

EMIR - Key Points
and Dates
Applicable to
Financial
Counterparties

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▣ KEY POINTS AND DATES RELATING TO EMIR AS APPLICABLE TO FINANCIAL COUNTERPARTIES

Background

The EU Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (“EMIR”)¹ which was adopted on 4 July 2012 and entered into force on 16 August 2012 introduced the following:-

- ▣ reporting to trade repositories;
- ▣ clearing obligations;
- ▣ risk mitigation requirements for non-centrally cleared trades;
- ▣ requirements for central clearing counterparties (CCPs) and trade repositories (TRs).

Technical Standards

EMIR also required the European Securities and Markets Association (“ESMA”) to deliver to the European Commission its final report on a number of draft technical standards, some of which ESMA produced on 27 September 2012. Technical standards that are yet to be finalised include

- ▣ Risk mitigation techniques for OTC derivatives that are not centrally cleared relating to (i) the level and type of collateral to be exchanged and (ii) the level of capital required to manage the risk not covered by the exchange of collateral;
- ▣ OTC derivative contracts that are considered to have a direct substantial and foreseeable effect in the European Union or to prevent the evasion of EMIR.

On 19 December 2012, the European Commission endorsed the following draft regulatory and implementing technical standards:-

Regulatory Technical Standards

- ▣ Regulatory technical standards on capital requirements for central counterparties;
- ▣ Regulatory technical standards on requirements for central counterparties;

¹ See Dillon Eustace Brochure issued in September 2012 in relation to EMIR on the Dillon Eustace website at the following link <http://www.dilloneustace.ie/download/1/EMIR-%20September%202012.pdf>

- ▣ Regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, risk mitigation techniques for OTC derivatives contracts not cleared by a CCP;
- ▣ Regulatory technical standards on the minimum details of the data to be reported to trade repositories;
- ▣ Regulatory technical standards specifying the details of the application for registration as a trade repository;
- ▣ Regulatory technical standards specifying the data to be published and made available by trade repositories and operational standards for aggregating, comparing and accessing the data.

Implementing Technical Standards

- ▣ Implementing technical standards on requirements for central counterparties;
- ▣ Implementing technical standards on the minimum details of the data to be reported to trade repositories;
- ▣ Implementing technical standards specifying the details of the application for registration as a trade repository.

The European Council and European Parliament were given until 19 February 2013 to raise any objections to the draft regulatory technical standards. The implementing technical standards were not subject to the right of scrutiny of the European Parliament and European Council.

Given the European Council and European Parliament raised no objections to the draft regulatory technical standards, all of the above referenced draft technical standards (both regulatory and implementing) entered into force on 15 March 2013 (which was the twentieth day following their publication in the EU's Official Journal which occurred on 23 February 2013). As with any other EU Regulation, their provisions are directly applicable (i.e. legally binding in all Member States without implementation into national law) from 15 March 2013.

Key Provisions and Dates

The following is a summary of the key provisions of the EMIR Regulation and Technical Standards as applicable to financial counterparties (e.g. investment funds, investment managers, etc) including key dates when those provisions will or are likely to become effective:-

Reporting Obligation

Counterparties to all derivative contracts (OTC and exchange-traded) are required to report to a registered TR post-trade details of any derivative contract they have concluded and of any

modification or termination of the contract. The minimum details of the data to be reported to a registered TR are set out in both a regulatory and implementing technical standard. The details must be reported no later than the working day following the conclusion, modification or termination of the contract. The reporting party may be the counterparty to the trade, or a third-party (such as a CCP or trading platform). However where the reporting obligation is delegated, the counterparty to the trade remains legally responsible for the reporting obligation. The counterparties and/or CCPs and any other entities reporting on their behalf need to agree on the report's contents before submitting it to a registered TR given details of derivative contracts must be submitted "without duplication" according to EMIR.

A TR that is currently authorised or registered in its Member State of establishment to collect and maintain the records of derivatives, must apply for registration under EMIR within six months of the date of entry into force of the technical standards. Such TRs remain subject to existing national regimes until they have been registered with ESMA.

The effective date of the reporting obligations under EMIR depends on the class of OTC derivative contracts;-

Credit and interest rate derivatives;

If a TR is registered by 1 April 2013 – reporting begins 1 July 2013;
If no registered TRs by 1 April 2013 – 90 days after registration.

For all other derivatives;

If TR is registered by 1 October - reporting begins 1 January 2014;
If no registered TRs by 1 October – 90 days after registration.

Existing trades must be reported on the following basis:-

If outstanding at time of reporting date - 90 days to report to TR;
If not outstanding, but remained outstanding on 16 August 2012 (i.e. the date EMIR came into force)
- 3 years to report to TR.

Clearing Obligation

OTC derivative contracts that ESMA has determined are subject to a mandatory clearing obligation must be cleared by a CCP. An exemption exists from the clearing obligation in relation to OTC derivative contracts that constitute intragroup transactions as described under Article 3 of EMIR. The exemption will only apply where notification has been given to the relevant competent authorities in accordance with the provisions of EMIR.

The mandatory clearing obligation will apply to OTC derivative contracts entered into between any combination of (i) financial counterparties and (ii) non-financial counterparties that have OTC derivative positions above the clearing threshold. It also extends to OTC derivative contracts between an entity within (i) or (ii) above and a non-EU entity that would be subject to the clearing obligation if it was established in the EU. Finally the mandatory clearing obligation may apply to OTC derivative contracts between two non-EU entities that would be subject to the clearing obligation if they were established in the EU provided that the contract has a direct substantial and foreseeable effect within the EU or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR.

Furthermore the mandatory clearing obligation will only apply to OTC derivative contracts entered into or novated:-

- (i) on or after the date from which the clearing obligation takes effect; or
- (ii) on or after the date a competent authority notifies ESMA that it has authorised a CCP to clear a class of OTC derivatives under Article 14 or Article 15 of EMIR but before the date referred to in (i), if such contracts have a remaining maturity to be determined by the EU Commission.

Before the clearing obligation procedure can begin, CCPs must be authorised (or recognised in the case of a CCP from a third country) to clear under the new EMIR regime. Once a CCP has been authorised under EMIR to clear a certain class of OTC derivative contracts, ESMA is required, within six months, to develop and submit to the EU Commission for endorsement draft regulatory technical standards specifying (i) the class of OTC derivative contracts that should be subject to the clearing obligation; (ii) the date or dates from which the clearing obligation takes effect, including any phase in and the categories of counterparties to which the obligation applies; and (iii) the minimum remaining maturity of the OTC derivatives contracts referred to in the paragraph above.

In order to expedite the assessment of products for the clearing obligation, national authorities are required to notify ESMA of any existing clearing services for OTC derivatives in their jurisdictions within one month of entry into force of the technical standards (i.e. by 15 April 2013).

Given the above, the first clearing obligations are not expected to arise until the first quarter of 2014.

Risk Mitigation Requirements for Non-Centrally Cleared Trades

Counterparties that enter into an OTC derivative contract not cleared by a CCP, must “ensure, exercising due diligence, that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational risk and counterparty credit risk”. Some of these risk mitigation requirements include:-

- (a) Timely confirmation – The aim is for timely confirmation, where available by electronic means, of the terms of the relevant OTC derivative contract to take place no later than the

business day following execution although a phase in period will apply. In relation to OTC derivative contracts concluded between financial counterparties or non-financial counterparties that have OTC derivative positions that exceed the clearing threshold, this phase in basis is as follows:-

Derivative type	Final Confirmation deadline (end of X business day)	Phasing until August 2013	Phasing until August 2014
Credit and Interest rate Derivatives	T+1	T+2	T+2
All Other Derivatives	T+1	T+3	T+2

In relation to OTC derivative contracts concluded with a non-financial counterparty that has OTC derivative positions that do not exceed the clearing threshold, this phase in basis is as follows:-

Derivative type	Final Confirmation deadline (end of X business day)	Phasing until August 2013	Phasing until August 2014
Credit and Interest rate Derivatives	T+2	T+5	T+3
All Other Derivatives	T+2	T+7	T+4

This requirement regarding timely confirmations applies from the date of entry into force of the technical standards (i.e. from 15 March 2013).

- (b) Dispute resolution – Counterparties must agree detailed processes and procedures for the identification, recording and monitoring of disputes and their timely resolution (including a specific process and procedure for disputes lasting longer than five days). In addition counterparties must notify the relevant competent authority where a dispute lasts longer than 15 business days and is for an amount or value higher than Euro 15 million. These

requirements will enter into force 6 months after the entry into force of the technical standards (i.e. on 15 September 2013).

- (c) Portfolio Reconciliation – the frequency of portfolio reconciliation for financial counterparties (i.e. daily, weekly or quarterly) will depend on how many OTC derivative contracts are outstanding between counterparties. Daily reconciliations will be required when the number of outstanding OTC derivative contracts between counterparties is greater than 500. Weekly reconciliations will be required when the number of outstanding OTC derivative contracts between counterparties is greater than 50 and less than 500. Quarterly reconciliations will be required when the number of OTC derivative contracts between counterparties is less than 50. These requirements will enter into force 6 months after the entry into force of the technical standards (i.e. on 15 September 2013).
- (d) Portfolio compression - Counterparties with 500 or more OTC derivative contracts outstanding with a counterparty which are not centrally cleared 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. Counterparties must ensure that they are able to provide a reasonable and valid explanation to the relevant competent authority for concluding that a portfolio compression exercise is not appropriate. These requirements will enter into force 6 months after the entry into force of the technical standards (i.e. on 15 September 2013).
- (e) Daily valuation – Counterparties are required to value outstanding non-centrally cleared OTC derivatives contracts on a daily basis on a mark to market basis or where market conditions determine otherwise, a “reliable and prudent marking to model” may be used. This requirement applies from the date of entry into force of the technical standards (i.e. on 15 March 2013).
- (f) Exchange of Collateral and Requirements regarding Capital - EMIR requires counterparties to have in place procedures for "the timely, accurate and appropriate segregated exchange of collateral" for non-centrally cleared "OTC derivative contracts that are entered into on or after 16 August 2012". Financial counterparties are required to hold an appropriate and proportionate amount of capital to manage the risk not covered by the appropriate exchange of collateral. The precise level and exact type of collateral to be exchanged and the level of capital required to manage the risk not covered by the appropriate exchange of collateral will be specified by further regulatory technical standards to be issued later in 2013.

Suggested steps to be taken by Financial Counterparties

The following are suggested steps that financial counterparties should consider taking (if not already done so) in order to ensure that they are in a position to comply with the relevant requirements under EMIR:-

- (i) Establish clearing arrangements – In order to comply with the clearing obligation which is expected to come into play in 2014, counterparties who are not a clearing member of a CCP will need to enter into client clearing or indirect clearing arrangements with a broker. An indirect clearing arrangement is defined as a set of contractual relationships between the CCP, the clearing member, the client of a clearing member and indirect client (i.e. a client of a client of a clearing member) that allows the client of a clearing member to provide clearing services to an indirect client;

Where a clearing member is prepared to facilitate indirect clearing, any client of such a clearing member is permitted to provide indirect clearing services to one or more of its own clients, provided that the client of the clearing member is an authorised credit institution, investment firm or an equivalent third country credit institution or investment firm. The contractual terms of an indirect clearing arrangement must be agreed between the client of a clearing member and the indirect client, after consultation with the clearing member on the aspects that can impact the operations of the clearing member. Such terms must include contractual requirements on the client to honour all obligations of the indirect client towards the clearing member. These requirements must refer only to transactions arising as part of the indirect clearing arrangement, the scope of which must be clearly documented in the agreed contracts.

- (ii) Address risk management requirements for non-centrally cleared OTC derivative contracts by putting appropriate procedures and arrangements in place to measure, monitor and mitigate operational risk and counterparty credit risk. In addition priority needs to be given to those risk management requirements that apply from 15 March 2013 being the date of entry into force of the technical standards e.g. timely confirmations and valuations.
- (iii) Take steps to ensure compliance with the reporting obligations to TRs. Will the counterparty report directly or rely on its counterparty or a third party in which case contractual commitments should be obtained? If a counterparty intends to report directly, the counterparty should commence discussions with applicable TRs.
- (iv) Review of Documentation – Does existing bilateral OTC derivative documentation need to be amended to reflect EMIR requirements e.g. to address the risk mitigation requirements for non-centrally cleared OTC derivative contracts?

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