Delphi

April 2012

EMIR – Regulating the OTC Derivates Market

The Presidency of the Council of the European Union recently published the final compromise text of the proposed European Market Infrastructure Regulation (EMIR), which the European Parliament adopted on 29 March 2012. As part of the European Union's efforts to create a sounder and more stable financial market, a new regulation aimed at the over-the-counter (OTC) derivatives market is being introduced. EMIR provides significant changes to the OTC derivatives market by requiring standardized OTC-derivatives to be centrally cleared through central counterparties (CCPs). Non-centrally cleared derivatives contracts will be subject to higher regulatory capital charges and other risk mitigation standards. In order to increase transparency, derivatives transactions also have to be reported to so called trade repositories.

Introduction

The absence of a regulatory framework for the OTC derivatives markets is believed to have contributed to the financial meltdown in 2008. The leaders of the G20 agreed in September 2009 that, by the end of 2012, all standardized OTC derivatives contracts should, where appropriate, be traded on exchanges or electronic trading platforms and cleared through CCPs. They further agreed that OTC derivatives contracts should be reported to trade repositories and that non-centrally cleared contracts should be subject to higher capital requirements.

Clearing of OTC derivatives involves a CCP being imposed as a counterparty to the two parties to every transaction. This means that clearing through CCPs reduces counterparty credit risk, i.e. the risk that a party to a transaction enters into default. The reporting of OTC derivatives to trade repositories introduces greater transparency. A trade repository is a central data warehouse where information about transactions is stored. Regulators will have access to this information, enabling them to have a better overview of the market and detect potential problems. The trade repositories will also publish aggregate positions by class of derivatives to the market, increasing the transparency further.

More complex OTC derivatives transactions will remain un-cleared. Instead, other risk mitigation standards such as higher capital charges and increased collateral requirements will apply.

The requirement that OTC derivatives contracts should be traded on exchanges or electronic trading platforms is dealt with in the review of the Markets in Financial Instruments Directive (MiFID II).

EMIR takes the form of a regulation which means that it will have direct effect in all the EU member states. It is expected to come into force on 1 January 2013.

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The US is implementing similar measures; in 2010, the Dodd-Frank Act governing OTC derivatives was passed. Other jurisdictions such as Japan are putting in place corresponding regulations.

Clearing Obligation
Under EMIR, standardized OTC derivatives contracts will have to be cleared through CCPs. The clearing process means that the CCP will contractually interpose itself between the parties to a transaction and become the "buyer to every seller" and the "seller to every buyer".

A lot of risk will be accumulated by the CCPs. For this reason, EMIR imposes stringent conduct of business, organizational, capital, liquidity and collateral requirements for these institutions.

The scope of the OTC derivatives transactions that are covered by the clearing obligation still has to be determined. The aim is to include as many standardized OTC-derivatives as possible. Some exemptions will, however, be made. For instance, the clearing obligation will not apply to certain intra-group transactions. OTC-derivatives that are objectively measurable as reducing risks directly related to the financial solvency of certain pension schemes arrangements are also excluded during a transitional period.

The clearing obligation will apply to financial counterparties such as investment firms, credit institutions, insurance and reinsurance companies, UCITS funds and managers, certain pension funds and alternative investment funds managed by alternative investment fund managers under the Alternative Investment Fund Managers Directive (AIFMD).

Non-financial counterparties such as corporates that exceed a certain clearing threshold are also covered. A non-financial counterparty has to consider all OTC-derivatives which are not entered into for hedging purposes when determining if the threshold has been reached.

The EU Commission will decide which classes of OTC derivatives that must be cleared based on certain technical standards prepared by the European Securities and Markets Authority (ESMA). ESMA will also prepare the levels of clearing thresholds that will determine if non-financial counterparties are covered by the clearing obligation. The technical standards were scheduled to be delivered to the EU Commission by the end of June this year. However, this deadline has now been postponed to 30 September 2012.

Reporting Obligation
Transparency is considered necessary, as market stability depends on the overview that regulators, policy makers and market participants have of the OTC derivatives market. Under EMIR, all counterparties and CCPs shall ensure that the details of any derivatives contract they have entered into and any modification or termination of the contract is reported to a trade repository. The reporting obligation may be delegated. Counterparties and CCPs must ensure though that the contracts are reported without duplication.

ESMA will be responsible for the supervision and authorization of trade repositories. National supervisory authorities will have access to the repositories, enabling them to monitor the market. In order to give all market participants a clearer view of the market, the trade repositories are required to publish aggregate positions of the classes

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of derivatives. However, no data at trade level will be published due to commercial sensitivity.

Alternative Risk Management Procedures

The clearing obligation under EMIR will not cover all OTC derivatives contracts. Some bespoke contracts are not suitable for clearing. For OTC-derivatives that are not cleared, EMIR requires that alternative risk management procedures are put in place.

All counterparties will need to ensure that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational and credit risk. The obligation includes timely confirmation, where available, by electronic means, of the terms of the OTC derivatives contracts. Counterparties must also put in place robust, resilient and auditable processes in order to reconcile portfolios, to manage the associated risks and to identify disputes between parties and resolve them. They must also monitor the value of outstanding contracts. Financial counterparties and non-financial counterparties exceeding the specified clearing threshold must also, on a daily basis, mark-to-market the value of outstanding contracts and shall have risk management procedures that require the timely, accurate and appropriate exchange of collateral. Financial counterparties shall also hold appropriate and proportionate amounts of capital to manage the risk not covered by appropriate exchange of collateral.

What Happens Next?

As mentioned, the EU Commission will adopt technical standards setting out the details of which OTC-derivatives will be covered by the clearing obligation and the non-financial clearing thresholds. The technical standards will be prepared by ESMA. The deadline for this has been moved from 30 June to 30 September this year.

EMIR is expected to come into force on 1 January 2013. Even if the implementation time seems tight there has not yet been any formal indication that the implementation date will be postponed. This leaves market participants with a lot to do in terms of understanding how EMIR impacts their businesses, implementing relevant operational measures, choosing CCPs and clearing members, entering into agreements and updating their documentation.

Erica Johansson/ Partner / Advokat,
Phone: +46 8 677 54 24
Mobile: +46 709 25 25 49
erica.johansson@delphi.se

Olof Hagberg/ Associate / Jur. kand.,
Phone: +46 8 677 55 01
Mobile: +46 767 72 00 01
olof.hagberg@delphi.se