become operative. In addition to setting out a regulatory framework for CCPs and TRs, EMIR imposes a number of obligations on EU counterparties, as well as on non-EU counterparties that enter into derivatives deemed to have a "direct, substantial and foreseeable effect" within the EU or to have been designed to evade EMIR requirements. With additional EMIR requirements

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being implemented in 2014, OTC derivative market participants need to consider the implications of the legislation.

EMIR'S SCOPE

EMIR applies to a wide variety of derivatives — credit default swaps, options, futures/forwards, swaps and contracts for differences — over a broad range of underlying financial instruments, assets, commodities and indices. Spot contracts are excluded. However, different EU jurisdictions and markets take different views on the maximum time allowed to settle spots, with settlement cycles varying between two and five business days. These differences can create confusion when a trade that is considered a spot in one jurisdiction is classified as a derivative in another.

The majority of EMIR requirements apply to OTC derivatives, although the trade reporting obligations notably apply to all derivatives. The OTC derivative concept is narrowly defined to include contracts that are not traded on a "'Markets in Financial Instruments Directive ("MIFID') regulated market" or "equivalent third-country (*i.e.*, non-EU) market." This means that derivatives traded on EU multilateral trading facilities or U.S. swap execution facilities that are not EU-recognized technically will be regarded as OTC.

COUNTERPARTY OBLIGATIONS

If OTC derivatives are not centrally cleared by an authorized EU, or recognized non-EU CP, EMIR requires the counterparties to enter into an agreement that sets out how they will mitigate risks. This requirement went into effect in 2013. Depending on their classification, counterparties must:

- confirm OTC trades within specified timeframes;
- have formal procedures to reconcile derivative portfolios;
- where applicable, perform portfolio compression exercises that involve trade netting to maintain the same risk profile while reducing the number of outstanding contracts and gross notional value;
- have dispute resolution procedures;

- utilize mark-to-market or, where applicable, mark-to-model accounting principles;
- exchange and segregate collateral; and
- hold capital against positions.

The risk mitigation obligations are being implemented through a mixture of International Swaps and Derivatives Association protocols and bilateral agreements between the sell-side and buy-side. The process has been far from smooth: with limited exceptions, non-EU counterparties are not subject to EMIR risk mitigation obligations. However, EU counterparties are required to enter into an agreement with non-EU counterparties, which enables them to secure compliance with their own EU obligations.

Starting February 12, 2014, all EU counterparties had to comply with the trade reporting obligation. This involves reporting to a TR all derivative transactions entered into from February 12, 2014, or which are outstanding on that date. There also is a requirement to back report derivatives transactions that are not outstanding on February 12, 2014, and either were outstanding on August 16, 2012, or entered into after that date. It is possible for one counterparty to delegate the performance of, but not the legal responsibility for, trade reporting to the other. It remains to be seen, however, whether the sell side will agree to trade report on behalf of the buy side given liability concerns. In any event, such a service will not assist nonfinancial counterparties that enter into intragroup hedging transactions. Either they will have to report those trades themselves or find a third-party provider solution.

Finally, EMIR will require specific types of counterparties to clear specified classes of OTC derivatives through authorized or recognized CCPs. The EU has fallen behind the U.S. in implementing the clearing obligation, and the requirement is not expected to come into force until late 2014 at the earliest because EU regulators still need to authorize and recognize CCPs and identify classes of clearing-eligible derivatives.

COUNTERPARTY CLASSIFICATION

EMIR requirements are applied differently, depending on counterparty classification. EMIR divides counterparties into:

- *Financial counterparties* ("FCs"): EU banks, investment firms, insurers and pension providers, UCITS funds (and their managers) and alternative fund managers authorized or registered under the Alternative Investment Fund Managers Directive. Generally, FCs are (or will be) subject to all EMIR risk mitigation, trade reporting and applicable clearing obligations;
- *Nonfinancial counterparties* ("NFCs"): EU-established entities that are not FCs. There are two types of NFCs: NFC+s, with 30-day rolling average OTC derivative positions entered into for nonhedging purposes above specified thresholds, and NFC-s, with contracts that do not exceed such thresholds. Generally NFC+s will be subject to most of the EMIR risk mitigation, trade reporting and applicable clearing obligations, while NFC-s will be subject only to trade reporting and some of the EMIR risk migration requirements;[3] and
- *Third-country entities*: those that enter into derivative contracts that have a "direct, substantial and foreseeable effect" within the EU or have been designed to evade EMIR requirements. They will be subject to the clearing obligation and relevant risk mitigation obligations.

CROSS-BORDER IMPLICATIONS

EMIR allows the European Commission to declare that a non-EU country's risk mitigation, trade reporting and clearing obligations are equivalent to EU requirements, which would allow an EU and non-EU counterparty to agree that they will comply with non-EU requirements. ESMA, the pan-EU securities regulator, has been advising the European Commission on whether the OTC derivative regimes of the U.S. and a number of other countries are equivalent. While these discussions are at an initial stage, early indications are that the equivalence declarations will not be straightforward. Nevertheless, OTC derivatives market participants hope that some international agreement among regulators and lawmakers eventually will ease the burden in one of the most globally active markets.

CONCLUSION

As EMIR provisions become effective in 2014, OTC derivatives market participants should reinforce their compliance efforts across the spectrum. They must prepare for clearing obligation compliance, deal with data required to perform portfolio reconciliations and have processes to prepare for the variety of trade reporting requirements under the new regime. In addition, internationally active market participants will need to identify how to comply with overlapping requirements arising from the Dodd-Frank Act in the United States.

NOTES

[1] The G20 also agreed to move the trading of certain OTC derivatives on to trading venues. The EU will implement this commitment separately through the "MIFID 2" process.
[2] Regulation (EU) No 648/2012, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.
[3] NFC-s need only comply with trade confirmation, portfolio reconciliation and compression, and dispute resolution requirements.