News Bulletin

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Regulating Europe's Derivative Markets – Where Are We Now?

After the publication of fifteen revised drafts of the long-awaited Regulation of the European Parliament and Council on OTC Derivatives, Central Counterparties and Trade Repositories (commonly known as "EMIR"), you would be forgiven for thinking that the Europeans were never likely to see a conclusion to legislative attempts to regulate their over-the-counter ("OTC") derivatives market. However, on 9 February 2012, a trialogue meeting of the European Parliament, the Council and the European Commission at long last reached agreement on the final text of EMIR [1], and since we last provided an update on OTC derivatives reform in the EU[2], the wheels of the legislative process have turned extensively, even if slowly.

Although the publication of the legislation finally puts in place the broad regulatory framework to govern the OTC derivatives market and establishes common rules for central counterparties and trade repositories, much of the real detail has yet to be drafted. The European Securities and Markets Authority ("ESMA") now has responsibility for putting the flesh on the bones, in the form of drafting scores of technical standards to implement the EMIR provisions.

Even before the final text of EMIR was released, ESMA published a draft discussion paper (the "Paper") setting out some draft proposals for some of these technical standards, and requesting views. Insights that can be gleaned from the Paper into ESMA's thinking are somewhat mixed. In some areas, ESMA has clearly had time to develop its analysis and has provided a detailed view of the appropriate technical standards that it currently considers should be applied, subject to the views and comments of affected parties (referred to in the Paper as "stakeholders"). In other places, it is clear that ESMA has a more nascent view of the position that it wishes to take, perhaps because the relevant requirement for a technical standard has appeared relatively late in the EMIR negotiation process and it simply has not had enough time to develop its thinking. In these cases, ESMA has still invited stakeholder views generally, although this questioning is much less focused and provides limited guidance to the stakeholder.

This update aims to summarise where the final provisions of EMIR ended up and set out ESMA's initial views on how the key parts of EMIR will be applied.

Scope of the Clearing Obligation

EMIR provides that all OTC derivative contracts declared subject to a clearing obligation shall be mandatorily cleared through third party central clearing counterparties ("CCPs"). A dual process has been put in place to

[1] See http://register.consilium.europa.eu/pdf/en/12/st07/st07509-re01.en12.pdf.
[2] See Morrison & Foerster client alert "Draft EU Regulation on OTC Derivatives, Central Counterparties and Trade Repositories", http://www.mofo.com/files/Uploads/Images/100920-Draft-EU-Regulation-on-OTC-Derivatives.pdf.

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determine which OTC derivative contracts will be subject to the clearing obligation. The first element of this process arises when a competent authority provides approval to a CCP to clear a class of OTC derivative contracts. The competent authority must inform ESMA, which will then determine (after conducting a public consultation and also consulting with at least the European Systemic Risk Board ("ESRB") and possibly also the competent authorities of countries outside the EU) whether a clearing obligation should apply to all such contracts in the EU and, if so, the date from which that clearing obligation should take effect. This is often referred to as the 'bottom up' approach. In tandem, ESMA (again having consulted with ESRB and third countries) will identify certain contracts which are not currently cleared by a CCP, and declare such contracts subject to a clearing obligation. This is referred to as the 'top down' approach. Certain types of transactions are, however, automatically exempt from the clearing obligation, in particular any derivative contracts which constitute intra-group transactions[3].

Despite widespread opposition from, amongst others, the International Securities and Derivatives Association ("ISDA"), the British Bankers Association ("BBA"), and even the Chairman of the Commodity Futures Trading Commission in the United States, the clearing obligation under EMIR will only apply to OTC Derivatives[4]. These are derivative contracts as set forth in paragraphs (4) to (10) of Section C of Annex I to the Markets in Financial Instruments Directive ("MiFID"), but where execution does not take place on a regulated market (as defined in Article 4(1)(14) of MiFID).

Affected Parties

In terms of the entities that will be affected, the clearing obligation shall apply to Financial Counterparties, which are primarily investment firms authorised under MiFID (but also certain other entities including insurance and re-insurance undertakings), as well as non-Financial Counterparties (i.e., entities which are established in the EU but which are not Financial Counterparties) whose positions in OTC Derivatives exceed a clearing threshold ("Relevant Non-Financial Counterparties"). In determining the clearing threshold, non-Financial Counterparties are not required to take into account OTC Derivatives which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the relevant entity or its group. However, once the threshold has been exceeded, all OTC Derivatives which are subject to a clearing obligation, and are entered into by the non-Financial Counterparty after the time it exceeded such threshold, will be subject to the clearing obligation.

Extra-territorial Effect

The classification and definition of Financial and non-Financial Counterparties ensures that they include only entities that will be based in the EU. However, the clearing obligation may also apply in circumstances where (i) a Financial Counterparty or a Relevant Non-Financial Counterparty enters into an OTC Derivative with an entity, established in a third country, which would be subject to the clearing obligation if it were established in the EU, or (ii) an OTC Derivative is concluded between two entities established outside the EU, if such contract has a "*direct, substantial and foreseeable effect*" within the EU, or where such a clearing obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR.

On the latter point, ESMA has been mandated to draft technical guidance as to what is meant by "*direct, substantial and foreseeable effect*", as well as the circumstances in which it will be "necessary or appropriate to prevent evasion" of any part of EMIR, and it has accordingly asked for views from stakeholders in the Paper, although it has not provided any hint of what its current views are. Initial responses on this point have called above all for clarity on this issue, in order to ensure that there is no delay in the process of determining which

[3] Intra-group transactions are, very broadly, any OTC derivative transactions entered into between counterparties that are part of the same group consolidation (for accounting purposes or for regulatory purposes) (outlined in detail at Article 2a of EMIR).
[4] In the ISDA/AFME position paper on the scope of EMIR (May 2011), it was argued that broadening the scope of EMIR would have the benefit of enhancing competition amongst trading venues on the basis that applying CCP access rules (see Article 5 of EMIR) would prohibit the bundling of execution and clearing services (known as 'vertical-silos').

contracts do and do not have to comply with the requirements. However, it is clear that this is going to be a difficult task, in part because (as the ISDA-AFME-BBA joint response (the "Joint Response")[5] points out) it is not at all clear how a transaction can have a "direct" effect in the EU when there is no EU counterparty.

Threshold for Non-Financial Counterparties

One area where ESMA appears to have more developed views, however, is in setting the level at which the clearing threshold should apply for non-Financial Counterparties. Although ESMA has not set out its thoughts on actual values, it makes clear in the Paper that any such threshold will be expressed in terms of the notional value of OTC Derivatives subject to a clearing obligation. It is likely to be "*set at a low level*" and to be the same across all asset classes. ESMA also envisages the need for a mechanism to be put in place with the purpose of preventing firms from multiplying their legal entities and splitting their derivatives trades between them, in order to benefit from multiple thresholds. So far, responses to this approach have been broadly favourable, although some commentators have noted that adopting a low threshold may be disadvantageous for non-financial corporate entities, leaving them particularly susceptible in cases of accounting mismatches (particularly where the relevant entity is hedging significant amounts of commercial risk).

Commercial Hedging Exemption

ESMA has also set out its current views as to the types of derivatives which should not count towards the clearing threshold, on the basis that they are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the relevant entity or its group. ESMA considers this exemption most likely to be applicable where the objective of an OTC derivative is to reduce certain risks (including changes in the value of assets, inputs, services and commodities etc. which the group owns, produces, provides or uses in the ordinary course of its business), or where the application of International Accounting Standard 39 on hedge accounting would treat the derivative as a hedging contract. According to ESMA, OTC Derivatives used for speculation, investment or trading purposes, will not qualify for this commercial hedging exemption. However, it is not entirely clear from the limited details in the Paper whether, a derivative which objectively reduces some commercial risk, but may also provide some speculative or investment potential for the non-Financial Counterparty, would still be ignored for the purpose of the clearing threshold.

CCP Membership

Once a particular OTC Derivative is required to be centrally cleared, Article 3 of EMIR requires that one of the counterparties shall become a clearing member of a CCP, a client of a clearing member, or alternatively will establish "indirect clearing arrangements" with a clearing member, so long as those arrangements ensure that its positions are protected by provisions equivalent to the position segregation and default procedures which EMIR requires of CCPs and do not increase counterparty risk.

ESMA has requested views in the Paper on what types of indirect clearing arrangements would satisfy these conditions, but has not provided its thoughts on the provisions.

Trade Reporting Obligation

In an effort to increase transparency and provide protection against market abuse and systemic risk, all Counterparties (both Financial and non-Financial) and CCPs must ensure that any concluded, modified or

[5] See http://www.bba.org.uk/policy/article/afme-bba-isda-response-to-1st-esma-discussion-paper; click on the download button at the bottom of that page.

terminated derivative contracts are reported to a trade repository within one working day of such conclusion, modification or termination. These requirements will apply to all contracts, whether traded OTC or otherwise, entered into after EMIR comes into force, as well as those entered into before EMIR comes into force but which remain outstanding after that date.

In the Paper, ESMA provides a detailed table (at Annex II) setting out its preliminary indication of the type of information that it would expect to be reported. This includes disclosure of contract type, details of the contracting parties and the main characteristics of the contract (broken down by asset class and including details such as the nature of the underlying, notional value, price/rate/spread and settlement date). The required information is also sub-divided into two tables. The first of these requires data on the counterparties, to be reported separately by each counterparty or an appointed reporting entity. This table will include, for example, the name, domicile and sector of the relevant counterparty, as well as details of any relevant beneficiaries, where the counterparty is not the economic beneficiary. The second table is used to disclose common data. This only needs to be provided by one of the counterparties, and includes, for example, the trade ID, venue of execution, trade specific details and the nature of any applicable risk mitigation techniques (such as collateralisation). It is clear, therefore, that a high level of detail is currently envisaged by ESMA. As a result, certain respondents (such as the European Fund and Asset Management Association ("EFAMA")[6]) to the report have argued that the requirements are too onerous and go far further than transaction reporting requirements in other sectors, with the consequence that such detailed reporting will inevitably require participants to undertake substantial systems upgrades. Others (such as the contributors to the Joint Response) have highlighted that the reporting obligations should also recognise variations in the approach to data collection between standardised products and more complex and bespoke products.

ESMA further notes that in order to ensure consistency between the reporting mechanisms under EMIR and MiFID, the draft MiFID II proposals[7] should provide for trade repositories to seek authorisation as Approved Reporting Mechanisms ("ARMs")[8]. This would ensure that reporting a trade to a relevant combined entity would provide simultaneous compliance with both sets of legislation. Unsurprisingly, industry responses show that stakeholders are largely supportive of these efforts to ensure there is a mechanism provided to prevent the need for double reporting. The Joint Report, however, states that it would welcome confirmation that the reporting of a contract under EMIR would satisfy the requirements under MiFID, regardless of whether the relevant trade repository is a registered ARM.

Non-Clearing Eligible Derivatives

OTC Derivatives that are not required to be cleared by Financial Counterparties and Relevant Non-Financial Counterparties will still be subject to certain mandatory 'risk mitigation techniques' – in other words, arrangements to measure, monitor and mitigate operational and counterparty credit risk. Such techniques include (amongst others) the following:

Timely Confirmation of OTC Derivative Transactions: ESMA considers that for trades which are confirmed by Financial Counterparties and Relevant Non-Financial Counterparties, confirmations should be provided within 15 minutes of the execution of the contract, where such contract can be electronically executed. The time is increased to 30 minutes where the confirmation can be processed (but not executed) electronically, and the confirmation must be provided on the same calendar day, in circumstances where neither electronic execution nor processing is available. For all other parties, confirmations should be provided no later than the business day after the transaction has been electronically processed, or a certain (as yet unspecified) number of days following execution

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[6] The EFAMA responses can be found at: http://www.esma.europa.eu/system/files/12-4016_efama_reply_to_esma_-_consultation_on_emir_questionnaire_-_answer.pdf.
[7] See Morrison & Foerster client alert, "Higher, Wider, Deeper: EU Commission Publishes MiFID II and MiFIR Proposals", http://www.mofo.com/files/Uploads/Images/111031-EU-Publishes-MiFID-II- MiFIR.pdf.
[8] Under MiFID, reportable transactions have to be reported to an Approved Reporting Mechanism.

where neither electronic processing nor execution is available. Questions have been raised by respondents regarding the realistic prospect of stakeholders being able to meet the relevant requirements, given relevant practical considerations including: missing information at the time of confirmation (such as initial fixing rates or prices), the high level of legal analysis that may be required to prepare confirmations for more bespoke transactions, and time constraints generated by the need to follow compliance procedures and receive client instructions.

Portfolio Reconciliation: In order to identify discrepancies in the material terms of a contract or in its valuation, ESMA believes that parties should reconcile their portfolios based upon the number of OTC derivative contracts in place with each other. An indicative threshold of 300 trades between two counterparties has been suggested as the point at which portfolio reconciliation should be required on a daily basis. ESMA would also like to implement two lower thresholds below this whereby a medium (currently unspecified) level would require weekly reconciliation and a lower (also currently unspecified) level would require quarterly reconciliation. In both cases, however, the frequency of reconciliations will need to be appropriate to the size and volatility of the relevant derivatives portfolio.

Marking-to-Market: All Financial Counterparties and Relevant Non-Financial Counterparties are required to mark-to-market, on a daily basis, the value of their outstanding contracts. If marking-to-market is not possible, a reliant and prudent marking-to-model shall be used.

Collateralisation: EMIR provides that Financial Counterparties and Relevant Non-Financial Counterparties should put in place risk-management procedures which require the timely, accurate and appropriately segregated exchange of collateral with respect to any OTC Derivatives (i.e., not just cleared trades) entered into after EMIR comes into force (or, in the case of Relevant Non-Financial Counterparties, after the clearing threshold is breached). It should be noted, however, that intra-group transactions are generally exempt from this requirement. While this exemption is automatic in respect of counterparties established in the same Member State, certain conditions must be fulfilled[9] in order for the exemption to apply where the counterparties are established in different Member States (or indeed where one counterparty is established within the EU while the other is established outside the EU).

Dispute Resolution: Counterparties are required under EMIR, to put in place formalised processes which are robust, resilient and auditable in order to identify disputes between parties early on and resolve them. In order to achieve this, ESMA will require counterparties to record and monitor any disputes which relate to the recognition or valuation of contracts, or to the exchange of collateral between parties. In particular, the length of the dispute, identity of the counterparty and amount at issue should be recorded. Suggested dispute resolution procedures for disputes not resolved within 5 business days include a combination of legal settlement, arbitration or a market polling method[10]. ESMA may also require that Financial Counterparties report to a competent authority, the details of any dispute relating to an OTC Derivative with a valuation (or exchange of collateral) in excess of EUR 15 million and where the dispute lasts longer than 15 business days.

Requirements for CCPs

A CCP established in the EU must be authorised (under Article 10 of EMIR) by the competent authority of the Member State in which it is established. In order to be authorised, the CCP must have permanent and available initial capital of at least EUR 7.5 million. However, at all times, the amount of capital (including retained earnings

[9] The conditions include that the risk management procedures are considered adequately robust and consistent with the level of complexity of the derivative transaction, and that there is no practical or legal impediment to the prompt transfer of funds or repayment of liabilities between the counterparties.

[10] Many respondents pointed out that these are not the only options available to counterparties to a dispute. Indeed, legal settlement and arbitration may be an option, but only after exhausting all potential out-of-court remedies. Such remedies might include unwinding the relevant trade that is in dispute, or identifying and eliminating any structural differences in each disputing party's valuation methods.

and reserves) of a CCP, shall be proportional to the risks stemming from such CCP's activities. Once granted, authorisation under Article 10 must be recognised throughout the EU.

The advent of compulsory centralised clearing of OTC derivatives will lead to enormous concentrations of risk in CCPs and therefore the CCPs will be subject to a great number of organisational, prudential and business conduct requirements as outlined below.

Organisational Requirements: CCPs should have robust governance arrangements in place (including a clear organisational structure with clear and consistent reporting lines) to identify, manage, monitor and report risks to which they may be exposed. CCPs are also required (amongst other things) to establish risk committees and internal risk management functions, maintain comprehensive records allowing competent authorities to monitor their compliance and develop business continuity policies and recovery disaster plans.

Prudential Requirements: In order to mitigate the enormous amounts of counterparty risk concentrated in CCPs, EMIR also lays down extensive prudential requirements. These include (amongst other things), imposing, calling and collecting margins sufficient to cover potential exposures that the CCP estimates will occur until liquidation of the relevant positions. Margin requirements must be determined, which capture the risk characteristics of the products cleared. CCPs must also consider the intervals between margin collections, market liquidity and the possibility of changes over the duration of a transaction. These parameters are to be validated by a competent authority. Other prudential requirements include establishing and maintaining a pre-default fund to help absorb losses of even the largest clearing members and putting default procedures in place to deal with clearing members that are failing to comply with their requirements.

Conduct of Business Rules: EMIR sets out a number of conduct of business rules applicable to CCPs. As a general matter, CCPs are required to act fairly and professionally in accordance with the best interests of the clearing members and, where relevant, their clients and have accessible, transparent and fair rules for the prompt handling of complaints.

CCPs will be required to establish the categories of admissible clearing members and the admission criteria for those categories. This criteria must be non-discriminatory, transparent and objective, in order to ensure open access to the CCP. Clearing members must have sufficient financial resources and operational capacity to meet the obligations arising from participation in a CCP, and a CCP's rules must allow it to gather relevant basic information to identify, monitor and manage relevant concentrations of risk related to the provision of services to clients.

Transparency

A CCP and its clearing members must also publicly disclose the prices and fees associated with the services they provide. Any breaches of this or the criteria above must also be publicly disclosed unless the competent authority, having consulted ESMA, considers this disclosure would constitute a threat to financial stability or market confidence. A CCP is also obliged to disclose to clearing members and its competent authority the price information used to calculate its end of day exposures with its clearing members, and to disclose to the public the volumes of the cleared transactions for each class of instruments cleared on an aggregated basis.

Segregation

CCPs must keep separate records and accounts allowing them to distinguish one clearing member's assets and positions from another, and it must offer to keep separate records and accounts enabling each clearing member to distinguish, in accounts with the CCP, (i) the clearing member's assets from its clients' assets ("omnibus client segregation"), and (ii) the assets of each client of the clearing member from those of other clients of the clearing member ("individual client segregation").

A clearing member, in turn, is under an obligation to keep records and accounts enabling it to distinguish its assets and positions with a CCP from its clients' assets and positions, both in its accounts and in accounts held with the CCP.

Interoperability

Interoperability is defined in Article 2 of EMIR to mean "*an arrangement between two or more CCPs that involves a cross-system execution of transaction*s". If a CCP wishes to enter into an interoperability arrangement with another CCP, it must comply with certain requirements (as described in the next paragraph) and the arrangement must be approved by the competent authorities of the CCPs involved.

CCPs entering into an interoperability arrangement must put in place adequate risk management policies, procedures and systems. The respective rights and obligations, as well as the applicable law governing such an arrangement, must be decided upon and the credit and liquidity risks must be managed so that the default of one clearing member does not affect an interoperable CCP. CCPs must also distinguish in accounts the assets and positions held for the CCPs with whom they have entered into an interoperability arrangement.

Requirements for Trade Repositories

An entity wishing to become a trade repository for the purpose of EMIR must register with ESMA, which registration will then be effective throughout the EU. In order to be eligible to register, the trade repository must be a legal person established within the EU. The trade repository must have robust governance arrangements including a clear organisational structure. Any potential conflicts of interest concerning managers, employees and persons linked to them must be identified and managed via effective written organisational and administrative arrangements, and any ancillary services offered by the repository must be kept operationally separate from the collecting and recording function. The trade repository must also identify sources of operational risk and minimise them through appropriate controls, procedures and systems. Information received must be kept confidential and secure. Any such information received must be kept for ten years following termination of the relevant contracts.

The Commission is empowered to adopt implementing legislation to the effect that the legal and supervisory arrangements of a country outside the EU are adequate to ensure that trade repositories authorised in that country comply with legally binding requirements equivalent to EMIR, are effectively supervised and monitored and that guarantees of professional secrecy exist, which are at least equivalent to EMIR. If a relevant third country has no trade repositories but wishes to access information on derivatives contracts held in EU trade repositories, its competent authority may contact ESMA in this regard who is empowered to enter into cooperation arrangements with that competent authority, subject to sufficient confidentiality being ensured.

Implementation

On 29 March 2012, the European Parliament finally voted in favour of EMIR, several months after the regulation had originally been expected to be in place. The vote, however, is only the first step towards EMIR taking full effect. As discussed above, there are a huge number of technical standards to be drafted (for example, the types of OTC derivative contracts subject to a clearing obligation and the thresholds for non-Financial Counterparties to become obliged to clear OTC Derivatives centrally). ESMA's final technical standards are due by September 30, 2012, and it is currently intended by EMIR that its technical standards will be fully adopted by the Commission by the end of 2012. This, however, is a hugely optimistic time scale. Requests to the Commission for a more realistic time scale for ESMA's rulemaking have fallen on deaf ears and it is to be hoped that the determination to meet the G20 deadline (despite the delay in passing EMIR) will not result in rulemaking that has not been adequately considered. All eyes are now on ESMA.

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