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EU Council Reviews the EMIR Proposal: Issues for End-Users

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In September 2010, the European Commission published a draft proposal (Commission Proposal) for a Regulation of the European Parliament and of the Council on over-the-counter (OTC) derivatives, central counterparties and trade repositories (commonly referred to as the "European Market Infrastructure Regulation" or "EMIR").[1] In the course of the EU legislative procedure, the Council has published a series of compromise proposals – the latest proposal is dated 17 March 2010 (Council Proposal).[2] This article highlights some of the changes considered by the Council Proposal and its potential impact on end-users of derivatives.[3]

G20 Leaders' Statement

In September 2009, G20 Leaders agreed in Pittsburgh that: all standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest; OTC derivatives contracts should be reported to trade repositories; and non-centrally cleared contracts should be subject to higher capital requirements.[4] The Commission Proposal seeks to ensure implementation of the G20 commitments as part of a larger international effort to increase the stability of the financial system in general.

International Input

In October 2010, the Financial Stability Board (FSB) published its recommendations, entitled "Implementing OTC Derivatives Market Reforms" (FSB Report).[5] This publication addressed practical issues that regulators may encounter in implementing the G20 commitments in relation to 1) standardisation of OTC contracts from a legal and operational perspective, 2) central clearing of derivatives to enhance liquidity and price transparency, 3) exchange and electronic platform trading and 4) reporting to trade repositories.

At this time, the International Organization of Securities Commissions (IOSCO) formed the Task Force on OTC Derivatives Regulation. In part, the Task Force was charged with implementing the recommendation in the FSB Report that IOSCO conduct a study to evaluate the benefits and challenges associated with the implementation of measures aimed at increasing exchange and electronic trading of OTC derivative products. IOSCO's subsequent "Report on Trading of OTC Derivatives" (IOSCO Report)[6] promotes, among other things, 1) the trading of standardised derivatives contracts on exchanges or electronic trading platforms, 2) the registration of trading platforms with national authorities, 3) operational efficiency, 4) post-trade infrastructure, 5) active market surveillance and 6) transparency.

A number of the suggested changes to the Commission Proposal contained in the Council Proposal draw on the recommendations made in the FSB and IOSCO Reports.[7]

Mandatory Clearing

"Bottom-up" and "Top-down" Approaches

In line with the FSB Report, the Council Proposal provides further detail on the "bottom-up" and "top-down" approaches[8] to determining the classes of derivatives to be subject to mandatory clearing. Under the "bottom-up" approach, where a home state regulator authorises a central clearing counterparty (CCP) to clear a class of derivatives, the home state regulator must inform the European Securities and Markets Authority (ESMA). ESMA then has six months to submit to the Commission for endorsement technical standards determining whether that class of derivatives is subject to the clearing obligation. Under the "top-down" approach, ESMA, on its own initiative after public consultation and consultation with the European Systemic Risk Board (ESRB), can identify classes of derivatives contracts that should be subject to the clearing obligation.

In each case, the determination of whether a class of derivatives is subject to the clearing obligation is ultimately made by ESMA based on a number of factors, including 1) the impact of clearing the new class of derivatives on counterparty credit risk, 2) the degree of standardisation of the relevant class of derivatives instruments' contractual terms and operational processes, 3) volume and liquidity, 4) the availability of pricing information and 5) the impact on competition. Interestingly, the reduction of systemic risk in the financial system is no longer a criterion upon which ESMA will base its decision as to eligibility, although it is still a general principle to be considered.

Standardisation

Standardisation is introduced in the Council Proposal as a factor to be considered by ESMA in assessing eligibility for clearing. As pointed out in the FSB Report, standardisation of derivatives occurs at two levels: legal and operational. Legal standardisation relates to the use of common contractual terms (*e.g.*, International Swaps and Derivatives Association (ISDA) Master Agreements, confirmations and applicable definitions) in a sufficiently large number of derivatives contracts. Operational standardisation is posited on product trade processing and lifecycle events – such as trade capture and revision, confirmation, settlement, close-out and termination – being managed in a consistent way and timeframe.

Private negotiation is characteristic of the OTC derivatives markets and therefore, while some derivatives contracts are already reasonably standardised in the marketplace (for example, single name credit default swaps (CDS) and fixed-floating interest rate swaps), others are not (for example, CDS referencing a portfolio of credits or equity swaps referencing a basket of shares). Even though CDS may appear standard as regards their economic terms, the swap confirmation may contain additional provisions that are bespoke (for example, specific provisions for calculating the "Cash Settlement Amount" or a particular definition of "Credit Event").

The definition of "class" contained in the Council Proposal identifies maturity, the underlying asset, rate, index, or other reference, and the currency in which the notional amount of the derivative is denominated as essential characteristics of a given class.[9] However, "class" itself is not a synonym for legal standardisation. Derivatives in the same class may still by their terms be different among themselves and may not all be suitable for clearing. However, the FSB Report and the IOSCO Report recognise that a certain degree of customisation may persist within a given class and that this should not preclude eligibility for clearing as such. By way of precedent, certain flexible exchange options are traded on the Chicago Board Options Exchange and allow for some of their terms to be tailored to the specific transaction.

Notwithstanding the political push for mandatory clearing on a global scale, the FSB Report acknowledges that certain bespoke derivatives may not be suitable for clearing. As part of a private negotiation, the parties may tailor the terms of the derivatives contract to their particular needs. Indeed, the FSB Report points to the following benefits to using bespoke derivatives:

- Achieving better hedging;
- Meeting the stringent criteria for hedge accounting treatment;
- Facilitating the creation of tailored investment strategies; and
- Avoiding mandatory clearing costs and margin requirements.

These benefits need to be weighed against the advantages of clearing derivatives including: 1) creating liquidity and competition which in turn may reduce pricing, 2) improved capital treatment for parties subject to prudential regulation, and 3) collateral protection through segregation and portability in the case of a clearing member's insolvency. Each of these factors may play a significant role in influencing the choice between standardised and bespoke derivatives.

To achieve the level of standardisation required for a particular class of derivatives contracts to be eligible for clearing, market participants will be required to review carefully the legal terms relating to such contracts. In addition, bridging gaps to achieve operational standardisation will require close co-operation between dealers, clearing members, CCPs and trade repositories.

Non-financial Counterparties

The Council Proposal clarifies that the clearing obligation applies to 1) a financial counterparty (FC) dealing with another FC or a non-financial counterparty (NFC) which takes positions in derivatives contracts exceeding the clearing threshold[10] and is, therefore, subject to the clearing obligation pursuant to Article 7(2) (Article 7(2) NFC), and 2) an Article 7(2) NFC dealing with an FC or another Article 7(2) NFC. This point was less than obvious in the Commission Proposal and the clarification is helpful.

Accordingly, the clearing obligation is applicable if two NFCs transact with each other and both take positions in derivatives contracts exceeding the clearing threshold. If only one NFC, but not the other, has positions in derivatives contracts exceeding the clearing threshold, the clearing obligation is not applicable according to the Council Proposal. This may give Article 7(2) NFCs the opportunity for regulatory arbitrage as they may carefully choose to transact with special purpose NFCs that have positions in derivatives contracts below the clearing threshold to avoid the clearing obligation that would otherwise have applied. Arguably, it might have been logical under Article 7(2) to make an Article 7(2) NFC subject to the clearing obligation, irrespective of the identity of the counterparty.

The Council Proposal clarifies that once the clearing threshold is exceeded, an NFC is subject to the clearing obligation with regard to all its derivatives contracts entered into after the date on which such threshold is exceeded, including those entered into to reduce risks directly related to the commercial activity of that counterparty. This requirement creates an asymmetry between EMIR and the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank). Under Dodd-Frank, transactions for commercial risk hedging by non-financial entities are exempt from the clearing obligation.

Third Country Entities

A welcomed clarification is made in respect of certain third country aspects. The Council Proposal provides that the obligation to clear for FCs and NFCs transacting with third country entities is applicable only if the third country entities would be subject to the clearing obligation under EMIR if they were established in the EU.

Timing

The Commission Proposal provides that the clearing obligation in respect of a class of derivatives takes effect from the date specified by ESMA once ESMA has determined that such class of derivatives is eligible for the clearing obligation. The Commission Proposal gives no guidance as to the period of time that counterparties will have to comply with the clearing obligation. This is likely to raise difficulties in respect of derivatives contracts existing at the date when eligibility is determined by ESMA. It would have been preferable to apply the clearing obligation only to eligible derivatives contracts entered into after the effective date specified by ESMA and to provide for the grandfathering of existing contracts.

The Council Proposal provides for limited grandfathering in respect of derivatives contracts where the remaining maturity is less than a certain minimum (to be determined by technical standards). The Council Proposal also requires technical standards to be implemented relating to the timeframe within which counterparties become subject to the clearing obligation and the frontloading for clearing of derivatives contracts entered into before the date from which the clearing obligation takes effect. In determining the date from which the clearing obligation takes effect and the timeframe within which counterparties become subject to the clearing obligation, consideration is to be given to, amongst other things, the period of time a counterparty needs to put in place arrangements to clear its derivatives contracts through a CCP.

Reporting

The reporting obligations have been significantly amended in the Council Proposal. Under the Council Proposal, there is no longer a position threshold that is required to be exceeded before the reporting requirements are applicable to NFCs. This means that NFCs will have to report to trade repositories details of all derivative trades they enter into, together with details of any modification or termination of such trades. This is likely to increase operational costs for NFCs substantially, particularly where no FCs are involved in the transaction.

The Council Proposal also provides that the reporting obligation shall apply to all derivatives contracts which were entered into before the date of entry into force of EMIR and are still ongoing on such date. Again, this imposes onerous reporting obligations on both FCs and NFCs.

Non-cleared Derivatives

Few changes are proposed in the Council Proposal as to the trading and managing of non-cleared derivatives. Counterparties need to mark-to-market their exposures daily. However, where market conditions prevent marking-to-market, reliable and prudent marking-to-model shall be used by counterparties. Imposing mark-to-market obligations on NFCs may increase operational costs as it seems unlikely that NFCs will have the infrastructure to mark-to-market their risks on a daily basis.

The Council Proposal appears to introduce a requirement to segregate collateral in respect of non-cleared derivatives, if requested by the other party. The ambit of this obligation needs to be clarified. As drafted, dealers may simply offer counterparties better pricing in exchange for not making such a request. It is not clear if counterparties would be entitled to make such a request after the contract is entered into and require dealers to segregate *post facto*.

Segregation

The Council Proposal contains significant changes to segregation requirements for client assets held by clearing members with a CCP, in particular, as regards full segregation. The latter exists where assets of a client are segregated from 1) its clearing member's assets and 2) the assets of the other clients of such a clearing member. On the other hand, partial segregation is achieved where the assets of a client are segregated from its clearing member's assets but the client's assets are co-mingled with other clients' assets. Under the Council Proposal, CCPs are required to make it possible for their clearing members to fully segregate client assets. Clearing members, in turn, are required to offer their clients full segregation (inevitably, at a higher cost).

Post-Lehman, segregation and client asset protection has been a particularly difficult issue for regulators and market participants. By requiring clearing members to offer full segregation to their clients, EMIR may impose higher operating costs by requiring clearing members to ensure that the assets of each client are identifiable at any given point in time on the clearing member's books. If adopted, the full segregation requirement will make it more difficult for clearing members to use clients' collateral for re-hypothecation purposes, which has been standard practice for prime brokers and dealers. Whether or not full segregation is used in practice may turn on the price at which it is offered. The Council Proposal suggests that the recognition for regulatory capital purposes of a zero exposure value for derivatives contracts entered into with a CCP is available only when full segregation is in place.

Conveniently, the Council Proposal provides that a CCP may use margin or default fund contributions provided to it under a security financial collateral arrangement if 1) such a right is set out in the CCP operating rules and 2) public disclosure of such use is made. This does not change the way the depositary market currently operates, but it is an important clarification on the issue of whether a collateral taker may use collateral given to it under a security arrangement as opposed to a title transfer arrangement. Regrettably, the Council Proposal is silent as to whether this right is also afforded to clearing members (presumably so, if national law permits). The open question would then be how the requirement for full segregation of client assets and the rights of CCPs and clearing members to use margin can co-exist peacefully.

Default Procedures

The way in which the default by a clearing member is dealt with by a CCP is pivotal for the efficient functioning of derivatives clearing and settlement.

Default Waterfall

Several changes have been proposed in respect of default waterfall provisions, (*i.e.*, the way in which funds should be distributed in the case of a default of a clearing member). The priority of payments in the case of default will determine the way in which losses are allocated to the defaulting member, the CCP and the non-defaulting members.

Under the Council Proposal, the default waterfall is as follows (from junior to senior): 1) margin posted by the defaulting clearing member, 2) default fund contribution of the defaulting clearing member, 3) potentially, a CCP's dedicated own resources and 4) on a *pari passu* basis (presumably):

- Default fund contributions of non-defaulting members; and
- CCP's financial resources under Article 41(1).

Margin posted by non-defaulting members cannot be used to cover losses of a defaulting member in any case. The Council Proposal does not specify what is meant by "dedicated own resources." One can infer that such resources must be different from those under Article 41(1), (*i.e.*, pre-funded financial resources).

Portability

Portability is an essential feature of modern clearing and settlement procedures. Portability gives the clients of a defaulting clearing member the ability to transfer their positions to another clearing member of the same CCP (or, potentially, another CCP, if interoperability arrangements are in place). Under the Council Proposal, the CCP will be able to transfer the assets and positions of a defaulting clearing member's clients, without the consent of that defaulting clearing member, to another clearing member designated by the clients, provided that this other clearing member has previously entered into a contractual relationship with those clients. If this acceptance has not been obtained within a predefined transfer period, the CCP may actively manage its risk and liquidate the clients' assets and positions. Portability rights do not seem to be affected by the type of segregation provided to the client (*i.e.*, whether full or partial).

The portability regime is likely to be impacted by existing insolvency law at the Member State level and the Council Proposal recognises this by providing that the portability regime would prevail over any conflicting laws including insolvency legislation, regulations and administrative provisions of Member States. Issues regarding the enforcement of portability arrangements may arise if the defaulting member is not established under the law of a Member State. Conflicts between third country bankruptcy laws (*i.e.*, the automatic stay and the executory contracts provisions under sections 362 and 365, respectively, of the U.S. Bankruptcy Code) and EMIR may ensue.

Where to Next?

It is expected that political agreement on the text of EMIR will be achieved, and that EMIR will be adopted by the European Parliament, during the second quarter of 2011. All draft implementing technical standards are required to be submitted to the Commission by June 2012 with the expectation that EMIR will apply in Member States by the end of 2012.

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[1] Proposal for a Regulation on OTC derivatives, central counterparties and trade repositories – COM(2010) 484 final. *See* also Steven Lofchie, Edmond Curtin and Marco Crosignani, Cadwalader, Wickersham & Taft LLP "No Crisis Wasted: Proposed EU and U.S. Regulation of OTC Derivatives" Part I and Part II, Bloomberg UK Financial Services Law Journal (November and December 2010).

[2] *See* Council Proposal – Presidency Compromise of 17 March 2011.

[3] References to Articles are to Articles of the Council Proposal, unless otherwise provided.

[4] *See* Leaders' Statement: The Pittsburgh Summit – G20 Statement, 24-25 September 2009.

[5] *See* Implementing OTC Derivatives Markets Reforms – FSB Report, 25 October 2010.

[6] *See* Report on Trading of OTC Derivatives – IOSCO Report, FR03/11 of February 2011.

[7] The Commission Proposal has also been subject to industry consultation. *See* ISDA-AFME-NSA-ASSOSIM Comment on EC proposal for a Regulation on OTC derivatives, CCPs and trade repositories– Executive Summary, 28 October 2010.

[8] The difference between these two approaches is whether the initiative for clearing a new class of derivatives is taken by the national authorities or at the EU level.

[9] This list is not intended to be exhaustive.

[10] To be determined by the Commission pursuant to technical standards.