

European Market Infrastructure Regulation and Central Clearing: A Conceptual, Legal and Compliance Perspective

Gerry G. Kounadis, LL.M., M.Sc.

Associate, Tsibanoulis & Partners Law Firm, Greece

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Introductory remarks

The recent financial crisis¹ has drawn maximum regulatory attention to OTC derivative markets. Indeed, the near collapse of Bear Stearns in March 2008, the collapse of Lehman Brothers on September 15, 2008 and the bail-out of AIG on September 16 highlighted the fact that OTC derivatives carry systemic implications for the financial markets. Therefore, one basic lesson learned from the financial crisis, in relation to the over-the-counter (OTC) markets, is that the soundness, resilience and transparency of OTC derivatives should be improved.² As a result, unprecedented regulatory and supervisory changes, both at an international and European level, have already been or are to be adopted. It is within this frame that credit institutions and investment firms must not only progressively adapt to the new regulatory environment, but also, in a number of cases, they will be forced to change their business model.

The “flagship” of the European regulatory intervention in derivative market has been Regulation 648/2012 on OTC derivatives, central counterparties (CCPs) and trade repositories (TRs), which came into force on August 16, 2012, known as the European Market Infrastructure Regulation (EMIR) (the Regulation or EMIR).³ EMIR not only affects EU entities trading derivatives but also

non-EU entities, as certain extraterritorial issues arise from it, resulting in high compliance costs for businesses falling under it.

EMIR as a means of ensuring financial stability

Why EMIR?

Main risks inherent to OTC derivatives

Over recent years, the ever-growing part of the financial markets has been the OTC derivatives. Aimed at satisfying the need for bespoke contracts fashioned to the particular risks that a user may wish to hedge, OTC derivative markets are known for their flexibility and tailor-made instrument. Despite derivative transactions’ ability to spread risk and thereby facilitate the international financial system to absorb shocks, a number of stakeholders in those transactions have raised concerns with regard to the effect they may have on financial stability.⁴ Nevertheless, the derivative market has been tremendously large; the face value of all outstanding OTC derivatives peaked at \$685 trillion in June 2008 and was \$592 trillion at the end of 2008.⁵ By and large, redistribution of risk is one of the *raison d’être* of financial markets. Yet, OTC derivatives pose specific risks, which are considerably higher compared to exchange-traded derivative (ETD) markets.⁶

- **Credit risk**⁷ Counterparty’s creditworthiness constitutes a central issue in OTC derivative market. This is to say, in exchange-traded markets, the exchange ensures the payment of all obligations by being in itself the counterparty to every transaction upon the completion of the initial trade. On the other end of the scale, in OTC market, counterparty’s insolvency may entail his/her counterparty’s incapability of collecting the money owed. This apart, the economic value of a derivative contract is correlated to its replacement or market value rather than its nominal value.⁸ As a result, the loss in the event of default on derivative transactions is usually lower than the nominal amount of the deal. However, credit exposures generated by the replacement value of a derivative hold the ability of being either negative or positive at a certain point in time, following changes in market conditions, being therefore particularly volatile.

¹ As “recent financial crisis” is defined the major international crisis recently erupted (2007–2009), which was triggered by events in the US financial system and spilled over to the world economy.

² See European Central Bank, *Report on the Lessons Learned from the Financial Crisis with regard to the Functioning of European Financial Market Infrastructures* p.27.

³ See Regulation 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories [2012] OJ L2011(European Market Infrastructure Regulation).

⁴ See A. McKnight, *The Law of International Finance* (Oxford-New York: Oxford University Press, 2008), pp.561–562.

⁵ See M. Levinson, *The Economist: Guide to Financial Markets*, 5th edn (London: Profile Books Ltd, 2009), p.219.

⁶ M. Levinson, *The Economist: Guide to Financial Markets*, 5th edn (London: Profile Books Ltd, 2009), pp.220–221.

⁷ “Credit risk” is the potential for financial loss stemming from the failure of a borrower or counterparty to honour its financial or contractual obligation when this is due.

⁸ See M. Grouhy, D. Galai and R. Mark, *The Essentials of Risk Management* (New York: McGraw-Hill, 2006), p.29.

• **Operational Risk**⁹ Derivative trading, in particular, is largely prone to operational risk compared to cash transactions because derivatives are innately leveraged transactions. Moreover, the valuation of complex derivatives also generates substantial operational risk.¹⁰

• **Systemic risk** The definition given to systemic risk by the Financial Stability Board, International Monetary Fund and Bank for International Settlements in their joint Report to G-20 Finance Ministers and Central Bank Governors in October 2009 is worth mentioning:

“a risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy. Fundamental to this definition is the notion of negative externalities from a disruption or failure in a financial institution, market or instrument.”¹¹

The existence of extensive exposures among a small number of large financial entities renders OTC derivatives markets systemically significant.¹² Market-makers are largely responsible for the activity taking place in the OTC derivative market, which in turn suggests that any disruptions occurring at one major dealer can very easily be communicated to other vital financial institutions, with potential knock-on effects for the financial system as a whole, taking into consideration the interdependencies associated with OTC derivative trades amongst these dealers. Additionally, given the private and non-transparent character of OTC derivatives markets, it is difficult to evaluate the degree to which different institutions are interconnected and where the risk exposures lie.¹³

OTC market compilations in the financial crisis¹⁴

The recent financial crisis¹⁵ has drawn maximum regulatory attention to OTC derivatives, markets and to the way in which credit risk has been transferred. The near collapse of Bear Stearns in March 2008, the collapse of Lehman Brothers on September 15, 2008 and the

bail-out of AIG on September 16 highlighted the fact that OTC derivatives carry systemic implications for the financial markets. These three institutions were important players in the OTC derivatives either as dealers or users, or both. Regardless of the distress they experienced, rooted outside the OTC derivative markets and continued to a small segment of the OTC market (i.e. credit derivatives), their critical role in literally, all the segments of the OTC derivative market (in case of Lehman and Bear Stearns) had a negative knock-on effect for the OTC market in its entirety. Specifically, the fall of all three institutions can be attributed to their direct or indirect exposure to the sub-prime mortgages market. In the case of Bear Stearns and Lehman Brother, their exposure consisted in collateralised debt obligations (CDOs) backed by sub-prime mortgages they held in their books. In the case of AIG, the exposure consisted in CDSs that the latter had sold on those CDOs. As known, AIG and Bear were bailed out by the US Government in fear of systemic repercussions in case of their default. On the other end of the scale, the “Brothers”, which negligently had not been considered as such before its collapse, proved to be systemically important as well.

Complications in financial market infrastructures¹⁶

The opaqueness of the OTC market obscured awareness from the other participants of the exact magnitude of the exposures of Bear/Lehman/AIG counterparties to these three institutions.¹⁷ Both the ensuing mistrust and the drying up of liquidity in the inter-bank money market, came as no surprise. What is more, the lack of transparency hindered regulatory authorities from being capable of identifying the risks evolving within the financial system, the degree of concentration of these risks among few entities and, most importantly, the magnitude of the systemic implications emanating from their collapse.¹⁸ Last but not least, domination of a light-touch regulatory approach further intensified the problem, since supervisors’ access to information was poor.¹⁹

⁹“Operational risk” accounts for potential losses stemming from insufficient systems, management failure, ineffective controls, fraud and human error. See M. Grouhy, D. Galai and R. Mark, *The Essentials of Risk Management* (New York: McGraw-Hill, 2006), p.30.

¹⁰ See M. Grouhy, D. Galai and R. Mark, *The Essentials of Risk Management* (New York: McGraw-Hill, 2006), p.30.

¹¹ See on this Financial Stability Board, International Monetary Fund and Bank for International Settlements, *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations*, report to the G-20 Finance Ministers and Central Bank Governors, October 2009 at <http://www.bis.org/publ/othp07.pdf> [Accessed June 29, 2014], p.2.

¹² See European Central Bank, *OTC Derivatives and Post-trading Infrastructures* (2009), p.12.

¹³ European Central Bank, *OTC Derivatives and Post-trading Infrastructures* (2009), p.12.

¹⁴ The part of the article is based on European Commission: Commission Staff Working Paper Accompanying the Commission Communication *Ensuring efficient, safe and sound derivatives markets*, SEC (2009) 905 final, pp.5–6.

¹⁵ On the causes of the crisis see just indicatively—among others—Ch. Gortsos, *Fundamentals of Public International Financial Law: International Banking Law within the system of Public International Financial Law* (Nomos Verlagsgesellschaft, Baden-Baden, 2012), pp.127–129.

¹⁶ Financial Markets Infrastructures (FMIs) play a critical role in the financial system and the global economy. The term FMI refers to payment systems, central securities depositories, securities settlement systems, central counterparties, and trade repositories. These infrastructures facilitate the clearing, settlement, and recording of monetary and other financial transactions, such as payments, securities, and derivative contracts. See Committee on Payment and Settlement Systems and Technical Committee of the International Organisation of Securities Commissions, *Principles for financial market infrastructures* (2012) at <http://www.bis.org/publ/cpss101a.pdf> [Accessed June 29, 2014], p.5.

¹⁷ On this see European Commission: Commission Staff Working Paper Accompanying the Commission Communication *Ensuring efficient, safe and sound derivatives markets*, SEC (2009) 905 final p.5.

¹⁸ European Commission: Commission Staff Working Paper Accompanying the Commission Communication *Ensuring efficient, safe and sound derivatives markets*, SEC (2009) 905 final.

¹⁹ European Commission: Commission Staff Working Paper Accompanying the Commission Communication *Ensuring efficient, safe and sound derivatives markets*, SEC (2009) 905 final.

One basic lesson learned from the financial crisis, in relation to the OTC markets is that the soundness, resilience and transparency of OTC derivatives should be improved.²⁰ It is within this framework that securities regulators and overseers are currently have found themselves in a reconsideration process towards the direction of adopting regulatory and oversight measures with a view to encouraging safety, resilience and transparency of OTC markets.²¹ In particular, the severe drawbacks surfacing from the bilateral conduct of the trading, clearing and settlement of OTC derivatives throughout the crisis, has rendered imperative the establishment of market infrastructures for these processes.²² Regulatory authorities have been quick to recognise the flaws in the bilateral exposed during the recent crisis and, it is within this framework that in the future, we will see more and more OTC derivatives standardised and settled and cleared through clearing houses.

Regulatory developments in the aftermath of the financial crisis

EMIR as part of public international capital markets law and public international payment and settlement systems law²³

Consequently, in the aftermath of the crisis what was sought after was an international effort to strengthen stability in the financial market. At the highest political level, G-20 Leaders reached an agreement in Pittsburgh in September 2009²⁴ that:

“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. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to

improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”

As it is easily understood, the above political mandate not only prompted soft-law bodies but also market associations and regulatory authorities around the globe to bring the issue of OTC derivative market reform on the very top of their agenda. In this context, at the Pittsburgh Summit, the G20 Leaders welcomed the efforts of the Financial Stability Board (FSB) to coordinate and monitor progress in strengthening financial regulation, stressing that “the FSB’s ongoing efforts to monitor progress will be essential to the full and consistent implementation of needed reforms.”²⁵ The OTC Derivatives Regulators’ Forum was established in September 2009, thus putting on a more formal basis the arrangements already underway for cooperation and information sharing on OTC derivatives central counterparties and trade repositories, including promoting globally consistent oversight.²⁶

Committee on Payment and Settlement Systems (CPSS) and International Organisation of Securities Commissions (IOSCO) are jointly working to reform the current standards for Central Counterparties, Central Securities Depositories, payments systems, along with the treatment of Trade Repositories. The Principles for Financial Market Infrastructures,²⁷ issued by the Committee on Payment Settlement Systems and the International Organisation of Securities Commissions, include new international standards for FMIs, namely payment, clearing and settlement systems. These demanding standards aim at ensuring that the emerging infrastructure backing the global financial system will be more crisis-proof than the previous one.

²⁰ See European Central Bank, *Report on the Lessons Learned from the Financial Crisis with regard to the Functioning of European Financial Market Infrastructures* p.27.

²¹ European Central Bank, *Report on the Lessons Learned from the Financial Crisis with regard to the Functioning of European Financial Market Infrastructures*.

²² European Central Bank, *Report on the Lessons Learned from the Financial Crisis with regard to the Functioning of European Financial Market Infrastructures*.

e.g. while, at a bilateral level, close-out netting, as the main risk mitigation technique in OTC derivative transactions, may help ensure that the failure of one major dealer is unlikely to cause contagion and directly lead to the failure of other dealers, this credit risk mitigation mechanism is not capable of improving the disturbances to markets that could potentially stem from an abrupt termination of a large number of contracts and the ensuing fire-sales, revealing a major drawback of OTC market.

²³ On the one hand, public international capital markets law is the branch of international financial law containing provisions aimed at, inter alia, ensuring capital markets’ stability, efficiency and transparency. On the other hand, public international payment and settlement systems law is the branch of international financial law with a view to safeguarding the stability and efficiency of payment and settlement systems. Hence, public international capital markets law does not include the provisions pertaining to regulatory intervention in securities clearing and settlement systems, which constitute the infrastructure for the functioning of capital markets. It follows then that, to the extent that EMIR contains provisions seeking to bolster the stability and transparency of capital markets (part of which is the derivative market), it falls under the abovementioned definition of public international capital markets law, and, to the extent that it aims to improve the efficiency of capital market infrastructures, it constitutes part of public international payment and settlement systems law. As understood, from a systematic and a teleological point of view, EMIR can be regarded as forming part of both public international capital markets and payment and settlement systems law. See Ch. Gortos, *Fundamentals of Public International Financial Law: International Banking Law within the system of Public International Financial Law* (Nomos Verlagsgesellschaft, Baden-Baden, 2012), pp.115–117.

²⁴ See G20 Leaders Statement: *The Pittsburgh Summit*, September 2009 at <http://www.g20.utoronto.ca/2009/2009communiqu0925.html> [Accessed June 29, 2014].

²⁵ See Financial Stability Board, *Progress since the Pittsburgh Summit in Implementing the G20 Recommendations for Strengthening Financial Stability*, Report of the Financial Stability Board to G20 Finance Ministers and Governors (2009) at https://www.financialstabilityboard.org/publications/r_091107a.pdf [Accessed June 29, 2014], p.3.

²⁶ Financial Stability Board, *Progress since the Pittsburgh Summit in Implementing the G20 Recommendations for Strengthening Financial Stability*, Report of the Financial Stability Board to G20 Finance Ministers and Governors (2009), p.8.

²⁷ See *Committee on Payment and Settlement Systems and Technical Committee of the International Organisation of Securities Commissions* (2012).

EMIR as the EU regulatory response

Following CPSS/IOSCO workings, the Commission launched Consultations, on June 14, 2010²⁸ and on July 3, 2009²⁹ accordingly, evaluating the derivatives market in general and coming up with future policy actions. On September 15, 2010, the European Commission issued its final proposal for a Regulation of the European Parliament and of the Council,³⁰ which aims to increase stability within OTC derivative markets. Finally, European Market Infrastructure Regulation (EMIR) was published in its final form on July 27, 2012 and came into force, subject to transitional provisions, on August 16, 2012. On September 27, the European Securities and Markets Authority (ESMA), member of the new European System of Financial Supervisors (ESFS), provided its final advice on technical standards (Final Report)³¹ to the European Commission. Many of the provisions in EMIR will not be effective until the technical standards have been adopted by the European Commission.³²

EMIR: a legal and compliance perspective

EMIR: an overview

No matter the type, size or sector, any business in Europe that undertakes derivative transactions, including FX forwards, will be impacted by EMIR. Under EMIR, certain OTC derivative contracts should be cleared through CCPs. These OTC derivative contracts should meet a number of conditions stipulated in the Regulation.³³ The Regulation, also, provides for, inter alia, a number of obligations for CCPs,³⁴ such as application of organisational, conduct of business and prudential requirements; application of risk mitigation techniques for non-centrally cleared OTC derivatives³⁵; reporting to trade repositories³⁶; and application of requirements for trade repositories, such as the duty to make certain data available to the public and relevant authorities.³⁷ It is notable that, EMIR, as a Regulation of the European Union is directly applicable in all EU Member States.

Please note that, for the purposes of this article, only the relevant for the credit institutions obligations under EMIR will be analysed.

EMIR scope

Territorial³⁸

EMIR affects both entities established in the EU and non-EU entities (banks, insurance companies, pension funds, investment firms, corporates, special purpose vehicles) that enter into derivatives, whether they do so for trading purposes, to hedge commercial exposure or as part of their investment strategy. Specifically, within EMIR scope fall:

- (a) entities established in the European Union entering into OTC derivative contracts;
- (b) non-EU counterparties entering into OTC derivative contracts with EU counterparties; and
- (c) where certain conditions are met, OTC derivative contracts between non-EU counterparties.

The under (c) element introduces the concept of extraterritoriality under EMIR. An OTC derivative contract shall be considered to have "... direct, substantial and foreseeable effect within the EU"³⁹ when at least one of the counterparties benefits from a legally enforceable guarantee provided by a financial counterparty established in the Union and covering all or part of its liability resulting from the OTC derivative contract, to the extent that the guarantee meets the following conditions⁴⁰:

- Where it is a guarantee which covers all such liability, it covers OTC derivatives transactions entered into by the third country counterparty for an aggregated notional amount that is at least €8 billion or the equivalent amount in the relevant foreign currency or it covers only a percentage of such liability;

²⁸ See European Commission, Public Consultation on *Derivatives and Market Infrastructures* (2010) at http://ec.europa.eu/internal_market/consultations/docs/2010/derivatives/100614_derivatives.pdf [Accessed June 29, 2014].

²⁹ See European Commission, Consultation Document *Possible initiatives to enhance the resilience of OTC Derivatives Markets*, Commission Staff Working Paper, SEC (2009) 914 final.

³⁰ See Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (COM (2010) 484/5).

³¹ See European Securities and Markets Authority, *Final Report: Draft Technical Standards under the Regulation (648/2012 on OTC Derivatives, CCPs and Trade Repositories* (2012) at <http://www.esma.europa.eu/system/files/2012-600.pdf> [Accessed June 29, 2014].

³² EMIR requires ESMA to develop draft regulatory (RTS) and implementing technical standards (ITS) in relation to several provisions. RTS are legislative provisions made by the European Commission on the basis of advice received from ESMA. RTS imply strategic decisions, as opposed to ITS, which are again legislative provisions made by the European Commission on the basis of advice received from ESMA but they are purely technical. Please also note that RTS are adopted by the Commission as delegated acts under art.290 of the Treaty on the Functioning of the European Union (TFEU) and the European Parliament and the Council can block the measures or revoke the delegation. The key technical standards specifying the detail of many of the obligations under EMIR came into force in March 2013, although some obligations are deferred or subject to compliance schedules.

³³ See below.

³⁴ European Market Infrastructure Regulation arts 14–54.

³⁵ See below.

³⁶ See below.

³⁷ European Market Infrastructure Regulation arts 55–81.

³⁸ European Market Infrastructure Regulation art.4 para.1(a)(i)–(v).

³⁹ See European Market Infrastructure Regulation art.4 para.1(a)(v).

⁴⁰ See European Securities and Markets Authority, *Final Report: Draft technical standards under EMIR on contracts with a direct, substantial and foreseeable effect within the Union and non-evasion* (2013) at http://www.esma.europa.eu/system/files/2013-1657_final_report_on_emir_application_to_third_country_entities_and_non-evasion.pdf [Accessed June 29, 2014], p.18.

- it is at least equal to 5 percent of the sum of current exposures⁴¹ in OTC derivative contracts of the financial counterparty established in the Union issuing the guarantee. The two counterparties enter into the OTC derivative contract via their branches in the Union.

Products⁴²

The definition of derivative is not explicitly laid down in EMIR but cross-refers to definitions of financial instruments given by Markets in Financial Instruments Directive 2004/39 (known as “MiFID”).⁴³ In this context, derivatives may include any options, futures, swaps, forwards and other derivative contracts linked to securities, currencies, interest rates, financial indices, commodities, financial contract for differences and credit default swap.⁴⁴ However, this definition includes only bilateral derivative contracts, such as ETD and OTC contracts, and does not, as a rule, encompass derivatives embedded in other contracts, e.g. loans. Nonetheless, highly structured or hybrid contracts should be thoroughly examined with respect to their categorisation under EMIR.⁴⁵ It is also worth pointing out that, taking into consideration that spot FX transactions are not regarded as being derivatives, as such fall outside the EMIR product scope.

Entities

• **Introduction** EMIR makes a fundamental distinction as regards entities falling under it; it differentiates, on the one hand, financial counterparties (FCs) from, on the other hand, non-financial counterparties (NFCs). This categorisation is crucial for the understanding of obligations that an entity entered into derivative contracts should comply with under EMIR.

• **Financial Counterparties⁴⁶** In general, a financial counterparty is any financial sector entity trading derivatives. EMIR defines which entities shall fall under the concept of financial counterparty by referring to definitions provided by other European pieces of legislation. More specifically, the following entities can be characterised as FCs: investment firm authorised in

accordance with Directive 2004/39 (MiFID); credit institution authorised in accordance with Directive 2006/48 (CRD)⁴⁷; undertaking authorised in accordance with Directive 2002/83 (Life Assurance Directive)⁴⁸; reinsurance undertaking authorised in accordance with Directive 2005/68 (Reinsurance Directive)⁴⁹; Undertakings for Collective Investments in Transferable Securities (UCITS) and, where relevant, its management company, authorised in accordance with Directive 2009/65 (UCITS IV)⁵⁰; institution for occupational retirement provision within the meaning of art.6(a) of Directive 2003/41 (“EU Pensions Directive”)⁵¹; and, alternative investment fund managed by AIFMs authorised or registered in accordance with Directive 2011/61 Alternative Investment Fund Managers Directive (AIFM).⁵²

• **Non-Financial Counterparties⁵³** An NFC is an undertaking established in the European Union that is not an FC, a Central Counterparty or a Trade Repository. NFCs will be classified as either:

- Non-financial counterparties exceeding the clearing threshold (NFCs+). An NFC+ is subject to similar requirements on clearing and margining as an FC. If a corporate determines itself to be an NFC+, it must confirm its status as an NFC+ to its counterparties, ESMA and the local regulator (e.g. Financial Conduct Authority) (see below).
- Non-financial counterparties not exceeding the clearing threshold (NFCs-) (see below).

EMIR main obligations: the “troika”

The reporting obligation

• **A legal perspective** EMIR can be viewed as an attempt by regulators to gather information relating to OTC transactions. In this context, reporting aims to mitigate systemic risk stemming from the lack of transparency in OTC market. All the relevant information will be collected by Trade Repositories (TRs). A TR is an entity that centrally collects and maintains the records of OTC derivatives. These electronic platforms, acting as authoritative registries of key information regarding

⁴¹ As defined in Regulation 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation 648/2012 [2013] OJ L1761 art.272(17).

⁴² European Market Infrastructure Regulation art.2 para.5.

⁴³ Directive 2004/39 on markets in financial instruments amending Council Directives 85/611 and 93/6 and Directive 2000/12 and repealing Council Directive 93/22[2004] OJ L145/1 (Markets in Financial Instruments Directive).

⁴⁴ The types of derivative covered by EMIR are set out in points (4) to (10) of s.C of Annex I of Markets in Financial Instruments Directive, as implemented by Regulation 1287/2006 implementing Directive 2004/39 of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive [2006] OJ L241/1 arts 38 and 39.

⁴⁵ See on this Linklaters, *Guide to the European Market Infrastructure Regulation (EMIR)*(2013), p.3.

⁴⁶ European Market Infrastructure Regulation art.2 para.8.

⁴⁷ Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions [2006] OJ L177/1.

⁴⁸ Directive 2002/83 concerning life assurance [2002] OJ L345/1.

⁴⁹ Directive 2005/68 on reinsurance and amending Council Directives 73/239, 92/49 as well as Directives 98/87 and 2002/83[2005] OJ L323/1.

⁵⁰ Directive 2009/65 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities [2009] OJ L302/32.

⁵¹ Directive 2003/41 on the activities and supervision of Institutions for Occupational Retirement Provision [2003] OJ L235/10.

⁵² Directive 2011/61 on Alternative Investment Fund Managers and amending Directives 2003/41 and 2009/65 and Regulations 1060/2009 and 1095/2010 [2011] OJ L174/1.

⁵³ European Market Infrastructure Regulation art.2 para.9.

open OTC derivatives trades, provide an effective tool for mitigating the inherent opacity of OTC derivatives markets. By virtue of EMIR,⁵⁴ all FCs and NFCs are required to report all over-the-counter and exchange-traded contracts to an authorised TR. It is noteworthy that FX spot trades are out of scope. These include those derivative contracts which:

- were outstanding on August 16, 2012 and are still outstanding on the reporting start date and should be reported to a TR within 90 days of the reporting start date for a particular derivative class;
- were entered into before August 16, 2012 and are still outstanding on August 16, 2012; or were entered into on or after August 16, 2012, and are not outstanding on or after the reporting start date and should be reported to a TR within three years of the reporting start date for a particular derivative class.

More specifically, at a trade level, if the trade was outstanding at time of reporting day (February 12, 2014), it should be reported to a TR within 90 days. If the trade was not outstanding on February 12, 2014 but it was outstanding between August 16, 2012 (entry into force of EMIR) and February 12, 2014 (entry into force of the reporting obligation), the trade should be reported to a TR within three years. At an instrument level, credit and interest rate derivatives should be reported 90 days after recognition of a relevant TR by ESMA. For all other types of derivatives, reporting begins on February 12, 2014.

• **A compliance perspective** EMIR has a massive effect on credit institutions' and investment firms' compliance function. However, in the context of the present analysis only credit institutions' compliance function impacted by EMIR will be scrutinised. In terms of reporting obligation, credit institutions need to report their trades both to TRs and regulators alike. It follows, from the very nature of the reporting, that, despite what agreements are in place with regard to confidentiality as a result of the banking relationship, they need to be able to make trade details available to TRs and regulators. In so doing, from a legal point of view, they might require a confidentiality waiver when informing the client about EMIR or when they take on the reporting obligation on behalf of the client. Moreover, as understood, credit institutions will have to closely cooperate with a TR (e.g. Depository Trust & Clearing Corporation) and, within this frame, they need to develop a particularly robust data centralised system, seeing that new costs associated with increased data reporting to TRs are to be expected.

By and large, credit institutions must invest in people, processes and training and, to this end, strong liaison among Client Management, Compliance, Legal and IT is highly required. Aside this, specially designed EMIR

project and outreach teams must be assembled, consisting of people from diverse backgrounds and skills. However, given EMIR's complexity and the high volume of data needing to be processed, particular emphasis should be placed on skilful data analysts, legal counsels and compliance officers. Where it concerns the client-facing (outreach) teams, their members must grasp EMIR requirements and how these affect clients. For this, it is imperative that intensive training be part of their business. In their to-do-list, EMIR teams should provide their clients with comprehensive questionnaires in respect to their classification and other requirements under EMIR. As both parties have a mandatory obligation to comply with the Regulation, it is of utmost importance that clients do not ignore communications while, the outreach teams' main role is to encourage clients to carefully go over the communications and respond in a timely manner. Towards this direction, assistance to clients must be profuse, instant and readily available, especially for those clients who lack the level of sophistication to grasp EMIR and its importance.

At this very point, it should be noted that the vast majority of clients affected by EMIR will have in their portfolios plain, mainly ETD, derivatives and their financial sophistication might be limited. As far as the knowledgeable clients are concerned, should there be any queries that the outreach team cannot respond to, they should immediately be sent to legal counsels dealing with derivatives law. In terms of team management, there should be a client communication approach aimed at preventing a constant communication flow to client and a clear client query escalation procedure in place aimed at ensuring timely resolution to queries and compliance with external timeframes. It is within this framework that a credit institution ensures that its intranet and external website contains information to keep clients informed on regulatory requirements, their impact on them, from a practical standpoint, and the actions that should be taken by them in order to abide by those requirements.

In addition, EMIR introduces the concept of "delegated reporting", i.e. a client can delegate the process to its dealer, but *not* the obligation. Taking into account clients' unfamiliarity with financial regulatory processes, it stands to reason that the vast majority of a credit institution's clientele will want to exonerate themselves from the requirement, by delegating their trade reporting to their bank. In order then for credit institutions to be legally shielded against their clients, they should accompany the delegating reporting service with a "Delegated Reporting Standard Terms Agreement" acknowledging, inter alia, that, first, the reporting obligation still lies with the client and, subsequently, that they have no responsibility or liability for any acts or omissions of any third party services providers (e.g. TRs).

⁵⁴ European Market Infrastructure Regulation art.9.

Clearing obligation

• Central clearing

The clearance of financial instruments has a strategic standing for financial stability and is beneficial for the efficient mechanics of the financial markets.⁵⁵ Clearing covers all activities from the time a transaction involving securities is made until it is finally settled. This may include, for instance, the transmission, reconciliation and, in some cases, confirmation of transfer orders prior to settlement, possibly including the calculation of net positions (this may involve the netting of obligations, including netting by novation) and the establishment of final positions for settlement. In brief, it ensures that all the prerequisites for settlement are in place.⁵⁶ Clearing activities may be conducted by specialist clearing houses. The process of clearing may also involve a Central Counterparty (CCP)—a specialised financial institution—which is interposed between the counterparties to trades, acting as the buyer to every seller and the seller to every buyer. In this regard, the centralised clearing of financial instruments usually takes place through a single Central Counterparty, interposed as the counterparty and guarantor to every trade, calling for standardised contracts, entailing minimum initial margins and margin variations, centralising counterparty risk and reducing risk through conservative risk management practices and multilateral netting resulting in its members having less overall exposure.⁵⁷

• Central counterparty clearing: advantages and disadvantages

Advantages

Increased liquidity and transparency via loss mutualisation In a decentralised market, each entity is aware of its own exposures to other counterparties but rarely does it know its counterparty's exposure to others. As a result, this can lead to firms' unwillingness to trade with large numbers of other firms after the failure of a major market participant for fear of other firms being seriously exposed and are therefore risky themselves. In this regard, indirect contagion from a failure decreases liquidity in the market. On the other end of the scale, in

the centralised world, CCPs have developed a waterfall mechanism enabling them to absorb the losses in the event of default of a CCP member. At a first stage, positions with defaulted counterparty will be closed out and netted. At a second stage, the collateral will be liquidated. Subsequently, a CCP reserve fund (guarantee pool), which will have been created from contribution from other clearing members, shields the CCP against further losses.⁵⁸ As a consequence, the chances of a domino effect are slim (if any at all) since losses are shared among counterparties.

Increased liquidity and transparency via standardisation⁵⁹ Derivative contracts are concluded through the use of master agreements ("standard documentation"). The market in itself, via the larger trade associations and self-regulatory bodies, has developed its own set of rules to respond to the increased need for standardisation. By and large, standardisation in financial contacts aims at fulfilling the following goals⁶⁰; first, it offers minimisation of operational risk and facilitation of the execution of uniform post-trade processes, including clearing, via the standardisation of economic and contract terms. Secondly, it leads to maximisation of derivative trading on organised trading platforms and encouragement of more meaningful use of trade information by facilitating comparability amongst products. Thirdly, it provides time saving and less costly transactions as opposed to a separate documentation of each transaction. Lastly, standardisation ensures facilitation of the matching of back-to-back transactions.

At large, all these advantages allow participants to trade, settle and monitor positions with increased efficacy and, instead of promoting excessive complexity, encourage the use of simpler products.⁶¹ Moreover, from a legal perspective, the terms might be scrutinised by courts resulting in legal certainty and therefore market confidence. Against this backdrop, one major advantage of standard documentation is that it defines market practice.⁶²

What is more, the increased standardisation being at the epicentre of many of the regulatory initiatives, could form the analytical basis of systemic risk regulation.⁶³ In this regard, not only will a CCP require significant standardisation in relation to products traded through it and their pricing models, but also as regards operational

⁵⁵ See K. Alexander, "Solutions to Regulatory Differences Between the US Dodd Frank Act and the European Commission's Proposal, In Particular In Ensuring Equal Conditions for Market Access for EU and Third Country Central Counterparties (CCPS)" in: *Derivatives, central counterparties and trade repositories*, edited by Policy Department A: Economic and Scientific Policies, Directorate General for Internal Policies, European Parliament, Compilation of Briefing Notes (2011) (pp.6–23), p.8.

⁵⁶ See K. M. Löber, *The Developing EU Legal Framework for Clearing and Settlement of Financial Instruments*, ECB Legal Working Paper Series No.1 2006 p.6.

⁵⁷ See K. Alexander, "Solutions to Regulatory Differences Between the US Dodd Frank Act and the European Commission's Proposal, In Particular In Ensuring Equal Conditions for Market Access for EU and Third Country Central Counterparties (CCPS)" in: *Derivatives, central counterparties and trade repositories*, edited by Policy Department A: Economic and Scientific Policies, Directorate General for Internal Policies, European Parliament, Compilation of Briefing Notes (2011) (pp.6–23), p.8.

⁵⁸ See J. Gregory, *Impact of regulatory reform on clearing and settling OTC derivatives* (2010) at http://www.cvacentral.com/sites/default/files/CCP_Incusive_Presentation.pdf [Accessed June 29, 2014] pp.19–20.

⁵⁹ See G. Kounadis, *Evolving International and European Regulatory Regimes for Netting in Financial Transactions* (Master Thesis, Institute for Law and Finance, Johann Wolfgang Goethe University Frankfurt am Main, 2012), p.19.

⁶⁰ See R. P. Wood, *Set-off and Netting, Derivatives, Clearing Systems*, 2nd edn (London: Sweet and Maxwell, The Law and Practice of International Finance Series, Vol.4, 2007) pp.217–218.

⁶¹ See Financial Services Authority & HM Treasury, *Reforming OTC Derivative Markets: A UK perspective* (2009), p.8.

⁶² See G. Kounadis, *Evolving International and European Regulatory Regimes for Netting in Financial Transactions* (Master Thesis, Institute for Law and Finance, Johann Wolfgang Goethe University Frankfurt am Main, 2012), p.19.

⁶³ See G. Kounadis, *Evolving International and European Regulatory Regimes for Netting in Financial Transactions* (Master Thesis, Institute for Law and Finance, Johann Wolfgang Goethe University Frankfurt am Main, 2012).

and legal procedures (netting, collateral etc.). As a result, its ability to unwind trades—coupled with multilateral netting benefits—will be further enhanced, the number of counterparties that will trade in certain products will be increased, and the asymmetric information consequences will be reduced.⁶⁴ All these benefits are also likely to increase liquidity.⁶⁵ On the contrary, in the case of non-standardisation of a high volume product, the degree to which existing market infrastructure and transparency can be appropriately executed is moderate. Therefore, inadequacies may surface as regards price discovery, in the valuation of positions and low use of post-trade operational processes.⁶⁶

Increased liquidity and transparency via legal and operational efficiencies The operation of a CCP requires settlement, netting services, collateral management and centralisation of rules and mechanisms.⁶⁷ In other words, central clearing offers a series of legal and operational efficiencies, which could pave the way for smaller institutions to enter the market. This is to say that, a firm, which might not be capable of dealing, on an operational level, with the daily margin calls in a bilateral market, might be capable of doing so in a centralised market, by having only one counterparty (CCP) to trade with.⁶⁸ Furthermore, central clearing ensures anonymity during the straight-through process resulting in reduced spreads and therefore increasing market efficiency and liquidity.⁶⁹

More efficient credit risk management and redistribution Without being capable of totally eliminating counterparty risk, CCP employs central credit risk management by taking over the counterparty risk from all clearing members and thereby transforms the bilateral treatment of credit risk into centrally managed credit risk.

As a result, a clearing member, instead of dealing with a plethora of counterparties with various risk profiles, has only to transact with the CCP.⁷⁰

• Central counterparty clearing: advantages and disadvantages

Disadvantages

Cons of multilateral netting According to the “Angel Report”, despite its advantages, multilateral netting might pose systemic risk.⁷¹ First and foremost, by concentrating transactions through a CCP, multilateral netting could potentially increase concentration risk and thereby rendering the system susceptible to CCP’s failure. In addition, contrary to the perception that the presence of a multilateral netting arrangement reduces credit risk, it can actually increase it, due to the fact that participants could be tempted to expand their derivatives activities and, accordingly, their incentive for bilateral credit discipline could be weakened. What is more, efficacy of this form of netting completely depends on the robustness of the CCP. Put differently, only under the strict assumption of the CCP being unbreakable and thus ignoring counterparty credit risk exposure that market members have against it, has multilateral netting the ability to reduce overall exposure in the market.

Detriments of standardisation By and large, OTC derivative contracts tend to be customised and thus difficult to trade through a CCP.⁷² Since a number of OTC derivatives are traded with only the one party being knowledgeable on the exact valuation of the derivative (the other party might only be using derivative contract for hedging purposes), forcing standardisation could heavily disrupt the market.⁷³ Moreover, customisation might be in the parties’ interest (i.e. the contractually agreed maturity day may coincide with a certain cash flow needed to the firm). Without doubt, excessive complexity should be discouraged but simple customisations, which might be reasonable and necessary, could not be allowed in a CCP market.⁷⁴

The benefits of non-cleared OTC derivatives⁷⁵ Basis risk is the risk of market price changes between the underlying position and the hedging derivative instrument resulting from differences in

⁶⁴ See G. Kounadis, *Evolving International and European Regulatory Regimes for Netting in Financial Transactions* (Master Thesis, Institute for Law and Finance, Johann Wolfgang Goethe University Frankfurt am Main, 2012), p.22.

⁶⁵ See G. Kounadis, *Evolving International and European Regulatory Regimes for Netting in Financial Transactions* (Master Thesis, Institute for Law and Finance, Johann Wolfgang Goethe University Frankfurt am Main, 2012).

⁶⁶ See G. Kounadis, *Evolving International and European Regulatory Regimes for Netting in Financial Transactions* (Master Thesis, Institute for Law and Finance, Johann Wolfgang Goethe University Frankfurt am Main, 2012).

⁶⁷ See G. Kounadis, *Evolving International and European Regulatory Regimes for Netting in Financial Transactions* (Master Thesis, Institute for Law and Finance, Johann Wolfgang Goethe University Frankfurt am Main, 2012), p. 25.

⁶⁸ See G. Kounadis, *Evolving International and European Regulatory Regimes for Netting in Financial Transactions* (Master Thesis, Institute for Law and Finance, Johann Wolfgang Goethe University Frankfurt am Main, 2012).

⁶⁹ See G. Kounadis, *Evolving International and European Regulatory Regimes for Netting in Financial Transactions* (Master Thesis, Institute for Law and Finance, Johann Wolfgang Goethe University Frankfurt am Main, 2012).

⁷⁰ There are approximately 10 key large financial institutions that have engaged in OTC derivatives and dominate the market (*Goldman Sachs Group Inc., Citigroup Inc., JPMorgan Chase & Co., Bank of America Corp., Morgan Stanley, Deutsche Bank AG, Barclays Plc, UBS AG, Royal Bank of Scotland Plc, Credit Suisse Group AG*). Should the CCPs’ role be strengthened and they become major players in the OTC derivative market, the systemic risk from derivatives will spread from 10 entities to more entities, depending on the number of CCPs operating in the market. In case, for instance, there are 3 major CCPs in the market (i.e. *IntercontinentalExchange Inc., Eurex Clearing AG, and LCH Clearnet SA*) the risk will be spread among 13 institutions.

⁷¹ Group of Ten, *Report on Netting Schemes*, Group of Experts on Payment Systems (Basle, 1989), pp.16–20.

⁷² J. Gregory, *Impact of regulatory reform on clearing and settling OTC derivatives* (2010), p.31.

⁷³ J. Gregory, *Impact of regulatory reform on clearing and settling OTC derivatives* (2010).

⁷⁴ J. Gregory, *Impact of regulatory reform on clearing and settling OTC derivatives* (2010).

⁷⁵ See International Swaps and Derivatives Association, *Non-Cleared OTC Derivatives: Their Importance to the Global Economy* (2013) at <http://www2.isda.org/news/isda-publishes-paper-examining-non-cleared-otc-derivatives-and-their-importance-to-the-global-economy> [Accessed June 29, 2014], p.17.

underlying economic factors. Basis risk is a major issue for all types of firms that are in need of hedging their exposures. Derivative users employing imperfect hedges, by not being given the possibility of using non-cleared derivatives, might be faced with residual unwanted risk. Basis risk drives two important rationales for using OTC derivatives.

First, the basis risk of certain hedging transactions might be so high that derivatives users will not qualify for hedge accounting treatment; they could not offset in the same accounting period for accounting purposes the changes in value of the derivative with the changes in value of the underlying asset, leading thus to volatility to reported earnings. Consequently, they might decide to skip their hedging strategy, thus remain exposed to the risk they previously wished to manage. Additionally, in absence of appropriate hedges and hedge accounting treatment, firms are not likely to engage in previously productive activities that generated the underlying risk in the first place, negatively impacting, in this way, economic growth, capital investment and job creation.

Secondly, the other way in which basis risk drives derivatives usage is associated with the role of derivatives dealers in risk management. That is to say, any residual risk can also be managed by dealers via transactions, such as OTC derivatives transactions that are non-cleared. In this context, such firms may end up taking on basis risk as part of their role in providing instruments that enable users to perfectly hedge their risk, thereby providing an important benefit: they take on risk they are more able to cope with from firms that are less able to do so.

Homogenisation and asymmetric information The aforementioned loss mutualisation (see above) has the potential to generate risk. Homogenisation of counterparty risk might not be necessarily beneficial.⁷⁶ Owing to the very nature of bilateral market, firms are forced to carefully monitor their counterparties and thus institutions of low credit quality are refrained from entering the market. In this context, poorly credit rated firms have incentives to enhance their credit quality. On the contrary, in a multilateral market, credit ratings might play a less important role as long as participants will be less incentivised to place a great deal of importance to the credit quality of their counterparties. Consequently, less creditworthy firms might break into the market.⁷⁷

Within the same frame, another problem potentially arising from central clearing is that an entity, whose creditworthiness is ever-worsening, may, to a greater or a lesser extent, be disregarded. Hence, it can be said that poorly-rated firms might grow their positions faster compared to bilateral markets. This negative aspect of derivative central clearing can be further intensified if

taking into consideration that asymmetric information costs may be higher due to the lack of transparency and, also, that the valuation of the counterparty risk with respect to derivative transactions is always more complex than pricing the derivatives itself.⁷⁸ Thus, for many analysts, markets are better off burdening dealer's shoulders with the duty of gauging of counterparty risk than passing it on to a CCP.⁷⁹

Competition⁸⁰ To begin with, a central question in relation to competition among CCPs is whether a small number of large CCPs or a large number of small CCPs would be preferable with respect to the well-functioning of the financial system. However, any of these two models pose certain risks. This is to say that, the former model is the *optimum* as regards multilateral netting benefits maximisation but is also undesirable on monopolistic grounds, namely the potential of increased costs and margin requirements for several participants. In contrast, the latter model, not only limits netting benefits, but also the greater competition might result in CCPs' fees and collateral requirements being not conservative enough, creating thus the conditions for a "race to the bottom" among clearing houses.

Systemic implications from a CCP failure Riccardo Rebonato, Head of front-office risk management and quantitative analytics at Royal Bank of Scotland in London has claimed:

"We are moving away from a network system that can survive the failure of a single thread, to a hub-and-spoke system that must be 100% resilient. If the hub is ever allowed to fail, the aftermath of Lehman's default is going to look like a picnic. So we are placing a lot of reliance on regulators to get these standards right and ensure CCPs are really robust."⁸¹

This statement is indicative of the "too-big-to-fail" doctrine in relation to CCPs. It is easily understood that a CCP's failure could have disastrous implications on the financial system as a whole.

However, before coming up with an answer to the "too-big-to-fail" question relating to CCPs, the way in which the "too-big-to-fail" doctrine must be construed has to be clarified, especially on the part of regulatory authorities. This is to say that, the central issue might be whether a "too-big-to-fail" entity is the one which will always be given financial support in times of crises or/and the one which will not be allowed to exist in the first place (too-big-to-exist). For instance, it could be argued that a robust derivative market is not one heavily dominated by a few large institutions (all of which are viewed as being "too-big-to-fail") but rather a market which consists of

⁷⁶ See J. Gregory, *Impact of regulatory reform on clearing and settling OTC derivatives* (2010), p.33.

⁷⁷ J. Gregory, *Impact of regulatory reform on clearing and settling OTC derivatives* (2010).

⁷⁸ J. Gregory, *Impact of regulatory reform on clearing and settling OTC derivatives* (2010), p.34.

⁷⁹ J. Gregory, *Impact of regulatory reform on clearing and settling OTC derivatives* (2010).

⁸⁰ J. Gregory, *Impact of regulatory reform on clearing and settling OTC derivatives* (2010), pp.39–40.

⁸¹ See J. Clark, "Waiting for CCP standards" *Risk Magazine* (2010) at <http://www.risk.net/risk-magazine/feature/1603852/waiting-ccp-standards> [Accessed June 29, 2014].

smaller institutions with less chaotic repercussions in case of their failure, especially compared with those experienced in the recent global financial crisis.

In any case, despite the way in which the banking sector is shaped, CCPs—due to their systemic significance—should be undoubtedly shielded, to the greatest possible extent, against the possibility of failure, by employing mechanisms ensuring and enhancing their robustness, without necessarily being transformed to the next “too-big-to-fail” entities bolstering thus moral hazard issues revolving around these specialised financial institutions.

• A legal perspective

As understood, central clearing aims to mitigate counterparty credit risk, whose mitigation, as it has already been referred to, is one of the *raison d'être* of EMIR. Under EMIR, a clearing obligation will apply to contracts between any combination of FCs and NFCs+. ⁸² Mandatory clearing obligations will apply to trades between such firms where (a) one or more of the counterparties is in the European Union and (b) in limited circumstances, neither in the European Union (see above).

It is notable that trades may be exempt from clearing if certain conditions are met, such as in cases where both counterparties are included in the same consolidation on a full basis and/or appropriate centralised risk evaluation, measurement and control procedures are in place. ⁸³ESMA will assess the application of the clearing for OTC derivatives based on a top-down approach (from ESMA to local market) and a bottom-up approach (from local market to ESMA). The criteria which will be followed in identifying the class of contract subject to clearing are (a) degree of standardisation, (b) volume of trading and liquidity and (c) availability of pricing information.

Following the submission by ESMA of the RTS (probably on September 18, 2014), these RTS will be endorsed by the European Commission (one to three months) and non-objected by the European Parliament and the Council (one to three months). The actual date of application of the clearing obligation will depend on the date of entry into force of these RTS and the expected phase-in period per type of counterparty, to be defined in the RTS. The clearing obligation procedure ⁸⁴ is triggered every time a new CCP is authorised, and the assessment by ESMA of the suitability of the classes for the clearing obligation will be performed only on the classes notified to ESMA.

Test 1: Commercial purpose hedging ⁸⁵ An NFC's derivative contracts are exempt from clearing/margining if they meet ESMA's “hedging for commercial purposes”

definition: “[Swaps that are] ... objectively measurable as reducing risks related to commercial activity or treasury financing activity of the NFC or of that group”. To meet the definition one of the following conditions needs to be met:

- the swap covers the risk arising from the normal course of business (includes proxy hedging and stock options arising from employee benefits);
- the swap covers indirect risks;
- the swap is consistent with the IFRS hedging definition.

If NFC's derivative activity falls within the above thresholds, the test is met and the NFC is below the clearing threshold (NFC-). Accordingly, if NFC's activity does not meet the above conditions, the commercial purpose hedging test is not met and, as a result, the NFC should then apply threshold test.

Test 2: Threshold test ⁸⁶ An NFC will exceed the clearing threshold if its average rolling position over 30 working days (excluding hedging positions as defined above) remains above the following thresholds ⁸⁷:

- €1 billion in credit derivative contracts;
- €1 billion in equity derivative contracts;
- €3 billion in interest rate derivative contracts;
- €3 billion in FX derivative contracts; and
- €3 billion in commodity derivative contracts and other OTC derivative contracts not captured in the above categories.

Importantly, exceeding the threshold in any individual asset class would require an NFC+ to clear transactions in all asset classes where the product is mandated by the regulator. Furthermore, when calculating its positions, a NFC+ must include all contracts entered into by other NFCs within its group. If NFC's transactions meet the above thresholds, the test is met and therefore the entity is an NFC-. If the commercial purpose hedging test is not met, NFC exceeds the clearing threshold and is thus NFC+.

• A compliance perspective

Counterparties might meet the clearing obligation as a direct clearing member, client of a clearing member or indirectly through a clearing member. Again, the vast majority of clients will meet clearing obligation through their credit institutions. To this end, clients need to determine their classification under EMIR, namely

⁸² European Market Infrastructure Regulation art.4.

⁸³ See European Market Infrastructure Regulation art.3 para.1.

⁸⁴ See European Market Infrastructure Regulation art.5 para.2.

⁸⁵ See Commission Delegated Regulation 149/2013 supplementing Regulation 648/2012 with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP [2013] OJ L53/11 art.10.

⁸⁶ Commission Delegated Regulation 149/2013 art.11.

⁸⁷ All measured in gross notional value.

whether they are an FC, NFC- or NFC+ with a view to ascertaining if they fall under the clearing obligation. In case of uncertainty regarding their classification, clients might need guidance by the EMIR-focused teams; it is, however, of significance for the credit institutions not to offer advice on clients' classification but limit their service to merely offering guidance on the grounds of them excluding their liability. It is notable that, when NFC+ clients inform their counterparty (e.g. their bank) on their classification, they are also obliged to inform their local regulators. Given that the implementation process of the clearing obligation has neither yet been described in the relevant RTS thus nor commenced, the majority of compliance ramifications stemming from it remain to be seen.

Risk mitigation techniques for non-centrally cleared OTC derivatives

Introduction

Besides the introduction of clearing and reporting obligations for OTC derivatives, EMIR also specifies increased requirements for risk mitigation procedures for bilateral OTC derivative transactions. These risk mitigating measures are applied for all OTC derivative transactions not cleared through a CCP. In this context, the following risk mitigation requirements apply to all counterparties in respect of uncleared OTC derivative transactions.⁸⁸

Timely Trade Confirmation (effective March 2013)⁸⁹

The term "confirmation" means⁹⁰ the documentation of the agreement of the counterparties to all the terms of an OTC derivative contract. All OTC derivative trades must be confirmed within the EMIR timelines which range between one and four business days. The timelines are dependent on the counterparties' classification and the type of derivative contract.⁹¹

Dispute resolution procedures (effective September 2013)⁹²

Counterparties must have agreed formalised procedures and processes to (a) identify, record and monitor disputes relating to the recognition or valuation of the contract and to the exchange of collateral counterparties, and (b) resolve disputes in a timely manner with a specific process for those disputes that are not resolved within five business days.

Portfolio Reconciliation (effective September 2013)⁹³

All counterparties must agree in writing or other equivalent electronic means with each of their counterparties on the arrangements under which the portfolios must be reconciled. Such agreement must be reached before entering into the OTC derivative contract. The frequency where the portfolio reconciliation must be performed is dependent on the counterparty classification and the trade volumes outstanding.⁹⁴

Portfolio Compression (effective September 2013)⁹⁵

Portfolio compression involves parties netting trades with a view to maintaining the same risk profile but reducing the number of contracts and therefore the gross notional value. Specifically, counterparties with 500 or more OTC derivative contracts outstanding with another counterparty must have in place procedures to regularly, and at least twice a year, analyse the possibility to conduct a portfolio compression exercise in order to reduce their counterparty credit risk and engage in such a portfolio compression exercise.

Risk mitigation techniques for counterparties (FC and NFC+) subject to the clearing obligation

Introduction

More stringent obligations apply to FCs and NFCs + than to NFCs. FCs and NFC+ must comply with all the above and also with requirements to conduct daily

⁸⁸ European Market Infrastructure Regulation art.11.

⁸⁹ See Commission Delegated Regulation 149/2013 art.12.

⁹⁰ See Commission Delegated Regulation 149/2013 art.1(c).

⁹¹ As per transactions between FCs/NFCs+: (a) CDS/IRS, which are concluded until April 28, 2014, should be confirmed by the end of the 2nd business day following the date of execution of the OTC derivative contract (T+2), (b) other transactions, which are concluded until August 21, 2013, T+3; then until August 31, 2014, T+2. Concerning transactions with other NFCs: (a) CDS/IRS: until August 31, 2013, by end T+5, then until August 31, 2014, T+3, (b) other transactions: until August 31, 2013, T+7, then until August 31, 2014, T+5. See Commission Delegated Regulation 149/2013 art.12(a)-(e).

⁹² Commission Delegated Regulation 149/2013 art.15.

⁹³ Commission Delegated Regulation 149/2013 art.13.

⁹⁴ Portfolio reconciliation must be performed by an NFC on a quarterly basis when it has more than 100 OTC derivative contracts outstanding in place with another entity, and on a yearly basis when this threshold is not met. Portfolio reconciliation must be performed by an NFC+ each business day when it has 500 or more OTC derivative contracts in place with another entity, weekly when the number of contracts is between 51 and 499 and quarterly when 50 or fewer OTC derivative contracts are outstanding between such parties. See on this Commission Delegated Regulation 149/2013 art.13.

⁹⁵ See Commission Delegated Regulation 149/2013 art.14.

“mark-to-market” (or “mark-to-model”) valuations and to “exchange of appropriately segregated collateral” on uncleared OTC derivatives.⁹⁶

Mark-to-market (effective March 2013)⁹⁷

FCs and NFCs+ must also calculate the mark-to-market of their derivatives on a daily basis. Where market conditions prevent marking-to-market, reliable and prudent marking-to-model must be used.

Exchange of appropriately segregated collateral (effective date to be announced)

The exchange of variation and initial margin is obligatory for bilateral OTC derivative contracts. The requirements for exchanging variation margin are likely to come into effect as of 2015. The initial margin requirements should be introduced in stages within a transition period ranging from 2015 to 2019. The collateralisation obligation has been effective since the Regulation came into force on August 16, 2012. The specific guidelines for collateralisation, however, have not yet been transposed into final regulatory technical standards. These will be based on the guidelines on “Margin Requirements for Non-Centrally Cleared Derivatives” by BCBS and IOSCO,⁹⁸ which were released in their final version in September 2013. The technical standards for collateralisation of bilateral OTC transactions based on the BCBS/IOSCO guidelines are expected to enter into force as of December 2015.⁹⁹ Until then, market participants may carry out collateralisation according to the risk policies of the individual institutions, though under observation of the general requirement for collateralisation.

A compliance perspective

In terms of compliance with risk mitigation techniques, a credit institution must agree with its clients/counterparties processes for timely confirmation, dispute resolution and portfolio reconciliation. From a timely confirmation aspect, a credit institution should keep its counterparties in an OTC transaction analytically informed about confirmation timelines, which vary depending on the counterparties classification and the type of derivative contract. Concerning dispute resolution procedures, a specific process must be in place to resolve any disputes having been outstanding for more than five business days. In case either a credit institution or the client gives written notice of a dispute to the other, they

should agree to consult bona fide with one another in an attempt to resolve such disputes within X days from the notice day. That, in turn, entails the exchange of any relevant information following a pre-existing or a new resolution process, in case the former is unsuitable. Lastly, with regard to portfolio reconciliation a credit institutions should—by means of the aforementioned questionnaire—agree with its client on the way in which they will exchange information related to the data of their portfolios, e.g. whether the client would wish to be a data sending or data receiving entity. It goes, again, without saying that credit institutions shall offer the information to clients as regards the frequency of portfolio reconciliation under EMIR.

Concluding remarks

EMIR is a valiant effort to confront systemic, counterparty credit and operational risk by imposing the reporting and clearing obligations and risk mitigation techniques on entities trading derivatives respectively. By increasing the margin requirements for counterparties subject to the clearing obligation, EMIR aims at dealing with under-collateralisation in the OTC derivative market. As a result, the industry will be benefited from the reduction of counterparty credit risk and the increased transparency. Nonetheless, the overall cost stemming from EMIR might be high and possibly incommensurate, in terms of collateral demands resulting in an unintended decrease in hedging activity, which might be further reduced by the imposition of standardised contracts in the context of the clearing process. Additionally, the absence of global regulatory alignment could lead to regulatory arbitrage. In view of the high compliance costs imposed on credit institutions and the early stage of development of central clearing, the proposal would benefit from a slower and progressive implementation schedule with a view to minimising costs and disruption in business.

“Regulatory risk” can be defined as any legal or regulatory change made by the legislator or regulator leading to an increase in the costs of operating a business, reducing, consequently, the attractiveness of investment. In this regard, the largest cost of the Regulation will be the posting of initial margin and variation margin. Initial estimates suggest that the industry will need to post more than \$2 trillion of high quality assets to be used as collateral.¹⁰⁰ What is more, at a credit institution level, banks must also be prepared for new central counterparty fees, clearing member fees, costly changes to booking systems and processes, and other costs, such as increased costs and counterparty credit risk by breaking up netting

⁹⁶ European Market Infrastructure Regulation art.11 para.3.

⁹⁷ See Commission Delegated Regulation 149/2013 arts 16 and 17.

⁹⁸ See Basel Committee on Banking Supervision and Board of the International Organisation of Securities Commissions, *Second Consultative Document: Margin requirements for non-centrally cleared derivatives* (2013) at <http://www.bis.org/publ/bcbs242.pdf> [Accessed June 29, 2014].

⁹⁹ See European Commission, *EMIR: Frequently Asked Questions* (2013) at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/emir-faqs_en.pdf [Accessed June 29, 2014].

¹⁰⁰ See Herbert Smith, *Energy Markets and EMIR: The race towards EU regulation of OTC derivatives* is on (2012) at <http://www.herbertsmithfreehills.com/-/media/HS/L-200312%20-%20Energy%20Markets%20and%20EMIR%20-%20race%20towards%20EU%20regulation%20-%202010.pdf> [Accessed June 29, 2014], p.11.

sets.¹⁰¹ All the above will inevitably lead to a considerable increase in regulatory risk faced by credit institutions. At a client level, they will face a choice between hedging effectively and accepting higher costs, buying standardised exchange traded hedges that are cheaper or opting not to hedge entirely. As a result, they must review and re-document their OTC trading agreements, including amending their ISDA master agreements and entering into clearing documentation for cleared trades. Last but

not least, from a compliance risk¹⁰² point of view, the Regulation clarifies that proportionate but onerous penalties will be established and imposed upon those not complying with the clearing and reporting obligations.¹⁰³ Again, it is to be noted that teams' dealing with EMIR-related issues appropriate training, is of the utmost importance for the reduction of compliance risk all across lines of defence of a credit institution.

¹⁰¹ Unless CCP interoperability becomes a reality; interoperability or linking of CCPs would allow a market participant to concentrate its portfolio at a CCP of its choice, regardless of what CCP its trading counterparty chooses to use. Thus, at the level of each CCP, a CCP (CCPA), may have access to collateral from another CCP (CCPB) that may go bankrupt in the future, so that losses involved in closing out CCPB's obligations to CCPA can be covered.

¹⁰² "Compliance risk" is defined as the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities (together, "compliance laws, rules and standards"). See Basel Committee on Banking Supervision, *Compliance and the compliance function in banks* (2005) at <http://www.bis.org/publ/bcbs113.pdf> [Accessed June 29, 2014], p.7.

¹⁰³ See Herbert Smith, *Energy Markets and EMIR: The race towards EU regulation of OTC derivatives is on* (2012), p.11.