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EMIR Questions and Answers



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What is EMIR all about?

EMIR stands for the European Market Infrastructure Regulation. It is part of the European Union's response to the G20 commitment to mitigate the perceived risks in the OTC derivatives market which were exposed by the financial crisis of 2007/8. EMIR covers the clearing of certain OTC derivatives, risk mitigation procedures for non-cleared OTC derivatives and reporting of all derivatives.

Further requirements relating to the trading of OTC derivatives on exchanges and other platforms and transparency in the OTC derivatives markets will be implemented via MiFID II/MiFIR which is another body of regulation currently going through the legislative process in the EU.

What is EMIR?

EMIR is a European Regulation which applies directly in each Member State of the European Union. It does not require local governments or regulators to bring it in to force. The detail of EMIR is implemented via a set of technical standards which are also in the form of a European Regulation.

What is the scope of EMIR?

EMIR has four main strands:

- mandatory risk mitigation requirements for uncleared OTC trades which include timely confirmation, daily valuations, portfolio reconciliation, portfolio compression, dispute resolution and margin;
- an obligation to report all derivatives trades, both OTC and exchange-traded to a trade repository registered or recognised under EMIR;
- an obligation to clear all "eligible" OTC derivatives contracts via a central clearing house authorised or recognised under EMIR;

- a common regulatory regime for central clearing houses and trade repositories across Europe.

When does EMIR come into effect?

Most of the risk mitigation requirements relating to uncleared OTC derivatives are already in effect. Trade reporting is the next big piece to go live on 12 February 2014, followed by clearing of OTC derivatives some time later this year. Margin requirements for non-cleared OTC derivatives are expected to be effective from December 2015.

What types of transaction does EMIR cover?

EMIR relates to all derivatives transactions executed by a financial counterparty or non-financial counterparty, no matter where they are executed. Different elements of EMIR apply depending on whether the transaction is OTC, cleared or exchange-traded. So trade reporting applies to all derivatives transactions, the risk mitigation requirements apply to uncleared OTC trades and clearing will apply to a subset of OTC derivatives.

What is a derivatives transaction is defined by reference to MiFID. The definition of derivative under MiFID is very widely drafted and, as a Directive, it has been implemented in different ways across Europe. This has led to a certain amount of confusion over what is in and what is out, in particular in the case of forward FX. ESMA is expected to provide some more guidance on this soon.

Who is captured by EMIR?

EMIR imposes obligations on the counterparties to a derivatives trade. It divides the world into Financial Counterparties, Non-financial Counterparties over the clearing threshold and Non-Financial Counterparties below the clearing threshold. The extent to which the various pieces of EMIR apply depends on the category of the



counterparty and the threshold limits depend on the types of investments traded.

EMIR also imposes obligations on clearing members and clearing houses (referred to as CCPs) with respect to clearing of trades and on new entities called trade repositories. Trade Repositories will be responsible for receiving reports of derivatives trades from counterparties and providing access to regulators.

EMIR does not apply to private individuals.

What is a financial counterparty?

In summary a financial counterparty is an entity which is subject to financial or prudential regulation of some kind in the EU. It includes banks, investment firms, UCITS and UCITS management companies, AIFs managed by an AIFM which is authorised or registered under the AIFMD, insurance companies and pension funds.

What is a non-financial counterparty?

A non-financial counterparty is an entity which is established in the European Union which is neither a financial counterparty nor a clearing house. Non-financial counterparties are further divided into two categories – those whose outstanding derivatives trades are over the clearing threshold and those whose outstanding trades are not. For these purposes the notional amounts of the outstanding trades are used and any trades which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the entity may be ignored.

It is worth noting that a European AIF with an AIFM which is not yet registered or authorised under AIFMD will be a non-financial counterparty and so will need to monitor its trading volumes and report to ESMA and its competent authority if the clearing threshold is exceeded. The exemption for trades related to commercial and treasury hedging activity is unlikely to be relevant to AIFs.

Can EMIR apply to non-EU entities?

In general EMIR only applies directly to entities established in the European Union, but it will also be implemented in other non-EU EEA countries and can apply in some circumstances to non-EU entities such as a non-EU AIF where the AIFM is authorised or registered under the AIFMD.

Certain parts of EMIR can also apply to non-EU entities when concluding trades with entities which are subject to EMIR or where two non-EU entities enter into a derivatives transaction which has a direct, substantial and foreseeable effect within the EU.

The European Securities Markets Authority has proposed technical standards on what this means to the EU Commission. Broadly they propose that trades between the EU branches of two non-EU entities or trades between non-EU entities where one is guaranteed by an EU financial counterparty should be covered by EMIR.

Transactions may also be caught by EMIR where it is necessary or appropriate to prevent the evasion of any provision of EMIR. This has been interpreted to mean that if the way in which a contract has been concluded is considered, when viewed as a whole and having regard to the circumstances, to have its primary purpose for the avoidance of the application of any provision of EMIR. Essentially, any arrangement which intrinsically lacks business rationale, commercial substance or relevant economic jurisdiction may be considered an artificial arrangement for these purposes. It remains to be seen how this will be implemented in practice.

Are there any exemptions?

Yes. As well as the exemption from clearing for non-financial counterparties mentioned above, and the lighter touch in other areas for non-financial counterparties of EMIR there are also exemptions:

- (i) for intra-group transactions, from both the clearing obligation and the requirement to exchange collateral in respect of bi-lateral trades; and



- (ii) for pension scheme arrangements (as defined in Article 2(10) EMIR) in respect of the clearing obligation for transactions related to the solvency of the scheme.

Certain types of entity such as central banks are also exempt and some public sector entities are only required to comply with the reporting requirements.

What should firms be doing?

If you are executing derivatives trades with entities established in Europe you will need to consider the extent to which EMIR applies to you, if you haven't done so already.

If you are established in the EU you should determine whether you are a financial counterparty, non-financial counterparty or out of scope. You will need to determine the types of derivatives transaction you are executing and the EMIR status of the counterparties you are dealing with. Where necessary you will need to ensure that you have processes and procedures in place to deal with the risk mitigation requirements for OTC derivatives and ensure that you can report trades (including historic trades) to a trade repository from 12 February. For this you will also need a Legal Entity Identifier (LEIs). An LEI is a unique code which must be used by entities which execute derivatives transactions as a means of identifying that they are a party to or involved in the transaction. LEIs are required by all counterparties and intermediaries to derivatives trades for trade reporting. A global governance system has been set up to oversee the issuance of LEIs.

You will also need to start considering your options for OTC derivatives clearing if the trades you execute are likely to be caught in the first wave of instruments covered by mandatory clearing (probably interest rate swaps and credit default swaps and possibly non deliverable forwards). This will involve choosing one or more clearing brokers and assessing the client accounts available at the various clearing houses. Even if you only trade exchange traded derivatives you will be impacted by trade reporting and by the new clearing accounts which clearing houses will

be required to offer for their exchange traded derivatives clearing as well as their OTC offering.

Where you are not established in the EU the EMIR clearing obligation may apply to you in due course if you are executing OTC trades which are subject to mandatory clearing with an EU financial counterparty or non-financial counterparty over the clearing threshold. You may also be impacted by EMIR if you are using clearing houses for exchange traded derivatives clearing which are established in the EU.

Certain of the EMIR risk mitigation requirements may also be imposed upon you by contract if you are dealing with an entity which is subject to EMIR and reports of trades executed with such an entity will be made identifying you as the counterparty. You will also be required to provide an LEI to your counterparty for these purposes.

Where you are not executing trades with an entity subject to EMIR, EMIR requirements may still be imposed for instance if your counterparty is guaranteed by a financial counterparty or if the transaction has been structured in a way to avoid EMIR.

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