EU OTC Derivatives Regulation Under EMIR – An Analysis of the Final Agreed Text

Introduction

The European Market Infrastructure Regulation ("EMIR") was adopted by the European Parliament on 29 March 2012. The technical standards that will provide the detailed rules that give effect to EMIR are to be published by the European Securities and Markets Authority ("ESMA") by no later than 30 September 2012. Nevertheless, the provisions of EMIR, which is expected to become effective during 2013, provide the framework for affected firms to prepare, if they have not already done so, for the new regulatory regime that will shape the over-the-counter ("OTC") derivative markets (comprising derivative contracts which are not traded nor executed on a "regulated market"). In this update we highlight the anticipated impact of EMIR on participants in such markets.1

Background to EMIR

The objective of EMIR is to mitigate the perceived risks associated with OTC derivative contracts. EMIR seeks to increase transparency and liquidity in the OTC derivative markets, protect against market abuse and make markets safer by reducing counterparty risk and therefore systemic risk. In furtherance of this risk mitigation objective, robust central counterparties ("CCPs") will be required to intermediate specified types of OTC derivative contracts that are required to be cleared. EMIR contains provisions dealing with the authorisation, recognition and prudential regulation of CCPs and trade repositories.

It should be noted that the regulation of derivatives in the European Union ("EU") is set out not only in EMIR, but also in the current proposal to "recast" the existing EU Markets in Financial Instruments Directive (MiFID) framework (known as "MiFID II"). Please refer to our previous Update for an analysis of the MiFID II proposal.2

Finally, given the significant overlap between the OTC derivatives regulatory regimes in the United States and the EU, please refer to our Update3, comparing the two regimes.

Which market participants are affected by EMIR? 4

EMIR applies to the following entities:

1 Terms used but not defined in this update have the meanings given to them in EMIR.


4 See below under the heading "What are the exemptions from EMIR?" for a discussion on entities that are explicitly exempt from EMIR.
• "financial counterparties" which is defined broadly to include investment firms, credit institutions, insurance/reinsurance companies, UCITS5 funds and their managers, pension funds (although note the exemption below) and alternative investment funds managed by alternative investment fund managers;

• "non-financial counterparties" which refers to entities which are established in a member state of the EU, that are not financial counterparties, (and not CCPs, trade repositories or trading venues6) with OTC derivative contracts that exceed a clearing threshold to be specified pursuant to the contemplated technical standards to be published by the Commission (see "What are the exemptions under EMIR?" below);

• CCPs and their clearing members; and

• trade repositories.

What are the operational implications of EMIR?

Clearing obligation

One of the most significant changes introduced by EMIR is to require the clearing of certain OTC derivative contracts. "Clearing" refers to the process by which a CCP acts as an intermediary and assumes the role of both buyer and seller for transactions in order to reconcile orders between transacting parties. Under EMIR, CCPs will be used to meet the clearing obligation by interposing themselves between the counterparties to the affected OTC derivative contracts and becoming the buyer to every seller and the seller to every buyer in respect of such contracts.

A CCP connects with derivative counterparties through its clearing members. Clearing members contract directly with the CCP and are therefore responsible to the CCP for discharging all obligations arising under centrally-cleared OTC derivative contracts. Before clearing takes place, a financial or non-financial counterparty entering into an OTC derivative contract eligible for clearing will typically execute the contract with another counterparty with both parties agreeing to "give up" the contract straight away to their respective clearing members of the applicable CCP. The initial contract which is "given up" then takes effect as a series of matching contracts, one between each counterparty and its clearing member, and one between each clearing member and the CCP (with the CCP sitting in the middle between the two clearing members). So, whilst derivative counterparties initially execute contracts between themselves, the result after clearing is that each counterparty contracts with its clearing member, which in turn contracts with the CCP.

All financial counterparties and non-financial counterparties with OTC derivative contracts (which are intended to exclude many hedging or other risk mitigation contracts) in excess of a clearing threshold are required to clear, through CCPs, all OTC derivative contracts pertaining to a class of OTC derivatives that ESMA has declared subject to the clearing obligation in accordance with the procedure set out in EMIR. Such contracts have been concluded either:

• between two financial counterparties;

• between a financial counterparty and a non-financial counterparty (that meets the clearing threshold requirement);

• between two non-financial counterparties that each meet the clearing threshold requirement;

• between a financial counterparty or a non-financial counterparty (that meets the clearing threshold requirement) and an entity established in a third country (i.e. non-EU country) that would be subject to the clearing obligation if it were established in the EU; or

• between two entities established in one or more third countries that would be subject to the clearing obligation if they were established in the EU, provided that the contract has a direct, substantial and foreseeable effect within the EU or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR.

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5 Undertakings for Collective Investment in Transferable Securities.
6 A 'trading venue' broadly means a system operated by a market operator or investment firm which brings together buying or selling interests in financial instruments in the system.
As a consequence of the clearing obligation, firms that use OTC derivative contracts will need to supplement the terms of their existing ISDA master agreements to allow for the intervention of a clearing member and, where necessary, provide for the delivery of collateral at the level that may be required by the CCP. Firms must also establish relationships with one or more clearing members providing the firm with the facility to fulfil its clearing obligation.

**Margin obligation**

Each derivative counterparty will be required to post both initial margin and variation margin to the clearing member, which in turn will be required to post both initial margin and variation margin to the CCP. Variation margin is intended to protect against fluctuations in the market value of the contract, with initial margin acting as an additional buffer amount to absorb losses not covered by variation margin. In respect of variation margin and initial margin, EMIR requires that a CCP can accept only highly liquid collateral with minimal credit and market risk to cover its initial and ongoing exposure to its clearing members. For non-financial counterparties, CCPs may also accept commercial bank guarantees as collateral.

CCPs are required to segregate the assets and positions of each clearing member from the assets and positions of the CCP and the other clearing members. Each clearing member is also required to maintain its own records and accounts in such a manner to enable it to distinguish its assets and positions from those of the CCP and other entities.

It can be expected that the rules of a CCP will set out how collateral is held and accounted for in its records. For example, LCH.Clearnet’s SwapClear Client Clearing system provides that house collateral is segregated from client collateral and, further, that client collateral may be held in individual segregated client accounts or in omnibus segregated client accounts (whereby, in the latter case, the claims of the clients of the clearing member are effectively pooled). Derivative counterparties should have a clear understanding of the relevant CCP’s approach to segregation of collateral as well as an understanding of how their positions with the CCP (via the clearing member) may be transferred (i.e., ported) to another clearing member in the event of a default by the clearing member. Such analysis will enable such counterparties to choose a suitable clearing member and CCP. Derivative counterparties will, in any case, be able to negotiate the terms of their customer agreements with their clearing members.

**Reporting obligation**

All counterparties (including non-financial counterparties) and CCPs are required to ensure that the details of all concluded OTC or exchange traded derivative contracts are reported to a registered or recognised trade repository no later than the working day following the conclusion of the relevant contract. A counterparty or a CCP which is subject to the reporting obligation may delegate the obligation, for example, to a prime broker or other third party.

Counterparties and CCPs are required to ensure that the details of their OTC derivative contracts are reported without duplication by one or the other party. No breach under the relevant OTC derivative contract is deemed to arise from disclosure of information to trade repositories.

Under EMIR, trade repositories will be subject to operational, record keeping and data management requirements and will need to be registered with ESMA. Trade repositories are required to publish aggregate positions by class of derivatives on non-discriminatory terms (subject to necessary precautions on data protection). Where a trade repository is not available to record the details of an OTC derivative contract, counterparties and CCPs are responsible for ensuring that the details of the OTC derivative contracts are reported to ESMA.

**Bilateral risk mitigation obligation for OTC derivatives not cleared via a CCP**

If an OTC derivative contract is not deemed eligible for clearing or if one of the parties to an eligible OTC derivative contract is not subject to the clearing obligation, then that contract may not be cleared by a CCP. For such non-cleared OTC derivative contracts, whether entered into by financial or by non-financial counterparties, EMIR requires that

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7 Any modification or termination of the contract must be reported in the same way.
such parties subject to the clearing obligation establish and apply robust bilateral risk management techniques in order to measure, monitor and mitigate operational counterparty credit risk.

Such risk mitigation procedures should include: the timely confirmation (where available, by electronic means) of the terms of the OTC derivative contract; formalised processes for the reconciliation of portfolios; the segregated exchange of collateral; marking-to-market (or where this is not possible, reliable and prudent marking-to-model) on a daily basis of outstanding OTC derivative contracts and the posting and holding of additional collateral.

Financial counterparties need to have risk-management procedures that require the segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after the entry into force of EMIR. Non-financial counterparties also need to have risk-management procedures that require the segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after the date they exceed the clearing threshold.

Implications of the clearing, margin and reporting obligations

There are a number of implications that arise from the above obligations.

Bilateral risk mitigation. For example, some of the requirements suggested in order to satisfy the bilateral risk mitigation obligation are onerous, for instance, the suggested thirty (30) minutes to confirm an electronic trade is extremely short compared to current practice, which can take hours. End users will have to consider the operational systems that will be required to comply with the new requirements.

Operational systems. In addition, in order to satisfy the various margin and bilateral risk mitigation obligations, parties may have to change their internal operational systems and processes, for example, in order to effect a timely, accurate and appropriate exchange of margin/collateral. The costs associated with this, and the posting of margin/collateral, are likely to be significant, particularly in the case of non-financial institutions.

Which derivative contracts are covered by EMIR?

EMIR applies to all OTC derivative contracts regulated under MiFID, which includes interest rate, credit, equity, foreign exchange and commodity OTC derivative contracts. However, not all OTC derivative contracts will be subject to the clearing obligation. For instance, bespoke derivative contracts will not have the level of standardisation required for clearing and will, therefore, not be subject to the clearing obligation.

With the aim of promoting the clearing of as many OTC derivative contracts as possible through a CCP, EMIR introduces two approaches to determine which contracts must be cleared: a 'bottom-up' approach and a 'top-down' approach.

Under the 'bottom-up' approach, a relevant competent authority authorises a CCP to clear a class of derivatives. That competent authority will inform ESMA; ESMA will in turn assess whether a clearing obligation should apply to that class of derivatives in the EU, and develop draft regulatory technical standards that are subject to adoption by the European Commission.

Under the 'top-down' approach, ESMA, on its own initiative and in consultation with the European Systemic Risk Board, will identify derivative contracts that should be subject to the clearing obligation but for which no CCP has yet received ESMA authorisation.

The 'top down' approach will ensure that if no CCP clears a product that should be subject to the clearing obligation, there are tools available to regulators to lead to that product being cleared through a CCP. It will also ensure that new products are not overlooked.

In determining the applicability of the clearing obligation to particular OTC derivative contracts, ESMA will use, among other things, the following criteria: (i) the degree of standardisation of the contractual terms and operational processes of the relevant class of OTC derivatives, (ii) the volume and liquidity of the relevant class of OTC.
derivatives, and (iii) the availability of fair, reliable and generally accepted pricing information in the relevant class of OTC derivatives.

**What are the exemptions under EMIR?**

EMIR will not apply, by its explicit terms, to EU central banks, multilateral development banks or other supra-national entities.

EMIR also includes some limited exemptions for certain parties from certain obligations under EMIR. These are summarised as follows:

**Sub-threshold OTC derivative contracts by non-financial counterparties and trading venues**

Contracts by non-financial counterparties and trading venues below the specified clearing threshold will not have to be cleared through a CCP.

The Commission is to specify the clearing threshold on the basis of technical standards published by ESMA. When setting these thresholds, ESMA will take into account the systemic relevance of the sum of net position and exposures by counterparty per class of derivatives (i.e. looking at how much overall risk they pose to the system). Hedging and risk mitigation activities of the non-financial counterparty are intended to be excluded. This exemption applies to activities that are demonstrably for hedging purposes. Some market participants have raised concerns regarding the clearing threshold and the consequences of a non-financial counterparty repeatedly exceeding the threshold then falling below the threshold over a short period of time.

**Pension funds**

For three years after the entry into force of EMIR, the clearing obligation will not apply to OTC derivative contracts that are entered into by pension funds demonstrably for hedging purposes. However, such OTC derivative contracts that are exempt from clearing are subject to the risk mitigation requirements for contracts not cleared by a CCP discussed earlier (which includes the bilateral exchange of collateral). This derogation is aimed at ensuring that pension funds do not incur disproportionate costs that could adversely impact EU pensioners. Once the industry has developed the appropriate technical standards for the provision of non-cash collateral as variation margin by pension funds, the intention under EMIR is that pension schemes will then be subject to clearing.

**Intra-group transactions**

Certain intra-group transactions are exempt from the clearing obligation and, in certain circumstances, from the bilateral risk mitigation obligation. This exemption was considered necessary because requiring clearing of intra-group transactions could substantially increase the capital and liquidity required by parties that centralise risk management in certain entities as well as increase operational complexity. In most cases the exemption is subject to notification and sometimes approval of relevant competent authorities and typically subject to the following two conditions:

- there is no current or foreseeable practical or legal impediment to the prompt transfer of own funds and repayment of liabilities between the counterparties; and
- the risk management procedures of the counterparties are adequately sound, robust, and consistent with the level of complexity of the transactions.

Broadly, it appears that the exemption from the clearing obligation\(^8\) will only apply to OTC derivative contracts between the following two counterparties belonging to the same group. Namely where: (i) both counterparties are established in the EU, or (ii) one of the counterparties is established in an EU member state and the other counterparty is established in a third country jurisdiction with equivalent rules to the rules in EU in place. It appears that intra-group transactions between: (i) a counterparty established in an EU member state and a counterparty established in a third

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\(^8\) And in certain circumstances, the bilateral risk mitigation obligation.
country jurisdiction that does not have equivalent rules to the EU in place; or (ii) two counterparties established outside the EU do not qualify as exempt intra-group transactions and must, therefore, be treated as transactions between two unconnected counterparties.

**Cross-border implications**

EMIR provides that the European Commission must monitor and endeavour that the commitments set out in EMIR are implemented in a similar way by "international partners" which will require the European Commission to cooperate with third country authorities to ensure consistency between EMIR and what is established in such third country jurisdictions.

A third country counterparty that would be subject to the clearing obligation if it were established in the EU will also have to abide by the clearing obligation for any transaction with an EU entity that is subject to the clearing obligation, or for any transaction where the contract has a "direct, substantial and foreseeable effect" within the EU.

With respect to third country CCPs, ESMA is directly responsible for recognising CCPs established in third countries and thus allowing them to provide their services within the EU. Recognition of a third country CCP by ESMA will first require that the European Commission has determined the legal and supervisory framework of that third country to be equivalent to that of the EU. Other conditions must also be satisfied and a CCP of a third country will not be allowed to perform activities and services in the EU if such conditions are not met (one of which is that the CCP is authorised in the relevant third country, and is subject to effective supervision and is in compliance with the prudential requirements applicable in that third country).

Recognition of a third country trade repository will be subject to similar conditions to those for CCPs in terms of equivalent legal regime and supervisory framework determined by the European Commission, followed by ESMA recognition.

EMIR also includes a framework to manage the risks of counterparties being subject to two sets of potentially conflicting requirements on OTC derivatives (being EMIR and the laws of a third country).

**Cost implications of EMIR for market participants**

The cost implications of EMIR for market participants will likely be significant, as indicated by the following broad summary:

- Firms will need to spend time and bear costs relating to assessing the risks and merits of CCPs before they determine which CCP to use.
- Firms will inevitably need to post initial margin and variation margin. Furthermore, as an OTC derivative contract cleared by a CCP usually involves the posting of higher amounts of margin, for example, by making a default fund contribution (i.e. in excess of actual risk) than an equivalent contract that is not cleared by a CCP, this will increase the amount of collateral that will need to be posted.
- CCPs are likely to charge fees for clearing services provided by them to clearing members.
- Clearing members are likely to charge fees for services provided by them to client firms.
- OTC derivative contracts that are not cleared by a CCP will also in future require additional collateral to be posted to satisfy the bilateral risk mitigation obligation. It is expected that the levels of margin required of non-cleared OTC derivative contracts will exceed those for cleared OTC derivative contracts in order to satisfy such obligation.
- Firms may effectively have to use agents or other intermediaries in order to satisfy various obligations under EMIR, such as the reporting obligations, and such agents should be expected to charge fees for their services.
• There will be costs associated with changes to internal operational systems and processes in order for firms to be able to meet the clearing obligation and the bilateral risk mitigation obligation.

• There are likely to be costs associated with providing the required information and data to trade repositories or agents in order to satisfy the reporting obligation.

• Firms are likely to incur costs in the review of existing documentation and the review, negotiation and execution of clearing documentation, which they will not be familiar with and in most cases will be complex.

**Penalties for breaching EMIR obligations**

EU member states and CCPs are required to establish and implement "effective, proportionate and dissuasive" penalties for infringement of the obligations set out in EMIR. Such penalties are required to at least include administrative fines. Due to the role of the individual EU member states and CCPs in the establishment of such penalties, such penalties are likely to vary from one EU member state to another.

**The role of ESMA**

ESMA⁹ has been delegated the responsibility under EMIR to draft regulatory standards and implement technical standards in a number of areas, which will then be adopted by the Commission. Such standards cover: (i) the determination of which OTC derivative contracts are subject to the clearing obligation (including setting the clearing thresholds applicable to non-financial counterparties); (ii) the monitoring the activities of trade repositories, including the granting and withdrawal of their registration and their compliance and operational requirements; and (iii) the authorisation of CCPs.

**When will EMIR be implemented?**

EMIR will be implemented only after the technical standards are developed and published by ESMA. ESMA must submit these standards to the European Commission by 30 September 2012. ESMA is currently in the process on consulting on such technical standards. These new standards are in principle required to be fully adopted by the European Commission by the end of 2012.

CCPs both within and outside the EU will have to apply for authorisation to act as such under the new regime at the latest six months after the adoption of the technical standards by the European Commission. In the meantime, CCPs must continue to comply with national rules on authorisation.

The date of application of the reporting obligation and clearing obligation will be determined in the new technical standards to be developed by ESMA.

**Conclusion**

EMIR introduces fundamental changes in the trading of OTC derivative contracts. Market participants may wish to consider the following:

• whether it is a financial counterparty or a non-financial counterparty bearing in mind that some corporate groups include both financial and non-financial entities which may span jurisdictions both within and outside of the EU (this is particularly important with respect to the clearing threshold);

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⁹ ESMA is an independent EU authority with pan-European supervisory powers which include the power to draft technical standards that (upon adoption by the Commission) are legally binding in all EU member states; establish a framework for ensuring agreement and co-ordination between national supervisors of the same cross-border institution, launch a fast track procedure to ensure consistent application of EU law; resolve disagreements between national authorities; participate in Colleges of Supervisors and on-site inspections; monitor systemic risk of cross border financial institutions; and enter into administrative arrangements with supervisory authorities, international organisations and the equivalent supervisory authorities of third countries.
• in the case of a non-financial counterparty, whether certain activities fall within the ambit of hedging and risk mitigation transactions within the meaning of EMIR and therefore, qualify for the hedging exemption which is relevant for the clearing threshold and in turn the clearing obligations;

• whether or not an exemption such as the intra-group exemption applies to some/all of its OTC derivative contracts;

• which of its OTC derivative contracts will be affected by EMIR and whether (and how) this will affect its future derivative business;

• what internal operational changes need to be made, for example, to booking systems and processes, in order to satisfy the EMIR rules.

If a firm determines that it is in fact subject to the obligations in EMIR, it will then need to select one or more CCPs through whom its OTC derivatives contracts will be cleared and select one or more clearing member through whom access will be gained to the CCP. In addition, it will need to reviewing existing derivative documentation against the requirements of EMIR and ascertaining what supplemental terms may be required. Consideration must also be given to new derivative and clearing documentation that may be required with CCPs and clearing members in relation to future trades.

Finally, market participants will need to follow the negotiations relating to MiFID II, in which the obligation to transact derivatives on trading venues (and to clear those derivatives) is contained.

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