Delays and uncertainty cloud EMIR implementation


Introducing Linklaters’ breakfast seminar on EMIR on 27 February, Geortay noted that the legislation’s origins can be traced back to decisions taken by leaders of the G20 countries in 2009 and 2010 to improve the transparency of the OTC derivatives markets – a ‘massive phenomenon’ with a notional value of US$693trn, 43 times the size of the U.S. GDP – and to make that market safer and less vulnerable to systemic risk.

The European Union’s commitments to the G20 resolutions are implemented through the 2012 top-level regulation, followed by various delegated level 2 regulations enacted by the European Commission at the end of last year. The European Securities and Markets Authority has a key role, including the formulation of regulatory technical standards together with the Commission.

In addition, national regulatory authorities are also involved in the implementation and enforcement of all EMIR rules, notably because ESMA does not have its own penalty regime. Member state regulators including Luxembourg’s CSSF will play a role in oversight and licensing of key market players including central counterparties, in contrast to trade repositories, which are supervised and licensed by ESMA.

Both ESMA and national regulators are also using ‘soft’ mechanisms such as guidance and FAQs, including the CSSF’s press releases and circulars, because the system is still under construction, Geortay says, and many uncertainties remain.

Systemic importance criterion

EMIR divides the market into four categories: financial counterparties (EU financial institutions such as banks, insurance companies and investment funds); systemically important non-financial counterparties, defined according to financial and other criteria (NFC+ in EU jargon); non-financial counterparties that fall outside those criteria (NFC-) and third-country entities (3rd CE) if based in Europe, would be considered an FC or NFC+, where the trades they enter into have a significant impact within the EU.

In practice, however, the regulation divides the market into just two categories – counterparties that are systemically important (FCs, NFC+s and some 3rd CEs) and those that are not (NFC-s).

Emmanuel-Frédéric Henrion, a partner in Linklaters’ investment management group, relates that EMIR imposes obligations of clearing, reporting and risk mitigation to meet its objectives: averting default by a significant market player, and ensuring that regulators have good visibility of the derivatives market.

The clearing process involves the existing derivative contract being replaced by new ones between each party and the central counterparty, so that they are no longer exposed to each other’s credit risk. EMIR contains safeguards to ensure CCPs will never default.

In the first stage the clearing obligation will apply to financial counterparties, then to NFCs in 2015 or 2017. Uncertainty exists on the timing as to whether the three-year transition period applies from the date EMIR came into force in August 2012, or from when the clearing obligation is first applied to financial counterparties.

The reporting obligation already applies to all EU derivatives market participants, but so far only six trade repositories have been approved, although additional ones should be accepted in the future.

“EMIR, the European Market Infrastructure Regulation, is a child of the financial crisis.”

Patrick Geortay, partner, capital markets and banking group
Counterparty and transaction identifiers

EU counterparties are required to obtain a Legal Entity Identifier (LEI), although other identifiers can be used for non-EU parties. Various initiatives are underway through a new informal body, the Regulatory Oversight Committee (ROC), involving 70 national regulators. The ROC is working on a framework that can be applied worldwide, in a similar way to the Basel capital standards; in fact the ROC secretariat is carried out by the Bank for International Settlements.

A single-compartment SICAV will have a single LEI, but each legally segregated sub-fund within umbrella structures must obtain its own LEI. Pooling schemes should also have an LEI but this still has to be confirmed by ESMA. The question of whether individual unit classes will be able to obtain their own LEI numbers has not yet been raised, Henrion says, but it may be the case for fund classes that rely on a contractual segregation across the various unit classes of the same fund.

There is as yet no satisfactory solution in place for the generation of Unique Transaction Identifiers. This should be generated by “middleware” but a certain number of transactions are currently being reported using at least partially manual processes.

ESMA has submitted a large number of technical documents regarding delegation of reporting, Geortay notes. Where, for example, a fund is delegating reporting obligations to a third party such as a bank or broker, the fund remains responsible and ultimately potentially liable for any breaches, although the fund may have a contractual claim against the third-party reporting provider.

Regulators’ tougher stance?

EMIR’s risk mitigation requirements have applied since March and September 2013, but national regulators have up to now accepted ‘best efforts’, noting that industry members are not yet fully compliant. However, the UK’s FCA is now adopting a tougher stance, requiring all participants to comply with the rules by the end of April.

EU national authorities were supposed to implement rules including sanctions by February 2013, but in reality nothing has been done, Geortay says. In Luxembourg a bill has been drafted by the Finance Ministry establishing a framework for the CSSF to impose sanctions under EMIR as well as other legislation, but it is still a work in progress and no timetable has been set for parliamentary approval. This means the CSSF has no disciplinary powers applicable to market participants that are not regulated entities if they fail to meet their EMIR obligations.

ESMA has currently licensed six trade repositories, with the largest being the DTCC. However, it’s unclear what local regulators will do with the information they receive from ESMA; no agreement is yet in place on the format that will be used.

The reporting requirements entail completion of a total of 85 fields for each transaction, 26 for the counterparty data identifying each party and 59 for the common data containing transaction details. Data must be reported to a repository no later than the working day following conclusion, modification or termination of a transaction. A fund using a swap transaction to gain exposure to a financial index could face daily reporting if a notional amount of the swap is attributed on a daily basis, constituting modification.

The reporting obligation has been live since 12 February 2014 and applies to all classes of derivatives, OTC and exchange-traded, Henrion notes. In addition to the reporting of new transactions, historical transactions entered into before 12 August 2012 and outstanding on that date must be back-loaded, at the latest by February 2017 for transactions that had been terminated by 12 February this year. In addition, from 11 August this year FCs and NFC+s are obliged to report collateral and daily mark-to-market valuations as part of the risk mitigation measures.

If either a fund itself or its management company runs into reporting difficulties, it should notify the CSSF immediately and keep the regulator informed about developments.

Emmanuel-Frédéric Henrion, partner, investment management group
Missed deadlines for clearing

If either a fund itself or its management company runs into reporting difficulties, it should notify the CSSF immediately and keep the regulator informed about developments, Henrion says. When a fund delegates reporting to a third party, it must carry out initial and ongoing due diligence. A written agreement between fund and delegate is required; this does not have to be submitted to the CSSF, but the regulator can request it at any time.

The use of derivatives requires updating of the risk management process at least annually. The long form report, where it is required, must address the compliance with EMIR rules, and funds must ensure proper oversight of any provider. There are currently no guidelines on this, nor on how the delegate should report to the fund, so the latter must take whatever initiatives it deems appropriate and describe them in its risk management process.

The clearing obligation has been repeatedly postponed and is unlikely to go live before the end of this year, despite a current deadline of this summer. Clearing obligations will apply initially to financial counterparties only; NFC+s have a longer timeframe, probably between 2015 and 2017.

The first derivatives to be covered by the clearing obligations will be the most standardised and popular ones, likely starting with interest rate contracts. However, clearing depends on central counterparties, and none has yet been authorised by a national regulator. Given there are not expected to be many CCPs, the question arises of recognition of non-EU CCPs, from the U.S. and Asia, that are interested in providing services within the EU. There is a procedure for this under EMIR but no decision has been taken by the Commission, a required first step.

Risk mitigation requirements

Risk mitigation techniques apply to OTC derivatives that are not subject to clearing requirements, because they are not sufficiently standardised or because the obligation will only be applied in stages. ESMA may require a particular class of OTC derivatives to be cleared, but it depends on the availability of CCPs willing to do so; they cannot be forced. In the meantime the risk mitigation requirements apply.

The risk mitigation techniques are often underestimated by market participants – they are not easy to deal with, implement and document. They fall into three categories, starting with operational measures that are already in force: timely confirmation of trades, daily mark-to-market valuations (for FCs and NFC+s), the establishment of dispute resolution processes, portfolio reconciliation procedures between the two parties, and portfolio compression, involving procedures for offsetting positions in cases where counterparties have at least 500 contracts with each other.

Collateral exchange measures may apply from December 2015, but this has not been confirmed. Procedures must also be put in place this year regarding monitoring of capital requirements for prudentially regulated counterparties.

Despite the continuing uncertainty in many areas, much of EMIR is already in force. Although regulators have exhibited widespread tolerance of compliance delays so far, there are signs that they are starting to lay down a harder line. As Freddy Brausch, Linklaters Luxembourg managing partner and co-head of the investment management sector concludes, asset managers and other market participants would do well to get in line with the rules before national sanctions regimes are in place.

“Asset managers and other market participants would do well to get in line with the rules before national sanctions regimes are in place.”

Freddy Brausch, managing partner and co-head of the investment management sector
Speakers’ details

Freddy Brausch  
Managing Partner, Luxembourg  
Tel: +352 2608 8231  
freddy.brausch@linklaters.com

Patrick Geortay  
Partner, Luxembourg  
Tel: +352 2608 8232  
patrick.geortay@linklaters.com

Emmanuel-Frédéric Henrion  
Partner, Luxembourg  
Tel: +352 2608 8279  
emmanuel-frederic.henrion@linklaters.com