EMIR – An Overview

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CUMMINGS
lawyers for alternative investments

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Background

Where did it all start?

- Onset of the financial crisis – June 2007
- Lack of transparency in OTC derivatives market – regulators unable to establish where exposure lay in the market
- Build-up of systemic risk
- Regulatory tools unable to cope

G20 statement in Pittsburgh:

- All standardised 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.
- OTC derivative contracts should be reported to trade repositories.
- Non-centrally cleared contracts should be subject to higher capital requirements.

EMIR – an overview

What is EMIR?

- EMIR is an EU Regulation which applies directly in each Member State. It does not require local governments or regulators to bring it in to force. It also has a number of technical standards (also regulations)

- EMIR has 4 strands, the first 3 of which directly affect counterparties to derivatives trades:

  - mandatory risk mitigation requirements for uncleared OTC trades relating to timely confirmation, daily valuations, portfolio reconciliation, portfolio compression, dispute resolution, margin;

  - A trade reporting obligation requirement for all transactions in OTC derivatives and ETDs to be reported to a trade repository registered or recognised under EMIR;

  - mandatory clearing of “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.

EMIR – an overview

Timeframes:

- **Risk Mitigation techniques:**
  - Timely confirmations and daily valuations: 15 March 2013
  - Portfolio reconciliation, portfolio compression and dispute resolution: 15 September 2013
  - Margin requirements – likely to be 1 December 2015
- **Trade Reporting:**
  - All trades executed since 16 August 2012 and still outstanding on trade reporting start date – 12 February 2014
  - All trades outstanding on 16 August 2012 and still outstanding on trade reporting start date - within 90 days of trade reporting start date – i.e. by 13 May 2014
  - All trades outstanding on 16 August 2012 or entered into on or after 16 August 2012 but which are not still outstanding on trade reporting start date – within 3 years of trade reporting start date – i.e. by 12 February 2017
  - Reporting of valuations and collateral: 180 days after trade reporting start date for all outstanding trades – i.e. by 11 August 2014 (FCs and NFC+ only)
- **Clearing:**
  - Not likely before Q4 2014

EMIR – an overview

The players:

- Financial counterparties (FC).
- Non-financial counterparties (NFC).
- Clearing members (entities who facilitate clearing for clients).
- Central clearing houses (CCP) (entities who provide clearing services).
- Trade repositories (entities who provide trade repository services).

Investment managers are not directly affected unless executing trades as principal.

EMIR – an overview

Counterparty Categorisation:

- Application of EMIR depends on category of counterparty. EMIR distinguishes between:
  - Financial Counterparties (FCs): EEA Banks, investment firms, pension funds, insurance companies, UCITS, AIFs (Art 2(8) EMIR).
  - Non-Financial Counterparties (NFCs) – undertakings established in EEA other than CCPs, Trade repositories and FCs (Art 2(9) EMIR).
  - NFCs over clearing threshold (NFC+) (Art 10 EMIR).

What is the clearing threshold?

- It determines the extent to which EMIR obligations apply to NFCs and is calculated by assessing the OTC derivatives trading activities of an NFC which are not "objectively measurable as reducing risks directly relating to the commercial or treasury financing activities" of the NFC or its group.
- Where these activities exceed certain thresholds the NFC will become and NFC+ and will be required to clear all OTC derivatives transactions which are subject to mandatory clearing.
- NFC+ also subject to enhanced risk mitigation and reporting requirements.
- When NFC exceeds the threshold it is required to notify both ESMA and its competent authority.

EMIR – an overview

What is the clearing threshold?

Thresholds are measured in terms of gross notional amounts outstanding:

- €1bn in gross notional value for OTC <u>credit and equity derivatives</u> (individual thresholds).
- €3bn in gross notional value for <u>interest rate and FX</u> (individual thresholds).
- €3bn in gross notional value for <u>commodities and others</u> (combined threshold).

The clearing obligation applies to <u>all</u> OTC derivative contracts once <u>one</u> of the thresholds is reached.

EMIR – an overview

	FC	NFC+	NFC-
Clearing	Yes	Yes	No
Timely confirmation	Yes	Yes – no reporting	Yes – different and no reporting
Reconciliations	Yes	Yes	Yes - different
Valuation	Yes	Yes	No
Compression	Yes	Yes	Yes
Disputes	Yes	Yes – no reporting	Yes – no reporting
Exchange of collateral	Yes	Yes	No
Reporting	Yes	Yes	Yes – no exposures

EMIR – an overview

Extraterritoriality

- EMIR applies to non-EEA counterparties:
  - Non-EEA entity may fall within definition of FC e.g. non-EEA AIF.
  - Entity would be subject to clearing or bi-lateral requirements if established in EEA (TCE) and:
    - Clearing: contract concluded with FC or NFC+.
    - Clearing and bi-lateral requirements: contract between 2 TCEs which has a "direct, substantial and foreseeable effect" within EEA or necessary or appropriate to apply obligation to prevent evasion of EMIR.
- ESMA final report on RTS on direct, substantial and foreseeable submitted to EU Commission on 15 November 2013.

EMIR - the detail: trade reporting

- All derivatives trades must be reported – OTC and ETD.
- The obligations apply to **<u>both</u>** counterparties to each trade, therefore client as well as banks/clearing members/CCPs will have to report.
- The information required to be reported is very extensive – 87 fields in total - includes identification of each counterparty, clearing member, CCP, trade type, collateral and valuation position.
- Reports have to be made to a Trade Repository registered or recognised by ESMA – 6 so far registered.
- Although originally the timetable for the on-set of reporting differed according to underlying asset, all trade reporting will now commence on 12 February 2014. Reporting of valuations and collateral will commence after 180 days.
- Trade reporting does **not** apply to entities established outside the EU (other than non-EU FCs).
- Trade reporting can be delegated to the other counterparty or a third party provider.
- Problems with ETD reporting.

EMIR - the detail: trade reporting

What is an LEI?

- A unique code which can be used by entities which interact in the financial system as a means of identifying that they are a party to or involved in a financial transaction.
- LEIs are required by all counterparties and intermediaries to derivatives trades for trade reporting.
- A global system for LEIs has been established with a Regulatory Oversight Committee.

EMIR - the detail: clearing

What is clearing?

- Clearing is a mechanism for smooth management of the sale and purchase of financial contracts after the point of trade;
- Typically exchange traded derivatives will also clear.
- CCP has Clearing Members - usually banks; CMs deal with clients.
- CCP uses margin to cover trade risk, holds capital and operates a default fund (funded by CMs) to deal with market default.
- CCPs do not assume client credit risk.
- CCP interposes itself between every buyer and seller.
- EU Model – client contracts with a Clearing Member who contracts with CCP on a back-to-back principal basis.
- US model is agency based, but requires all trades to be routed through FCMs – client contracts with CCP.

EMIR - the detail: clearing

- Clearing obligation applies to FCs and NFC+s.
- Exemption available for pension scheme arrangements.
- Commission will specify types of transaction subject to clearing obligation in an RTS following advice from ESMA.
- Clearing obligation not yet in force – start date depends on authorisation of CCPs.
- Clearing will be subject to front loading from the date when a CCP is authorised.
- Phase-in will also be available for certain types of counterparty.
- Under EMIR CCPs and CMs are required to offer omnibus client segregation and individual client segregation – for ETD as well as OTC derivatives.
- Under EMIR CCPs are required to provide clients with opportunity to “port” i.e. transfer cleared trades to a new clearing member.

EMIR - the detail: risk mitigation

Timely confirmations

- Counterparties required to ensure that they have in place appropriate procedures and arrangements for the timely confirmation of OTC derivatives contracts which are not cleared by a CCP, where available, by electronic means.

- Timely means as soon as possible and at the latest within the time frames specified – these depend on category of counterparty and nature of underlying and also are subject to a phase-in.

- Periods range from 1 to 4 business days following trade date (since 31/08/13).

- FCs also require to have the necessary procedure to report on a monthly basis to their competent authority the number of unconfirmed trades which are outstanding for more than 5 business days after the date when they should have been reported.

- Requirements came into force on 15 March 2013.

EMIR - the detail: risk mitigation

Daily valuations

- FCs and NFC+s required to mark-to-market daily the value of outstanding uncleared OTC derivatives contracts.
- Mark-to-model permitted where the market is inactive, or the range of fair value estimates is significant and the probabilities of the various estimates cannot be assessed.
- Model must satisfy certain criteria: e.g. it must incorporate all factors that counterparties would consider in setting a price including as much mark-to-market data as possible; it must be independently validated and monitored.
- Where a model used it must be duly documented and approved at least annually by the board of directors (or similar body) of the counterparty (i.e. the client, not Invesco).
- Requirements came into force on 15 March 2013.

EMIR - the detail: risk mitigation

Portfolio reconciliations:

- Counterparties are required to agree the arrangements under which portfolios of uncleared OTC derivative contracts shall be reconciled.
- Frequency of reconciliations depends on category of each counterparty and number of outstanding contracts between them.
- Reconciliations should cover key terms that identify each OTC derivative contract.

Portfolio Compression

- Counterparties with 500 or more non-cleared OTC derivatives contracts outstanding with a single counterparty must have procedures in place to analyse at least twice a year the possibility of conducting a portfolio compression exercise.
- Counterparties must be able to explain if they have concluded it is not appropriate.
- Both Requirements came into force on 15 September 2013.

EMIR - the detail: risk mitigation

Dispute resolution

- All counterparties must have agreed procedures and processes to:
  - Identify record and monitor disputes relating contract recognition or valuation and exchange of collateral.
  - Resolve disputes in a timely manner.
  - Financial counterparties must report disputes to competent authority of an amount or value greater than €15m and outstanding for at least 15 business days.
  - Requirements came into force on 15 September 2013.

New margin requirements for counterparties (FC and NFC+)

- Initial and variation margin.
- Daily valuation.
- Detail not yet finalised at EU level but will follow BCBS/IOSCO framework and principles issued in September 2013.
- Requirements will be phased in from 1 December 2015.

EMIR - the challenges

General:

- Identifying how you fit in and you ned to do - Sheer volume and complexity of requirements.
- Extra-territorial scope and insufficient co-ordination at global level - Requirements conflict and overlap.
- Impact on funds – regime designed for CCPs and dealers not funds.
- Lack of clarity and short phase-in periods - legal and operational uncertainty during changeover.
- Increased costs – margin requirements, operational enhancements, lack of competition.