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THE EUROPEAN MARKET INFRASTRUCTURE REGULATION AND TRANSPARENCY IN THE OTC DERIVATIVES MARKET

ABSTRACT

The European Market Infrastructure Regulation[1] ("EMIR") is the European Union's ("EU") attempt to tame the over-the-counter ("OTC") derivatives market and is perhaps the greatest imposition of financial regulation in the EU's history. EMIR forms part of a global effort to regulate the OTC derivatives market in the wake of the 2008 financial crisis. The purpose of EMIR is—in broad terms—to impose clearing, reporting and risk mitigation obligations in respect of OTC derivatives transactions on a broad range of market participants, with the intention of reducing systemic risk and increasing market transparency. EMIR will affect not only financial institutions that are accustomed to financial services regulation but will also have far reaching consequences for corporations and other trading entities doing OTC business in (or into) the EU.

This White Paper sets out the requirements of EMIR's clearing, reporting and risk mitigation obligations and how these will apply to the various market participants who are caught by EMIR. Those market participants who assess how EMIR applies to them and determine the most effective means of compliance will have the advantage of a seamless transition to the new regulatory landscape when EMIR enters fully into force. The White Paper is designed to help Jones Day's clients and friends gain a greater understanding of the OTC derivatives market and EMIR's obligations.

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I. INTRODUCTION

Derivative contracts are not a recent innovation of the financial markets and were reportedly taking place "[a]s early as 1700 B.C.".[2] Derivatives became increasingly controversial in the last years of the 20th century, up until the recent financial crisis.

The role played by OTC derivatives in the financial crisis was examined by market supervisors, economists and others. Ultimately the G20 issued a call for action,[3] which mandated the clearing and reporting of OTC derivatives contracts. As a result of the G20's statement, OTC derivative contracts must be cleared and reported. Both EMIR and Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[4] ("Dodd-Frank") are intended to meet these clearing and reporting requirements for OTC derivatives. Recital 5 of EMIR specifically references the Pittsburgh Summit: "At the 26 September 2009 summit in Pittsburgh, G20 leaders agreed that all standardised OTC derivative contracts should be cleared through a central counterparty".

EMIR entered into force on 16 August 2012,[5] although much of the necessary detail of EMIR was left to the European Securities and Markets Authority ("ESMA"). ESMA drafted implementing and regulatory technical standards for the European Commission (the "Commission") to adopt.[6] ESMA published its Final Report and the majority of its draft technical standards on 27 September 2012.[7] These draft standards were published in the Official Journal of the European Union in December 2012 and February 2013 and are the subordinate legislation which underpins EMIR.[8]

Still waiting to be published is the draft technical standard which will set out the extra-territorial scope of EMIR, in particular which OTC derivatives contracts will be considered to have a "direct, substantial and foreseeable effect within the Union"[9] and the draft technical standards setting out which classes of OTC derivatives contracts will be subject to the clearing obligation, and the date or dates on which the clearing obligation will take effect. Given that these standards will set out the extraterritorial scope of EMIR and list the classes of OTC derivatives for which centralised clearing will be mandated, these are amongst the most significant details of EMIR. ESMA has published a consultation paper in respect of the extraterritorial rules[10] (the "Consultation Paper") and a discussion paper setting out initial proposals on the derivatives classes to be cleared[11] (the "Discussion Paper"), both of which are considered during the course of this White Paper.

EMIR is likely to prove to be the most significant legislation to be driven by the G20's Pittsburgh summit. This is because EMIR will be directly applicable as a matter of English and EU law[12] and the City of London is the world's primary centre for OTC derivatives trading: "some 42 percent of the turnover in all over-the-counter (OTC) derivatives took place in the UK, with only a quarter in the US".[13] EMIR is also noteworthy because of the range of firms it will apply to: "all participants in derivatives markets, from the largest bank to the smallest investment fund".[14]

In order to consider EMIR's clearing, reporting and risk mitigation obligations, this White Paper is structured as follows:

- Section II—The global regulation of OTC derivatives;
- Section III—An overview of the OTC derivatives market;
- Section IV—The purpose of clearing;
- Section V—The entities to which EMIR applies;
- Section VI—EMIR's territorial application;
- Section VII—EMIR's clearing obligation;
- Section VIII—EMIR's risk mitigation obligations;
- Section IX—EMIR's reporting obligation;
- Section X—The penalties for breaching EMIR's obligations; and
- Section XI—The conclusion.

Additionally, in the Annex to this White Paper is a timetable setting out when the obligations under EMIR will enter into force. Sections II to IV are intended to provide background information on the OTC derivatives market and the financial crisis, and Sections V to X particularise EMIR's regulatory regime and the obligations imposed on market participants. During the course of this White Paper, we will also briefly consider if the clearing obligation will add the extra security it is intended to by alleviating counterparty and systemic risk or if it will instead create unforeseen operational and economic consequences.

II. THE GLOBAL REGULATION OF OTC DERIVATIVES

EMIR is the Europe-wide legislative response to the G20's deliberations at the Pittsburgh summit. Whether the transnational regulation of OTC derivatives is an achievable goal is a question worthy of consideration.

For the most part, the U.K. and U.S., as the leading OTC derivatives markets, had sought to avoid the regulation of derivatives. In both jurisdictions the courts have held that derivatives are not subject to regulation under relevant gambling laws.[15] Indeed, the U.K. and U.S. have both sought to de-regulate the derivatives markets through the passage of the Financial Services Act 1986 in the U.K. and the Commodity Futures Modernization Act of 2000 in the U.S.[16]

Many have argued that OTC derivatives were a major contributor to the events that led up to the financial crisis.[17] However, the role played by derivatives in causing the financial crisis is by no means clear. Perhaps somewhat controversially, Henderson has written that the introduction of global derivatives regulation is:

> *In the US,... part of a broader effort to micromanage the US economy. In Europe, it is a means of reasserting the role of the state, so beloved of Eurocrats, in the financial markets with the added attraction of hobbling competition from London and New York. In neither is there any nexus established between derivatives and the crisis other than incessantly reiterated conclusory statements that, with their repetition, become the Orwellian substitute for truth.*[18]

Whether or not one agrees with Henderson, transnational regulation is inherently divisive. The legal systems of all jurisdictions are guided by the mix of culture, politics, ideology and history which determines a jurisdiction's legal norms.

These historical roots ought not to pose a significant problem in relation to financial services regulation in the EU; after all, financial services regulation is a comparatively recent phenomenon and therefore does not have the embedded foundations in a jurisdiction that, say, property law or contract law have. Also, the EU has a history of regulating financial institutions and investment activities—in addition to EMIR, other notable acronyms in this area include MiFID,[19] CRR[20] and AIFMD.[21]

Rightly or wrongly the financial crisis has been the accident turned opportunity that has been seized upon to regulate the vast OTC derivatives market.

III. OVERVIEW OF THE OTC DERIVATIVES MARKET

A. DEFINING A DERIVATIVE FOR THE PURPOSES OF EMIR

EMIR defines "derivatives" by reference to MiFID. For the purposes of MiFID (and, therefore, EMIR), the term "derivative" includes the following types of contracts (amongst others): "[o]ptions, futures, swaps, forward rate agreements";[22] credit default swaps;[23] and contracts for differences.[24] However, these contract types do not apply universally to all underliers. EMIR distinguishes between a number of underliers, including commodities "that must be settled in cash or may be settled in cash"[25] and commodities "that can be physically settled".[26] Other underliers include securities,[27] currencies,[28] climatic variables[29] and, more expansively, contracts "which have the characteristics of other derivative financial instruments".[30] Generally, the MiFID definition of "derivatives" includes all derivatives except spot transactions and FX forwards made for commercial purposes.

This is a potentially complex approach, which can be contrasted with that taken in Dodd-Frank. In accordance with Dodd-Frank, derivatives fall into two categories, "swaps" and "security-based swaps". "Swaps" are derivatives products referencing instruments (other than single securities, single loans or narrow-based security indices) such as interest rates, exchange rates, commodities or currencies, subject to applicable exclusions.[31] A "security-based swap" is any "agreement, contract, or transaction"[32] that would be a swap for the purposes of the Commodity Exchange Act of 1936 and has as its underlying: "a narrow-based security index";[33] "a single security or loan";[34] or "the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer".[35] It remains to be seen how the different definitions of "derivatives" provided by EMIR and Dodd-Frank will interact over time.

EMIR's definition of "OTC" also raises some potential issues. For the purposes of EMIR, a derivatives contract will be treated as being OTC when the execution of the contract does not take place on a regulated market (as defined in MiFID[36]) or a third country equivalent of a regulated market.[37] For a third country market to be considered the equivalent of a regulated market, the Commission must publish the name of the market on "a list of those markets to be considered as equivalent".[38] The Commission has never produced such a list and without the list all derivatives contracts executed outside of the EU are to be considered OTC for the purposes of EMIR.[39] Being exchange traded, it is almost certain that such derivatives will be subject to mandatory clearing but the question remains whether the clearing requirements of an exchange will be treated as "equivalent" to those of EMIR, in circumstances where these derivatives contracts are considered to have "substantial and foreseeable effect within the Union". The extraterritorial application of EMIR is set out in detail below in Section VI. This curious situation, whereby EMIR will treat exchange-traded derivatives as OTC contracts because of inaction on the part of the Commission, has the potential (albeit slim) to lead to potentially bizarre regulatory responses.

B. OTC TRADING OF DERIVATIVES

Derivatives trading can either take place on an exchange[40] or can be bilaterally negotiated between counterparties on the OTC market. OTC trading allows the counterparties greater flexibility as they can negotiate the terms of the derivative contract between each other, meaning that the counterparties can tailor the contract to suit their specific requirements. OTC trading also, historically, afforded the counterparties privacy as reporting requirements were largely limited to exchange-based trading.

OTC trading has proved a vastly more popular option than exchange-based trading. The House of Lords European Union Committee noted that, "[i]n 2007 the market value of OTC derivative contracts was eight times greater than the equivalent value of the exchange traded derivatives".[41] In June 2000, the total estimated notional amount of outstanding OTC derivatives contracts stood at US$94 trillion.[42] By June 2008, that figure had risen to US$683.7 trillion[43] (prior to the collapse of Lehman Brothers in September 2008) and, as of December 2012, the notional amount of outstanding OTC derivatives contracts was US$632.6 trillion.[44] Awrey notes that "[o]n the eve of the crisis, the outstanding notional value of all OTC derivatives [was] several times the global (M3) money supply".[45]

The collapse of Lehman Brothers puts the scale of the OTC derivatives market into perspective. At the time of its collapse, Lehman Brothers was counterparty to "over 900,000 derivatives contracts"[46] with an estimated notional value of US$35 trillion.[47] In contrast, the notional value of all exchange-traded derivatives in September 2008 was US$24.8 trillion.[48] So, Lehman Brothers, as one investment banking group, was counterparty to derivatives contracts with a notional value which exceeded the entire exchange-traded derivatives market by over US$10 trillion. While it is easy to be overwhelmed by these vast notional amounts and, since the financial crisis, the focus has been on these notional amounts (presumably to emphasise the dangers of the OTC derivatives market), OTC derivatives transactions involve "much smaller actual cash flows and credit risk".[49]

The extraordinary growth in the OTC derivatives market has been explained as being a result of their flexibility and potential profitability as well as the lack of regulatory oversight of the market.[50] These benefits also account for the perceived weaknesses of the OTC derivatives market, namely: "[o]ver-the-counter derivatives markets are said to be complex, opaque, and prone to abuse by market participants who take irresponsibly large amounts of risks".[51]

It is the ability to trade on bespoke terms that makes OTC derivatives "an important part of global financial markets" as they provide more appropriate "tools for risk mitigation" than exchange-traded derivatives.[52] The advantages that OTC derivatives can offer to individual counterparties is arguably outweighed by the problems that OTC derivatives can potentially create for the financial system as a whole. The lack of reporting requirements leads to a lack of transparency, which has the potential for market participants and/or regulators to act without being aware of the complete picture.

It is worthwhile looking at the way the U.K.'s Financial Conduct Authority ("FCA")[53] regulates OTC derivatives (given that the City of London is the major venue for OTC derivatives trading). The approach adopted in the U.K. has not been to regulate the OTC derivatives contracts themselves but instead to regulate the firms conducting derivatives transactions. Such firms, subject to certain exclusions, are regulated in accordance with the provisions of the Financial Services and Markets Act 2000 ("FSMA"). No person may conduct certain activities (known as "regulated activities") unless authorised by the FCA, in accordance with section 19 of FSMA. This regulatory regime will continue to be enforced concurrently with EMIR.

Granularity is added to section 19 by the Regulated Activities Order.[54] The Regulated Activities Order states that if a person carries out a "specified activity" in relation to a "specified investment" then this constitutes a "regulated activity",[55] subject to the relevant exclusions.[56]

Various specified activities apply to the trading of OTC derivatives, the prime examples of which are: dealing in investments as principal[57] or agent;[58] arranging (bringing about deals) in investments;[59] arrangements made with a view to transactions in investments;[60] and advising on investments.[61] These activities cover the trading of derivatives and the preliminary steps leading up to such trading.

In relation to the activity of dealing in investments as principal or agent, a risk management exclusion applies.[62] The exclusion relates to the specified investment provisions which apply to derivatives[63] and provides that a derivatives transaction will not fall within the scope of the Regulated Activities Order if the main purpose of the transaction is to hedge against an "identifiable risk" which is not related to carrying on a regulated activity.[64] This exclusion means that derivatives transactions which are used by non-financial firms to hedge against the inherent risks of their business (e.g., the oil firm which uses derivatives to hedge against fluctuations in oil prices) are excluded from the scope of the Regulated Activities Order.

The Regulated Activities Order applies to options,[65] futures[66] and the broader category of "contracts for differences".[67] "Contracts for differences" are defined by the FCA as being: "[a contract] the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in: (i) the value or price of property of any description; or (ii) an index or other factor designated for that purpose in the contract".[68]

As such, most speculative derivatives trading activity is covered by section 19 of FSMA, at least to the extent that the persons conducting the associated activities are regulated by the FCA. Further, the FCA requires that OTC derivatives transactions are reported where the value of the derivative derives from an equity or debt-based underlying instrument which is admitted to trading on an exchange.[69] Accordingly, the firms participating in the OTC derivatives market in London are regulated in the performance of their activities and, therefore, the OTC derivatives market is subject to a form of indirect regulation.

C. CRITICISM OF THE OTC DERIVATIVES MARKET

The House of Lords European Union Committee wrote that the OTC derivatives market was complex and lacked transparency, "which reduced the ability of supervisors to identify risk".[70] A lack of transparency creates numerous risks, particularly "that market participants and regulators ... underestimate[d] counterparty risk in a market dominated by a small number of large international banks and dealers".[71] Unidentified risk was coupled with an alleged lack of regulation which "reinforced the potential for excessive risk-taking, as regulators did not have a clear view into how OTC derivatives were being traded".[72] The result being, when the financial crisis did occur, regulatory responses were "significantly complicated"[73] as the regulators were unaware of the various counterparties' exposure to losses. It has been suggested that the OTC derivatives market allowed counterparties to "externalize some portion of the risk they had absorbed by holding inadequate 'reserves' against their potential ongoing obligations".[74]

Arguably of most concern at, and since, the time of the financial crisis has been the interlinkages between the major counterparties participating in the OTC derivatives market. As the major counterparties are international financial institutions, there is therefore the risk that should one counterparty default on its obligations in the OTC derivatives market, then this will have a domino effect:

Systemic risk describes the risk to the financial system posed by the default of a major player in the derivatives market. Interlinkages in the market created by the large number of derivatives contracts means that the default of one party can have far-reaching implications for the creditworthiness of its counterparties.[75]

The clearing requirement of EMIR is intended to alleviate the risks of the domino effect by centralising risk within Central Counterparties ("CCPs") who are considered better able to cope with a default scenario, given how comparatively well capitalised CCPs are.

IV. THE PURPOSE OF CLEARING

As the central obligation of EMIR is clearing, it is worth separately considering the purposes underpinning clearing. EMIR defines "clearing" as: "[T]he process of establishing positions, including the calculation of net obligations, and ensuring that financial instruments, cash, or both, are available to secure the exposures arising from those positions".[76] Benjamin provides a fuller explanation of the purpose and process of clearing:

[C]learing is a process that takes place after trading and before settlement. Its purpose is to manage the credit exposures that arise during this interval between the parties to a trade. The core function of clearing is the novation of market contracts, whereby a clearing house [CCP] is interposed between the original trade counterparties. Trades are novated so that the original contract between the buyer and the seller is replaced by two new contracts, one between seller and the clearing house as buyer, one between the buyer and the clearing house as seller. The clearing house is contractually required to perform on one contract even if its counterparty defaults on the other. Thus the original parties to the trade continue to bear credit risk, but the quality of the credit risk improved from that of original counterparty to that of the clearing house. Because clearing houses have significant financial resources, novation upgrades the quality of the credit exposures of participants.[77]

Clearing therefore protects each counterparty from the risk of default by the other, as the process of novation and creation of two separate contracts quarantines any risks arising from the potential default of the counterparties.[78]

Clearing allows CCPs to net gains and losses against each other, which reduces the overall costs to both the market and all counterparties who clear trades through the CCP.[79] By protecting individual counterparties against the default of another and spreading the cost of losses, clearing protects the market from systemic risk. However, this adds to the cost of every individual transaction as counterparties must pay a fee to the CCP and contribute to the CCP's capital reserves. In addition, the CCP will require highly liquid or near cash collateral.

Historically, each CCP has had a moderately different process for reacting to a counterparty default but EMIR imposes a standardised "default waterfall" to ensure greater uniformity.[80] In accordance with EMIR's default waterfall, each CCP must have recourse to the margins posted by the defaulting clearing member. When such margins are exhausted, the CCP turns to the "default fund contribution of the defaulting member"[81]; the CCP then shall use its own resources, and the CCP may use the default fund contributions of the non-defaulting clearing members.

In addition to the funds held by the CCP to protect against counterparty failure, the CCP is also likely to be the beneficiary of an insurance policy with respect to losses caused by counterparty failure.

Clearing replaces individual counterparty risk with a centralized risk, on the basis that the CCP is better placed to cope with that risk although risk still remains, in that the CCP may fail.[82] It should be noted that CCP failure is not unheard of:

Three [CCPs] have failed in recent decades. In 1974, the Caisse de Liquidation failed in Paris, due to default on margin calls when sugar-futures prices fell sharply. In 1983, it was the turn of the Kuala Lumpur Commodities Clearing House, when half a dozen large brokers defaulted following a crash in palm-oil futures. And, most dramatically, the Hong Kong Futures Exchange clearing house failed in the wake of the global stock market crash in 1987.[83]

The Hong Kong Futures Guarantee Corporation almost failed twice within the space of a few days. In October 1987, massive defaults by futures brokers caused the government of Hong Kong, "in conjunction with major brokers and banks", to put together a HK$2 billion[84] rescue package to prop up the Hong Kong Futures Guarantee Corporation.[85] However, when the markets reopened on 26 October 1987: "the market plunged a massive 33% and a further [HK]$2billion rescue package had to be put together overnight by the Government, the Hongkong and Shanghai Bank, Standard Chartered Bank and the Bank of China".[86] In the event, this second tranche of HK$2 billion proved not to be necessary.[87] Paul Tucker, previously deputy governor of the Bank of England responsible for financial stability, notes that had this occurred in "London, Chicago or New York, it would have entered the folklore of policy memory".[88]

Tucker states that CCPs can, potentially, "do a lot of good by simplifying the network of counterparty exposures and imposing standard valuations and margin requirements".[89] Nevertheless, Tucker voices a concern over CCP failure: "[t]here is a big gap in the regimes for CCPs—what happens if they go bust? I can tell you the simple answer: mayhem. As bad as, conceivably worse than, the failure of large and complex banks".[90]

For the most part clearing of derivatives transactions has traditionally been limited to exchange-traded derivatives.[91] However, regulators clearly prefer the potential benefits of clearing (in spite of the centralized risk) and want clearing to cover the OTC derivatives market. As recital 13 of EMIR states: "[m]andatory CCP clearing requirements for those OTC derivative contracts that can be cleared centrally are therefore necessary".

V. THE ENTITIES TO WHICH EMIR APPLIES

EMIR, in common with most EU legislation, applies to "undertakings". The term "undertaking" "encompasses every entity engaged in an economic activity, regardless of the legal status of the entity or the way in which it is financed".[92] Specifically, EMIR applies to CCPs, trade repositories, financial counterparties and non-financial counterparties.[93] This White Paper is primarily concerned with those obligations imposed on financial counterparties and non-financial counterparties.

Financial counterparties are defined by EMIR as including: investment undertakings; banks; insurance, assurance and reinsurance undertakings; undertakings which operate collective investment schemes and their managers; institutions for the provision of occupational retirement benefits; and alternative investment funds managed by alternative investment fund managers, which are authorised by the relevant EU directive.[94] For the purposes of EMIR, a non-financial counterparty is any undertaking that is not a CCP or a financial counterparty which has been established or incorporated in the European Union.[95] As a matter of EU law, the term "undertaking" can include individuals[96] but ESMA has indicated that individuals will fall outside the definitions of financial and non-financial counterparties[97] and, therefore, EMIR does not impose obligations upon individuals.

EMIR divides non-financial counterparties into two categories. The first category are those non-financial counterparties whose OTC derivatives trading activity is at such a level that it exceeds one of the following thresholds:

a) EUR 1 billion in gross notional value for OTC credit derivative contracts;
b) EUR 1 billion in gross notional value for OTC equity derivative contracts;
c) EUR 3 billion in gross notional value for OTC interest rate derivative contracts;
d) EUR 3 billion in gross notional value for OTC foreign exchange derivative contracts;
e) EUR 3 billion in gross notional value for OTC commodity derivative contracts and other OTC derivative contracts not defined under points (a) to (d).[98]

When calculating the above clearing thresholds, those OTC derivatives contracts which are entered into by the non-financial counterparty (or by other non-financial entities within the counterparty's corporate group) and are "objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group"[99] do not count towards calculating the threshold amount. In accordance with article 10 of Delegated Regulation 149/2013, an OTC derivatives contract will be objectively measurable as reducing the relevant risks if the OTC derivatives contract meets one of the following criteria: (i) it covers the risks arising from the potential change in the value (or indirect value) of various assets, commodities or services; or (ii) is a hedging contract pursuant to the International Financial Reporting Standards.[100]

Where a non-financial counterparty exceeds one of the clearing thresholds (such non-financial counterparties are referred to as "NFCs+"), it becomes subject to the clearing obligation in respect of all of its future OTC derivatives transactions and the more stringent risk mitigation obligations. Where the determination is made that an entity exceeds a clearing threshold, a notification must be made to the relevant national regulator (in the U.K., this is the FCA) to make them aware of this classification. Non-financial counterparties who do not exceed one of the above thresholds are subject to the least regulation under EMIR and are known as "NFCs-". Nevertheless, it is important to note that, with the exception of individuals and the exempt entities set out below, all OTC derivatives market participants are subject to EMIR's obligations to some extent. This includes those market participants that are not ordinarily subject to financial regulation, such as corporates, trading and commodities entities which use OTC derivatives only for hedging purposes, real estate investment firms, etc. Market participants therefore need to be aware of the extent to which EMIR applies to them and the most effective method through which they can comply with EMIR.

EMIR's definitions of "financial counterparties" and "non-financial counterparties" apply only to financial counterparties authorised under EU legislation or non-financial counterparties established in the EU. These definitions include the non-EU branches of an EU financial counterparty or EU non-financial counterparty but the definitions exclude non-EU entities (including the EU branches of non-EU banks). In order to take jurisdiction over such entities, EMIR applies extraterritoriality rules (discussed in Section VI below) and, in respect of the clearing obligation, article 4 of EMIR states that if a financial counterparty or NFC+ enters into a transaction with a non-EU entity that would be deemed to be a financial counterparty or NFC+ if it were authorised/established in the EU, then the clearing obligation applies. The reporting obligation does not distinguish between financial counterparties and non-financial counterparties; it simply refers to the broader class of "counterparties".[101] On this basis, the reporting obligation will also apply where a non-EU entity enters into an OTC derivatives transaction with a financial counterparty or non-financial counterparty.

The following entities' OTC derivatives trading activity is only subject to the reporting obligation: multilateral development banks (including the International Finance Corporation, the Inter-American Development Bank and the Asian Development Bank); public sector entities that are owned by a central government "and have explicit guarantee arrangements" provided by that central government (the predominant class of entities in this category is likely to be local and regional governments); the European Financial Stability Facility; and the European Stability Mechanism.[102]

Finally, some entities fall entirely outside the scope of EMIR. These are the European Central Bank, the national central banks of the member states (including the Bank of England) which make up the European System of Central Banks, other government or EU bodies "charged with intervening in the management of the public debt" and the Bank for International Settlements.[103] The U.S. Federal Reserve, the Bank of Japan and the debt management offices of those two countries have also been recognised as falling outside the scope of EMIR since July 2013. It is also anticipated that, in accordance with article 1(6) of EMIR, the Hong Kong Monetary Authority and the central banks of Switzerland, Australia and Canada will be exempted entirely from the scope of EMIR.

EMIR is drafted to apply to the broadest possible categories of market participants; therefore, firms that conduct OTC derivatives activity and are either based in the EU or are counterparty to an EU based entity are almost certainly caught by EMIR (to a greater or lesser extent). Firms need to consider the extent to which EMIR applies to them in order to work out the best means of compliance. The first step in this process is for market participants to determine if they are a financial counterparty, NFC+ or NFC-. Those market participants that are NFCs+ should notify the FCA as to their status.

VI. EMIR'S TERRITORIAL APPLICATION

EMIR (in common with Dodd-Frank[104]) has extraterritorial effect.[105] As explained above, EMIR is drafted to enable it to have jurisdiction over a transaction where one party is based within the EU and the other outside the EU. In addition, the clearing and risk mitigation obligations of EMIR will apply to two third-country entities, which would be subject to the clearing or risk mitigation obligations if authorised/established in the EU, where "the contract has a direct, substantial and foreseeable effect within the Union or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of this Regulation".[106]

This extraterritorial scope of EMIR raises two issues: (a) if EMIR applies to non-EU entities, there is the risk of overlap and conflict with other OTC derivatives regulatory regimes; and (b) which OTC derivatives contracts are considered to have a "direct, substantial and foreseeable effect within the Union".

A. EMIR'S CONFLICT WITH OTHER OTC REGULATORY REGIMES AND EQUIVALENCE

It is not yet entirely clear how the extraterritorial application of EMIR, Dodd-Frank and other OTC derivatives regulatory regimes will work in practice, and complications are likely to arise where one counterparty is based in the U.S. and the other in the EU. However, the clash of extraterritoriality provisions is perhaps of more concern when both counterparties are neither in the EU nor in the U.S. but the transaction has an "effect" in both the EU and U.S. In such situations, it is possible that the counterparties may well be faced with the awkward situation of attempting to comply with two potentially conflicting regulatory regimes.

Steps are being taken on both sides of the Atlantic to alleviate these issues surrounding conflicting regimes. In the U.S., the Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission (the "CFTC") are in the process of setting out rules for "substituted compliance", meaning that counterparties subject to Dodd-Frank would not, in certain circumstances, have to comply with Dodd-Frank in full if they can show alternative compliance with an equivalent regulatory regime.

In addition, the European Commission and CFTC have been collaborating in order to provide some guidance on the extra-territorial scope and overlap of EMIR and Dodd-Frank. Both organisations recognise that:

> *As the market subject to these regulations is international, it is acknowledged that, notwithstanding the high degree of similarity that already exists between the respective requirements, without coordination, subjecting the global market to the simultaneous application of each other's requirements could lead to conflicts of law, inconsistencies, and legal uncertainty.*[107]

As the above statement makes clear, the European Commission and CFTC acknowledge the similarities between EMIR and Dodd-Frank and the potential difficulties created by the enforcement of the two regimes. Additionally, the CFTC has published a No-Action Letter stating that where an OTC derivatives contract is subject to both Dodd-Frank's and EMIR's risk mitigation obligations, EMIR can be complied with instead of the CFTC's risk mitigation rules.[108]

As a general principle, the Commission and CFTC have also agreed on a "'stricter-rule-applies' approach to cross-border transactions where exemptions from mandatory clearing would exist in one jurisdiction but not in the other".[109] While it is to be lauded that regulators are seeking to introduce a degree of certainty in order to guide market participants, their approach of choosing to adopt the harshest possible standard is perhaps questionable. Those market participants who have already begun the compliance process may now find themselves having to cope with a stricter regulatory regime than that which was anticipated. Additionally, a "stricter-rule-applies" approach could encourage regulators on either side of the Atlantic to adopt a heavy-handed regime that the other regulator would be compelled to follow.

In the EU, article 13 of EMIR provides for a similar mechanism to substituted compliance. Article 13 of EMIR sets out a mechanism whereby the Commission can recognise third country regulation as being equivalent to the obligations imposed by EMIR. This is done by means of the Commission adopting an "implementing act"[110] recognising that a third country's regulation is equivalent to EMIR. Where the Commission has adopted such an "implementing act", this will "imply" that counterparties who are subject to the equivalent regime (who would otherwise be caught by EMIR) have fulfilled their obligations under EMIR.[111] Prior to adopting any implementing acts the Commission requested technical advice from ESMA on the OTC derivatives regulatory regimes of third countries. ESMA has now provided such technical advice in respect of the OTC derivatives regulatory regimes of the U.S., Japan, Australia, Hong Kong, Singapore and Switzerland.[112] Additionally, earlier in October, ESMA published its equivalence assessments of the regulatory regimes of Canada, India and South Korea.

The technical advice final reports produced by ESMA are granular in detail and have the aim of assessing the "capability of the regime in the third country to meet the objectives of [EMIR] … from a holistic perspective".[113] Generally, the reports are broadly divided into sections dealing with the regulation of CCPs, the regulation of trade repositories and advice on potentially duplicative or conflicting requirements between EMIR and the third country regime. It should be noted that these final reports of ESMA are only intended to be advisory and are not binding upon the Commission's determination of equivalence.

In respect of Dodd-Frank, the key finding of the technical report is that the reporting obligation imposed by Dodd-Frank is not considered equivalent to that of EMIR. This is because article 9 of EMIR (the reporting obligation) requires considerably more information than is required under Dodd-Frank:

> *Where one regime (EU) requires certain information to be reported and a second regime (US) does not, the reporting obligation under EMIR cannot be substituted with the reporting obligation under the US regime. Therefore, under Article 13(2) of EMIR, the US legal, supervisory and enforcement arrangements should not be considered equivalent to the requirements laid down in Article 9 of EMIR.*[114]

Amongst the additional data that EMIR requires to be reported is: more extensive counterparty information, trading activity information, and additional collateral data. Other than the reporting requirement, ESMA confirms that, broadly, Dodd-Frank's clearing and risk mitigation obligations are equivalent to that of EMIR. However, there are some differences; for instance, Dodd-Frank does not require the clearing of OTC derivatives transactions made for hedging purposes whereas EMIR does require the clearing of hedging transactions between financial counterparties and NFCs+ (under the "stricter-rule-applies" approach, it is possible that such hedging transactions, if caught by both EMIR and Dodd-Frank, will need to be cleared). Further, the dispute resolution obligations of Dodd-Frank are not considered equivalent. This is because Dodd-Frank is primarily focused on the regulation of entities known as "swap dealers" and "major swap participants" (in essence both entity types are financial institution counterparties that are regularly involved in OTC derivatives transactions) and Dodd-Frank's dispute resolution obligations are aimed at these entities. Given that EMIR sets out to regulate almost all market participants, there is no real EMIR equivalent to "swap dealers" and "major swap participants" and EMIR's dispute resolution obligations apply (to a varying extent) to financial counterparties, NFCs+ and NFCs-.

These gaps between EMIR and Dodd-Frank are likely to pose problems for market participants and, given that most OTC derivatives trading takes place in the U.K. and the U.S., these gaps are likely to be a particular problem for financial counterparties and the non-EU equivalents thereof. Should the Commission declare that Dodd-Frank is not entirely equivalent to EMIR, this may raise unexpected compliance issues. All market participants will need to be aware of the precise interaction between EMIR and Dodd-Frank when the Commission publishes its equivalency assessment.

For the remaining technical advice final reports, there is little sign that ESMA is prepared to consider a regime equivalent. For the most part the other final reports focus on the regulation and supervision of CCPs and whether such regulation and enforcement is equivalent to that required by EMIR. What this means to market participants is that, essentially, the only regime that is likely to be deemed equivalent to EMIR (or close to equivalent) in the near future will be Dodd-Frank. However, if the Commission recognises CCPs as equivalent, this will offer market participants, who are subject to EMIR's clearing obligation, a greater choice of CCP providers rather than simply those based in the EU.

B. THOSE OTC DERIVATIVES CONTRACTS HAVING A DIRECT, SUBSTANTIAL AND FORESEEABLE EFFECT WITHIN THE EU

ESMA is expected to produce a draft technical standard on the extraterritorial scope of EMIR by 15 November 2013 (this was originally intended to be published on 25 September 2013 but ESMA delayed publication in order to consider responses to its Consultation Paper).[115] In preparation for the publication of this draft technical standard, ESMA has produced a Consultation Paper which has a preliminary draft of the technical standards (the "Extraterritorial DTS") appended to it. Based on previous experience, Jones Day anticipates that the technical standards which are enacted will be very similar, if not identical, to the Extraterritorial DTS. EMIR's extraterritoriality provisions, including the determination of which contracts have a direct, substantial and foreseeable effect, as set out in the Extraterritorial DTS, are explained in the following paragraphs.

Recital 2 of the Extraterritorial DTS states that where at least one counterparty to an OTC derivatives transaction is subject to a regime that is equivalent to EMIR, the counterparties can elect to disapply EMIR and adopt the third country regime. This is helpful in reducing the risk of conflict between EMIR and other regulatory regimes, but the usefulness of this recital is dependent on the Commission recognising other regimes as being "equivalent" and the "stricter-rule-applies" approach removes that freedom of choice when the options are EMIR or Dodd-Frank.

Subject to the ability of at least one counterparty to rely on an equivalent regime and the counterparties electing to do so, an OTC derivatives contract between an EU financial counterparty or an NFC+ and the non-EU equivalent of a financial counterparty or an NFC+ will fall within the scope of EMIR.[116]

Where the EU branches of two third country entities enter into an OTC derivatives contract, EMIR will, as a general rule, apply. Article 2(3) of the Extraterritorial DTS (in accordance with article 4(1)(a)(v) of EMIR) states that: "[a]n OTC derivative contract shall be considered to have a direct, substantial and foreseeable effect within the Union when … [t]he two counterparties enter into the OTC derivative contract via their branches in the Union". However, this general rule is modified by the application of recital 2 of the Extraterritorial DTS, which allows the counterparties to rely on an equivalent regime (as provided for by article 13 of EMIR). This is supported by paragraph 35 of the Consultation Paper, which reads: "all transactions concluded between EU branches of non-equivalent third country entities", indicating that EMIR will apply only to the EU branches of non-equivalent third country entities.

EMIR will not apply to OTC derivatives transactions between two or more third country entities (where there is no EU entity as a counterparty), unless the performance of one of the counterparties is guaranteed by an EU financial counterparty. Where an EU financial counterparty is providing a guarantee, the OTC derivatives contract may be deemed "to have a direct, substantial and foreseeable effect within the Union". In order to have such an effect, the guarantee must be of a type which meets the following conditions: the guarantee covers all the non-EU entity's liability and the notional amount of such liability is at least EUR 8 billion; or the guarantee covers only a percentage of the non-EU entity's liability and the notional amount of such liability is at least EUR 8 billion, divided by the percentage of liability covered; and the guarantee is equal to at least 5 per cent of the financial counterparty's "current exposures"[117] in OTC derivatives contracts.[118] Again, where permissible, the parties can instead elect to comply with an equivalent regime.

The Consultation Paper also makes clear the types of OTC derivatives transaction where EMIR will not apply. EMIR will not apply, simply because: one of the counterparties to an OTC derivatives transaction is a third country subsidiary of an EU incorporated entity (unless the EU financial counterparty guarantee provision applies); the cross-default provision of a derivatives master agreement provides for the acceleration of various specified entities (including EU entities) in the event of default by a third country counterparty; and the underlying currency of the OTC derivatives contract is expressed to be in the currency of an EU Member State (e.g., EUR, GBP, etc.).

As a related point, the Extraterritorial DTS sets out EMIR's "anti-evasion" provisions; these are intended to capture transactions which ought properly to be subject to EMIR but have been structured in such a way so as to avoid its application. In determining whether an arrangement or series of arrangements is artificial, the Commission will consider the following:

- The legal characterization of the individual steps of an arrangement is inconsistent with the legal substance of the arrangement as a whole;
- The arrangement or series of arrangements is carried out in a manner which would not ordinarily be employed in what is expected to be a reasonable business conduct;

- The arrangement or series of arrangements includes elements which have the effect of offsetting or cancelling the economic meaning of each other;
- Transactions concluded are circular in nature; and
- The arrangement or series of arrangements results in non-application of [EMIR] but this is not reflected in the business risks undertaken by the entities relating this activity.[119]

Accordingly, in circumstances where EMIR should ordinarily apply (and it is not proposed to rely on an equivalent regime) counterparties will need to be alert to the possibility that the structure of the OTC derivatives transaction has the potential to fall foul of article 3(3) of the Extraterritorial DTS. If this provision is enforced in too aggressive a fashion, it has the potential to stifle innovation in the financial markets. The potential over-enforcement of article 3(3) emphasises the importance of counterparties getting a legal opinion when using new structures for OTC derivatives contracts.

The Consultation Paper and appended Extraterritorial DTS set out a number of ways in which the OTC derivatives transactions of third country entities can be caught by EMIR. However, balanced against this is the ability to rely on equivalent regimes. Although problems are likely to arise (particularly and most importantly in relation to Dodd-Frank) there is now enough guidance to enable market participants to start taking a view as to how to achieve compliance with EMIR and the other regulatory regimes that mandate an OTC derivatives clearing obligation.

VII. EMIR'S CLEARING OBLIGATION

EMIR's clearing obligation is simple; it requires that all OTC derivatives that fall within the scope of the clearing obligation (essentially those OTC derivatives contracts that are standardised and liquid) are cleared through a CCP based in the EU and authorised by the competent authority of its home Member State; or a CCP based outside the EU which has been recognised by ESMA.[120] The clearing obligation is seen as the cornerstone of EMIR, which will protect the financial markets and prevent future financial crises:

> *The regulation [EMIR] also requires standard derivative contracts to be cleared through central counterparties (CCPs) and establishes stringent organisational, business conduct and prudential requirements for these CCPs. This will considerably increase financial stability and safety in the EU by preventing the situation where a collapse of one financial firm can cause the collapse of other financial firms. We are clearly learning the lessons of the 2008 crisis.*[121]

As the above quote indicates, the Commission's view is that clearing will protect the financial markets henceforth. In respect of the clearing obligation the following is considered: (a) the scope of the clearing obligation; (b) client clearing and indirect clearing; (c) client money; and (d) the risks of clearing.

A. THE SCOPE OF EMIR'S CLEARING OBLIGATION

1. Counterparties Within Scope. The clearing obligation applies to those counterparties who are classified as financial counterparties, NFCs+ or non-EU equivalents thereof which enter into transactions with financial counterparties or NFCs+. So the clearing obligation does not apply to NFCs- or those exempted entities set out at Section V. The table on the following page sets out the counterparty combinations which will lead to the application of the clearing obligation.

As noted in the previous Section, it is also possible for EMIR to apply to an OTC derivatives transaction even when no EU financial counterparty or NFC+ is a counterparty to the transaction. In such circumstances, EMIR's clearing obligation will apply in accordance with article 4(1)(a)(v) if "the contract has a direct, substantial and foreseeable effect within the Union or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of [EMIR]".

Entities operating pension scheme arrangements are currently exempt from the clearing obligation and this exemption is to continue until CCPs develop a solution which will allow the pension schemes to post non-cash collateral.[122] The CCPs have three years in order to develop a solution which will allow for the transfer of non-cash collateral as margin. The intention underlying this exemption is to prevent the clearing obligation having a "negative impact" on "the retirement income of future pensioners".[123] EMIR justifies this special treatment on the basis that pension schemes:

TABLE: WHEN EMIR'S CLEARING OBLIGATION APPLIES

		Counterparty 2				
Counterparty 1		FC (financial counterparty)	NFC+	NFC-	3rd C FC (non-EU financial counterparty)	3rd C NFC+ (non-EU NFC+)
	FC	✓ (EMIR applies)	✓	✗ (EMIR does not apply)	✓	✓
	NFC+	✓	✓	✗	✓	✓
	NFC-	✗	✗	✗	✗	✗
	3rd C FC	✓	✓	✗	✗	✗
	3rd C NFC+	✓	✓	✗	✗	✗

> *[T]ypically minimise their allocation to cash in order to maximise the efficiency and the return for their policy holders. Hence, requiring such entities to clear OTC derivative contracts centrally would lead to divesting a significant proportion of their assets for cash in order for them to meet the ongoing margin requirements of CCPs.*[124]

However, it is unclear why this exemption should be given to pension scheme arrangements but not institutions providing occupational retirement benefits.

Additionally, certain intragroup transactions are excluded from EMIR's clearing obligation on the basis that: "intragroup transactions may be necessary for aggregating risks within a group structure and that intragroup risks are therefore specific".[125] Article 3 of EMIR sets out those intra-group transactions that qualify for exemption from EMIR's clearing obligation. These exemptions do not automatically apply and counterparties that intend to make use of them will need to notify their competent authority (in the U.K. this is the FCA) prior to relying on the exemptions.[126]

With respect to NFCs+, the intra-group exemption applies where the counterparties are: both members of the same corporate group; included in the same consolidated accounts on a full basis; subject to appropriate centralised risk evaluation, measurement and control procedures; and established in the EU or, if established in a third country jurisdiction, the Commission has determined that the relevant legal and supervisory arrangements are equivalent in accordance with article 13.[127] For NFCs+, "group" has the meaning given in articles 1 and 2 of the Seventh Council Directive on consolidated accounts (83/349/EEC).[128]

Article 3(2) of EMIR provides for four different types of intragroup transaction which apply to financial counterparties and are exempt from the clearing obligation. The first type of exempt intragroup transaction is if: (i) the financial counterparty seeking to rely on the exemption is established in the EU or in a third country jurisdiction, in respect of which the Commission has adopted an article 13 implementing act; (ii) the financial counterparty's counterparty is: a financial counterparty, a financial holding company,[129] financial institution[130] or an ancillary services undertaking,[131] "subject to appropriate prudential requirements"[132]; (iii) both counterparties are included in the same consolidated accounts on a full basis; and (iv) "both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures".[133] The second type of exempt intragroup transaction is where both counterparties are part of the same "institutional pension scheme" as defined in article 80(8) of the Banking Consolidation Directive (2006/48/EC) and the counterparties are financial counterparties, financial holding companies, financial institutions or ancillary services undertakings, "subject to appropriate prudential requirements".[134] Thirdly, where a financial counterparty (which is a credit institution) enters into an OTC derivatives contract with another credit institution affiliated to the same central body (essentially a bank holding company) or the financial counterparty enters into an OTC derivatives contract with the central body (as referred to in article 3(1) of the Banking

Consolidation Directive) this will be an exempt intragroup transaction.[135] Finally, article 3(2)(d) provides that where a financial counterparty enters into an OTC derivatives transaction with an NFC+ within the same group, the criteria set out in article 3(1) can be relied upon to exempt the transaction from the clearing obligation.

2. Derivatives Within Scope. EMIR takes two approaches to determining which class of OTC derivatives are eligible for clearing. Under the first approach, the competent regulatory authority of an EU member state,[136] e.g., the FCA, can authorise a CCP to clear a class of derivatives or those CCPs that are already authorised by a competent authority to clear a certain class of derivatives are authorised for the purposes of EMIR.[137] This is known as the "bottom up" approach.[138] This approach has been criticised by the Financial Markets Law Committee in the U.K. as being likely to create uncertainty, as the acts of one competent authority will become binding throughout the EU.[139] However, in accordance with article 5(1) of EMIR, when a competent authority makes such a determination it must immediately inform ESMA. ESMA will then recommend to the Commission whether the derivatives that will be cleared by the new CCP, as authorised by the competent authority, should be subject to the clearing obligation. It will then fall to the Commission to determine whether or not adopt ESMA's recommendation. This process ought to ensure a degree of uniformity and certainty across the EU.

The second approach is a "top down" approach, whereby ESMA identifies a class of derivatives which should be subject to the clearing obligation but for which no CCP has yet received authorisation or recognition.[140] In considering what OTC derivatives should be made subject to the clearing obligation, ESMA must have regard to the following: (i) the "standardisation of … contractual terms and operational processes"; (ii) "the volume and liquidity of the relevant class of OTC derivatives"; and (iii) "the availability of fair, reliable and generally accepted pricing information" on the OTC derivatives.[141] In accordance with article 6 of EMIR, ESMA will be required to maintain a register identifying all the classes of OTC derivatives contracts that are subject to the clearing obligation.

Article 7 of Delegated Regulation 149/2013 provides further information on what ESMA will take into account when considering if a class of OTC derivatives should be subject to the clearing obligation. For instance, in considering if a class of OTC derivatives is subject to standard terms, ESMA will look at whether a standard form of documentation is used.[142] In respect of the volume and liquidity requirement, ESMA will look at the stability and depth of the market, the value of transactions and whether imposing a clearing obligation "would be proportionate to the risk that the clearing obligation intends to mitigate".[143] With regard to the third criteria relating to pricing information, ESMA will look to see if pricing information is "easily accessible to market participants on a reasonable commercial basis and whether it would continue to be easily accessible if the relevant class of OTC derivative contracts became subject to the clearing obligation".[144]

ESMA's Discussion Paper on the clearing obligation sets out its views on which classes of OTC derivatives contracts ought to be subject to the clearing obligation. EMIR defines a "class of derivatives" as being: "a subset of derivatives sharing common and essential characteristics including at least the relationship with the underlying asset, the type of underlying asset, and currency of notional amount. Derivatives belonging to the same class may have different maturities".[145] In order to further distinguish classes of derivatives, article 8(1)(k) of Delegated Regulation 149/2013 provides that the Public Register (which includes details on each class of OTC derivatives contract subject to the clearing obligation) should include "any other characteristic required to distinguish one contract in the relevant class of OTC derivative contracts from another".

So as to avoid producing too many different classes, "ESMA will aim at defining the classes in the [technical standards] with key characteristics reflecting the economic benefit of entering into an OTC derivative contract for its user, as opposed to specifications which impact the mechanics of calculations, however do not affect the underlying economic benefit of entering into transaction".[146] For interest rate derivatives, as an example, ESMA considers that the following variables may be of assistance in separating contracts into derivatives classes for the purposes of clearing: "the floating reference rate, the settlement currency, the currency type (i.e. whether the contracts are based on a single currency or on multiple currencies), the maturity, the existence of embedded optionality and the notional amount type (constant, variable or conditional)".[147] For foreign exchange derivatives, ESMA has identified the following broad classes: "non-deliverable forwards (NDF), FX forwards, non-deliverable options (NDO), vanilla options and exotic options would belong to different classes based on structural differences between those types of products".[148] ESMA notes that the only FX derivatives products that are currently cleared are: "non-deliverable forwards (NDF) on emerging market currencies, and Cash-Settled Forward".[149]

For the majority of derivative classes, market participants will have to wait until ESMA arrives at a conclusion as to what derivatives classes will be subject to the clearing obligation. However, the Discussion Paper does offer some further guidance on those derivatives that are likely to be subject to mandatory clearing. The Discussion Paper notes that the largest single class of OTC derivatives is interest rate derivatives, which account for 82.9 per cent of all OTC derivatives.[150] Of those OTC interest rate derivatives, 40 to 50 per cent (of notional outstanding amounts) are already cleared.[151] Interest rate derivatives are the only type of derivative of which a significant proportion are cleared. Therefore, as a first step in the process of implementing the EMIR clearing obligation, it should be relatively straightforward for certain classes of interest rate derivatives to become subject to the clearing obligation.

Given the lack of available data on clearing other types of OTC derivatives contracts, it will be more difficult for ESMA to determine which further classes of derivatives should be subject to EMIR's clearing obligation. ESMA identifies this problem:

> *When defining the classes to be subject to the clearing obligation ESMA shall take into consideration the volume and liquidity of the classes. The main challenge identified in relation to this criteria comes down to the existence of sufficiently granular data to make the assessment, and in particular the availability of data allowing for a comparison between cleared and non-cleared volumes. This is essential to measure the impact of a potential clearing obligation on a given class.*[152]

The obvious solution to this problem would be to delay the clearing obligation for perhaps two years from the date the reporting obligation comes into force. Data collected via the reporting obligation would then enable ESMA to develop a clear view of the market and, therefore, enable ESMA to measure the potential impact of the clearing obligation. While ESMA recognises this,[153] there is no suggestion that the clearing obligation will be delayed to permit a period of time to allow market data to be gathered.

On the basis of EMIR, the relevant subordinate legislation produced so far and the Discussion Paper, it seems apparent that those OTC derivatives which will become subject to clearing are those which could easily have been traded on an exchange—that is to say, those derivatives which are standardised and for which there is a large and liquid market. However, two potential issues can be identified with this approach. The first is that the competent authorities of EU member states may adopt divergent approaches which create confusion on the OTC derivatives market. The second would appear to be that ESMA's criteria may be rendered ineffective by counterparties seeking to avoid the clearing obligation. It seems at least arguable that if standardisation will be used as a basis for ESMA's decision as to whether or not to clear a class of derivatives, this may cause counterparties to "tweak" their OTC derivatives contracts so as to make the contracts non-standard. The clearing obligation may lead to increasingly complex documentation and counterparties seeking legal opinions to confirm that their derivatives contracts are non-standard. However, the competent authorities of the Member States may consider that such non-standard derivatives contracts fall foul of EMIR's anti-avoidance provisions and, as such, care should be exercised.

3. When the Clearing Obligation Will Come Into Force. Neither EMIR nor the subordinate legislation gives a set date for when the clearing obligation will come into force, although it is anticipated that the obligation will begin in July 2014 at the earliest. However, clearing can begin only when an EU-based CCP has been authorised or a third country CCP has been recognised in accordance with article 25 of EMIR. At the time of writing, no CCP has been authorised or recognised. EMIR states that the clearing obligation will apply to OTC derivatives contracts which are entered into after the clearing obligation "takes effect".[154] Additionally, the clearing obligation will apply to OTC derivatives contracts that were entered into before the clearing obligation takes effect but have an outstanding maturity period which exceeds that set by the Commission.[155] ESMA has yet to recommend maturity periods to the Commission. The Discussion Paper notes that if the maturity period is too short, this would place an unnecessary burden on the counterparties and not impact upon systemic risk, as "such risk could ... only materialise during a very limited period of time".[156] Whereas, if the maturity period is too long, this will capture only a small number of transactions.[157] In order to arrive at the correct maturity periods for the various classes of OTC derivatives contracts, ESMA has stated that it requires more detailed information "on the distribution of the maturity of the contracts belonging to a certain asset class".[158]

The Financial Markets Law Committee has been critical of the fact that the clearing obligation may apply to OTC derivatives contracts that were entered into before the obligation takes effect. This is because an OTC derivatives contract may become subject to the clearing obligation "contrary to the contractual expectation of the [counter]parties".[159] This criticism is valid; even now, counterparties do not know which class of derivatives will be subject to the clearing obligation and what maturity date the Commission will set. This creates an unnecessary state of uncertainty.

In its Discussion Paper, ESMA proposes that the entry into force of the clearing obligation is likely to vary depending on the class of OTC derivatives and the type of counterparty. Where more than one CCP has either been authorised or recognised to clear a certain class of derivatives, then ESMA anticipates that it will be easier and quicker to implement the clearing obligation. However, if only one CCP has been authorised or recognised to clear a class of derivatives, ESMA anticipates that operational and/or market issues may result in a longer lead-in period before the clearing obligations come into effect.[160]

In respect of counterparties, ESMA anticipates that non-financial counterparties should be given more time than financial counterparties to implement clearing solutions. Further, the Discussion Paper notes that "the scope of [financial counterparties] is very wide and the access to clearing may be heterogeneous within this category".[161] As such, ESMA is considering dividing financial counterparties into clearing members (who have direct access to a CCP) and the remaining financial counterparties.[162] Under this method, ESMA envisages that EMIR's clearing obligation would first be imposed upon clearing members, then the remaining financial counterparties and, finally, non-financial counterparties.

Although the clearing obligation will not start until July 2014 (at the earliest) market participants will need to think about compliance with the clearing obligation prior to this. For instance, how CCPs and clearing members will deal with client money and the terms of business on which they contract with their clients (and the clients with indirect clients) will be a significant documentation exercise for all parties. Additionally, the clearing obligation will necessitate the construction of systems and controls in order for market participants to comply with their obligations.

B. CLIENT CLEARING AND INDIRECT CLEARING

EMIR envisages indirect clearing as well as client clearing, the purpose of which is to maximise the number of counterparties to whom clearing is available. The financially strongest counterparties will deal directly with CCPs as clearing members, i.e., those counterparties who "have sufficient financial resources and operational capacity to meet the obligations arising from participation in a CCP".[163] Clearing members then provide clearing services to their clients who, in turn, provide clearing services (via indirect clearing) to the smallest counterparties.

The client of a clearing member is an "undertaking with a contractual relationship with a clearing member of a CCP which enables that undertaking to clear its transactions with that CCP".[164] There are two methods for accomplishing client clearing: the principal model and the agency model.[165]

Under the principal model the client enters into a trade with the clearing member and the clearing member enters into an identical trade with the CCP. This means that for one transaction to be executed and settled between two counterparties, each counterparty will contract with its respective clearing member and, in turn, the clearing members will enter into identical contracts with the CCP. In exchange for this service the counterparties (being clearing member clients) will pay margin to the clearing members to cover the trade; in turn, the clearing members will pay margin on to the CCP.

Under the agency model, the clearing member will enter into a contract with the CCP on the client's behalf and the client will owe obligations directly to the CCP (including the obligation to provide margin directly to the CCP). These obligations are guaranteed by the clearing member and the clearing member assumes responsibility for collecting the margin on behalf of the CCP. Traditionally, the principal model is used in the EU for derivatives trading and the agency mode is used in the U.S.[166]

"Indirect clearing arrangement" is defined in Delegated Regulation 149/2013 as being: "the set of contractual relationships between the central counterparty (CCP), the clearing member, the client of a clearing member and indirect client that allows the client of a clearing member to provide clearing services to an indirect client".[167] Indirect clearing is therefore intended to ensure that all counterparties which are active on the relevant market have access to CCPs as, in many cases, indirect clearing will be the only way for counterparties to have access to CCPs.

Article 4(3) of EMIR provides that indirect clearing arrangements must not "increase counterparty risk" and that clients and indirect clients benefit from protections which are equivalent to those provided by the CCP to its clearing members.[168] Delegated Regulation 149/2013 sets out the types of indirect clearing arrangements that meet the EMIR requirements.

Article 2(1) of Delegated Regulation 149/2013 sets out the requirements that a client of a clearing member must meet in order to provide indirect clearing services. The client of the clearing member must be authorised as a "credit institution, investment firm or an equivalent third country credit institution or investment firm".[169] The indirect clearing contract is formed between the client of the clearing member and the indirect client, but only "after consultation with the clearing member on the aspects that can impact the operations of the clearing member".[170] These contractual requirements include an obligation that the client of the clearing member will be liable to the clearing member in the event of default of the indirect client.[171] Therefore, the indirect clearing arrangements will be largely dictated by the operational requirements of the clearing members. Such measures are doubtless intended to reduce the possibility of counterparty risk arising out of the default of an indirect client. Yet, arguably, this rigid structure may stifle innovative processes which could be developed to create more effective bespoke clearing solutions which better suit the needs of indirect clients.

Further, the clearing member which is facilitating its clients' indirect clearing services must make a public disclosure of "the general terms on which it is prepared to facilitate indirect clearing services".[172] Delegated Regulation 149/2013 also places CCPs under an obligation to "identify, monitor and manage any material risks arising from indirect clearing arrangements that could affect the resilience of the CCP".[173]

ESMA had originally envisaged that facilitating indirect clearing would be a mandatory obligation imposed upon clearing members.[174] This was met with an outcry from the industry as it would have created risk management problems and issues surrounding the freedom of parties to contract.[175] Accordingly, ESMA relented.[176]

The Commission and ESMA have gone to great lengths to impose an indirect clearing regime on the OTC derivatives market. However, such indirect clearing arrangements look set to impose a complex and potentially costly system on the smallest counterparties (those forced to make use of indirect clearing). Potentially these small counterparties will be least able to cope with the added cost and lack the adequate systems and controls to manage their clearing arrangements. It could be suggested that the risk mitigation techniques set out in Article 11 of EMIR (discussed below, in Section VIII) offer a better solution to managing risk in the OTC derivatives market. The expansion of the clearing obligation has had the knock-on effect of impacting on how client money is to be treated.

C. CLIENT MONEY AND ASSET SEGREGATION

Client clearing and indirect clearing under EMIR has necessitated various changes being made to how the FCA will treat client money. Client money, broadly speaking, refers to money that a firm holds on behalf of its clients.[177] EMIR itself does not refer to client money but is concerned with the segregation of assets and positions belonging to clearing members, their clients and the indirect clients. In particular, EMIR seeks to ensure the segregation of funds in order to ensure that clients can transfer positions away from a defaulting clearing to a backup non-defaulting clearing member and that when positions are transferred, any associated collateral is also transferred to the non-defaulting clearing member—this is called "porting".

Article 39 of EMIR requires that a clearing member offer its clients the choice between omnibus client segregation (where the clearing member arranges with the CCP separate records and accounts to distinguish assets and positions of clients from the clearing member's own assets and positions) and individual client segregation (where the records and accounts at the CCP level will enable the clearing member to distinguish the assets and positions held for the account of a client from those held for the account of other clients).

Under both omnibus and individual segregation, the clearing member is required to ensure that the CCP can distinguish between the clearing member's own assets and positions and the assets and positions of the clearing member's clients. This can be achieved either through the principal or agency clearing models. However, the individual segregation method goes further in that it requires the CCP to be able to identify the assets and positions held on behalf of each individual client of a clearing member. Although identifying individual clients' assets and positions would be possible under the principal model, it would arguably be easier to accomplish under the agency model, given that the client will be providing margin directly to the CCP. Given that the principal model is preferred in the EU, it would seem likely that the omnibus method of segregation will be encouraged by both clearing members and CCPs

Where a client opts for individual client segregation, any margin in excess of the client's requirement must be posted to the CCP and separated from other clients' margin. In the case of omnibus segregation, it may be that margin will be called by the CCP on a net basis (i.e., on the basis of the net of all positions in the omnibus account) while the clearing member may in turn call margin from individual clients on a gross basis (i.e., from each individual client to cover that client's positions). Where this happens, the clearing member will hold the difference between the gross margin it calls from clients and the net margin posted to the CCP for the credit of the omnibus client account.

Article 48 EMIR provides that, in default of compliance with the rules of a CCP on the part of a clearing member, the CCP may "port" (i.e., transfer) the positions and associated margin of the defaulting clearing member's clients to a backup or alternative clearing member. The process of porting allows clients to either carry on trading or see their positions closed and their money returned.

This process of porting required major changes to the FCA's client money rules (with still further changes anticipated[178]). The FCA's client money rules are set out in Chapter 7 of the Client Assets Sourcebook ("CASS 7"). Prior to EMIR, CASS 7 provided that when a firm became insolvent, all client money held by a firm for its clients was notionally pooled. When a pooling event occurred, all client money was consolidated and then would be distributed to the clients. Porting prevents this pooling in respect of money held by a CCP on behalf of a clearing member's clients in relation to EMIR.[179] Instead, the CCP can prevent the pooling of money it holds on behalf of the clearing member's clients and instead port it.[180] This allows the money to be transferred to an alternative clearing member, satisfying the article 48 requirements.

Building upon porting, further changes are proposed to CASS 7 which would allow the establishment of "sub-pools".[181] Sub-pools would allow further segregation, and the perceived advantage of such arrangements are as follows:

> *[T]he advantages of porting include increasing market confidence through allowing clients' transactions to survive the insolvency of their clearing member firms and reducing the prospect of client money margin associated with such transactions from becoming tied up in ongoing proceedings over the distribution of the insolvent firm's general client money pool.*[182]

These changes were described by the FCA's predecessor, the Financial Services Authority ("FSA"), as "the most significant changes we have made to the client assets regime in over 20 years".[183]

Porting and the corresponding changes to CASS 7 have the potential to improve client money protection far beyond the scope of EMIR, but it is not without problems; a potential issue with porting is that it may result in client money being ported to a clearing member who is not subject to

CASS (e.g., a clearing member outside the UK). However, the FCA has pointed out that client consent is required in order to facilitate porting and, accordingly, the clients "will be aware of the relevant arrangements".[184] Another potential issue is that clients who elect to use individual client accounts will be afforded a greater level of protection and be able to recover their money more easily in default situations because the CCP will be better able to identify their accounts.[185] This can be contrasted with omnibus accounts where the clients' money could potentially form part of the notional pool unless it is "readily apparent" as to which client the money belongs to.[186] As such, for omnibus clients, the CCP will transfer client money to the clearing member for the account of those clients. In such a situation the clients are exposed to the credit risk of the clearing member. The Financial Markets Law Committee has identified:

> *[A] consequence of creating multiple client money pools is that it becomes less clear what is to happen in the event that a firm has misallocated money—either by appropriating such money to itself or by allocating it to the wrong pool—the risk of delay, uncertainty and litigation are likely to increase. If firms operate multiple pools, in practice, the risk of misallocation appears to increase as well.*[187]

Clearly, the EMIR-driven changes to the client money regime are likely to cause system and control issues for firms holding client money and more general confusion. It seems possible that such confusion may not be resolved until these issues have been the subject of litigation or enforcement action.

Money held by clearing members on behalf of their clients for indirect clearing clients is, given the layers involved, more likely to be at risk of being pooled when a default event occurs. Clients providing indirect clearing services must make similar arrangements with the clearing member so that indirect clients are offered accounts that are segregated via either the omnibus or individual segregation method. Recital 6 of Delegated Regulation 149/2013 provides that "[i]ndirect clearing arrangements should be established so as to ensure that indirect clients can obtain an equivalent level of protection as direct clients in a default scenario" and, as such, clearing members must have "robust procedures to manage the default of a client that provides indirect clearing services. These procedures shall include a credible mechanism for transferring the positions and assets to an alternative client or clearing member, subject to the agreement of the indirect clients affected". This is an almost identical obligation to porting at the CCP level. Accordingly, the FCA is intending to amend CASS 7 so that clearing members may port the money of indirect clients, when a client is in default, and discharge their fiduciary obligations when doing so.[188]

This emphasis on segregation of client money is an effort to avoid any of the client money issues that arose following the collapse of Lehman Brothers.[189] As previously discussed, the collapse of Lehman Brothers had global consequences. Lehman Brothers' principal European trading subsidiary was Lehman Brothers International (Europe) ("LBIE"), which held considerable amounts of money and assets on behalf of its clients. These assets were held by LBIE through a number of third parties, including nominee companies, custodians, depositaries, exchanges and CCPs. LBIE went into administration on 15 September 2008 and the fact that client monies were spread across a diverse range of third parties created problems of identification for the administrators. Some of these client monies and assets had been appropriately segregated and designated as client money, in accordance with CASS 7, whereas other monies that should have been so designated had not been. Accordingly, the administrators made a number of applications to the English courts for directions on how to determine which monies and assets fell within the CASS 7 regime.

The judge of first instance held that where client money had not been appropriately segregated (in accordance with CASS 7), this money would not be identifiable as client money and the clients would be unable to assert a proprietary claim against any segregated pools of client money.[190] This judgment was overturned by the Court of Appeal[191] and the Supreme Court agreed with the judgment of the Court of Appeal and made three primary holdings: (i) a statutory trust over client monies arose at the time LBIE received such monies, not when those monies were segregated; (ii) the client money pool would include client money held in both segregated and unsegregated accounts; and (iii) any client with a contractual claim to client money has a right to share in the client money, regardless of whether money has actually been segregated on the client's behalf.[192]

Although the *Lehman Brothers International* cases were not solely concerned with the treatment of client money held in a clearing situation, the case law does serve to indicate the emphasis placed on the adequate protection of client monies and assets since the financial crisis. The *Lehman Brothers International* cases also serve as a reminder that the rules of the FCA, whilst vital in guiding the conduct of firms, are not absolute and are ultimately subject to interpretation by the courts.

In addition, EMIR's asset segregation requirements will also have an impact upon title transfer collateral arrangements ("TTCAs") and the pre-funding of margin calls. At present CASS 7.2.3 R (1) provides that where a client transfers full ownership of money to a firm for the purpose of securing obligations, such money should no longer be regarded as client money. However, in accordance with EMIR, where a clearing member conducts its OTC derivatives business with a client on a TTCA basis, it must still offer a choice between omnibus and individual segregation at a CCP. This means that clearing members who enter into TTCAs with clients will need their own accounts at CCP level, individual or omnibus accounts for their clients' assets and positions, and individual and omnibus accounts in respect of TTCAs with clients.

Within the OTC derivatives market there is a practice of pre-funding margin calls. When CCPs call variation margin from clearing members, clearing members often fund the margin calls by extending credit to the relevant client because there is less time to meet the call than the client might take to put the clearing member in funds. The treatment of pre-funded margin under EMIR has been a source of considerable comment by the industry. Under EMIR, the margin will require to be credited to either an omnibus or client segregated account. In the event of clearing member failure, those accounts are subject to the porting provisions of Article 48 EMIR and in some circumstances may be returned directly to clients. In the latter event, the client would end up owing money to the failed or defaulted clearing member and would have to be pursued for it.

In PS 12/23 the FSA showed little sympathy for firms in relation to pre-funded margin and the changes in the risks which EMIR will bring about. The FSA lacked sympathy on the basis that firms assess the risks involved in pre-funding specific clients and that pre-funding already exists and is not an innovation introduced by EMIR. However, the regulator did indicate that it will consider pre-funding and issues that touch on it as part of the ongoing wider CASS review.

In terms of the process, it is important to recognise that those clearing members providing pre-funds are extending credit to their clients. If the margin would have been treated as client money in the hands of the clearing member had the client paid it, the pre-funded margin must be accounted for as part of the bank's client money requirement under CASS and segregated in accordance with EMIR. If the margin would have been delivered to the clearing member under a TTCA, then it is not client money, although it will still be credited to a segregated account.

For the clients of clearing members and indirect clients, a decision will have to be made as to whether to use individual client segregation or omnibus client segregation accounts. Additionally, where a number of CCPs are available to clear the same class of OTC derivatives, assessments will have to be made as to which CCP is to be preferred (bearing in mind that similar individual client segregation or omnibus client segregation systems may vary in terms of outcome, as between CCPs). As part of this analysis, the comparative cost as between CCPs is likely to be a factor in determining decisions. The costs associated with using individual client segregation accounts will be higher, but individual client segregation (if it works as intended) will result in a clear identification of position and asset ownership in the event of clearing member default. This will facilitate either porting to a backup clearing member or return of the funds directly to the client. With omnibus segregation, clients face the risk of pooling in the event of clearing member default.

Ultimately, expanding clearing to cover the OTC derivatives market can perhaps be seen as a complex and unnecessary imposition, when the market can be tamed through the use of reporting and risk mitigation techniques. Reporting and risk mitigation would not create the complex client money issues that are the inevitable outcome of EMIR's clearing obligation.

VIII. EMIR'S RISK MITIGATION OBLIGATIONS

Where a class of OTC derivatives is not covered by the clearing obligation or the OTC derivatives transaction involves an NFC, article 11 of EMIR will apply. Article 11 sets out the risk-mitigation techniques to be employed when an OTC derivatives contract is not cleared by a CCP, such risk-mitigation techniques are extensive. The general principle is that counterparties shall establish "appropriate procedures and arrangements" to "monitor and mitigate operational risk and counterparty credit risk"[193] with the risk mitigation obligations intending to mimic the protections that would have been provided if the transaction had been cleared.

Counterparties will be under an obligation to confirm their trades in a "timely" manner.[194] What constitutes "timely" will vary depending on the date at which the OTC derivatives are traded, the class of derivative that is being traded and the counterparty making the confirmation (e.g., FC, NFC+ or NFC-).[195] This obligation entered into force on 15 March 2013.

For OTC derivatives contracts concluded between FCs and/ or NFCs+, which are not cleared by a CCP, these shall be confirmed (preferably by electronic means) by:

i) For credit default swaps and interest rate swaps that are concluded—
   (1) up until 28 February 2014, timely confirmation will be by the end of the second business day;
   (2) from 1 March 2014, timely confirmation will be by the end of the next business day,

   following the date of execution; and
ii) For equity swaps, foreign exchange swaps, commodity swaps and all other classes of derivatives that are concluded—
   (1) up until 31 August 2013, timely confirmation will be by the end of the third business day;
   (2) from 1 September 2013 until 31 August 2014, timely confirmation will be by the end of the second business day; and
   (3) from 1 September 2014, timely confirmation will be by the end of the next business day,

   following the date of execution.[196]

For OTC derivatives contracts involving an NFC-, which are not cleared by a CCP, these shall be confirmed (preferably by electronic means) by:

i) For credit default swaps and interest rate swaps that are concluded—
   (1) up to and including 31 August 2013, by the end of the fifth business day;
   (2) after 31 August 2013 up to and including 31 August 2014, by the end of the third business day;
   (3) after 31 August 2014, by the end of the second business day,

   following the date of execution.
ii) Equity swaps, foreign exchange swaps, commodity swaps and all other derivatives that are concluded—
   (1) up to and including 31 August 2013, by the end of the seventh business day;
   (2) after 31 August 2013 up to and including 31 August 2014, by the end of the fourth business day; and
   (3) after 31 August 2014, by the end of the second business day,

   following the date of execution. [197]

It is also a requirement of Article 11 that, on a daily basis, financial counterparties and NFCs+ either "mark-to-market" or "mark-to-model" the value of their outstanding contracts.[198] Marking-to-market entails tracking the current market value of an OTC derivatives contract so that losses or gains on a position can be calculated. Marking-to-model is where a financial model is used to price a position instead of using market prices to calculate values (as used in the mark-to-market method). The marking-to-model method is used where a class of derivatives contract lacks the necessary liquidity for the value of a contract to be determined on a mark-to-market basis. When marking-to-model, the model must: incorporate all factors that would be considered in setting a price, including using as much marking-to-market information as possible; be consistent with accepted economic methodologies for pricing financial instruments; be calibrated and tested for validity using prices from any observable current market transactions in the same financial instrument or based on any available observable market data; be validated and monitored independently; and be duly documented and approved by the board of directors as frequently as necessary.[199] The requirement of board approval for the model is likely to involve certain operational difficulties, given that the directors of the relevant firm will be required to understand the financial modelling of bespoke, and often complex, financial instruments. This valuation obligation entered into force on 15 March 2013.

Article 11(1)(b) of EMIR requires a portfolio reconciliation process to be undertaken. Portfolio reconciliation is the process by which counterparties check that they have a consistent record of the terms of their transactions with each other by comparing the descriptions of their respective portfolios. As noted in recital 28 to Delegated Regulation 149/2013, this will allow counterparties to "identify any misunderstandings of key transaction terms". Depending on the volume of OTC derivatives contracts between the counterparties and the type of counterparty (e.g., financial counterparty, NFC+ or NFC-), portfolio reconciliation may have to take place as often as once a day or as rarely as once a year.[200] This obligation entered into force on 15 September 2013.

As part of the risk management process, Delegated Regulation 149/2013 requires the consideration of portfolio compression. Where a financial or non-financial counterparty has 500 or more contracts with the same counterparty, there is an obligation to review those contracts and assess the possibility of engaging in "a portfolio compression exercise".[201] Portfolio compression entails terminating equal and offsetting trades with the same counterparty. It reduces the gross notional size and number of trades in a party's portfolio without changing the overall risk profile or value of the portfolio. Benefits include reduced operational risk and cost and reduced counterparty risk. Article 14 of Delegated Regulation 149/2013, does not mandate compression but requires entities with 500 or more contracts with the same counterparty to consider whether compression is appropriate. This obligation entered into force on 15 September 2013.

Dispute resolution procedures are also a requirement of EMIR. Market participants must agree with their counterparties' procedures and processes to identify, record and monitor disputes relating to the OTC derivatives contracts between them. The procedures must at least record the length of time for which the dispute remains outstanding, the counterparty and the amount disputed. For disputes that remain outstanding for more than five business days, the parties must have in place a contractual process for the timely resolution of such disputes.[202] Financial counterparties that have a dispute with a counterparty which is outstanding for at least 15 business days and where the "valuation or the exchange of collateral" relating to the OTC derivatives contract is higher than EUR 15 million must report the dispute to the relevant competent authority (the FCA).[203] This obligation entered into force on 15 September 2013.

In respect of the portfolio reconciliation and dispute resolution obligations, ISDA has produced a protocol (the "PRDR Protocol"). The PRDR Protocol aims to allow parties to comply with the portfolio reconciliation and dispute resolution risk mitigation obligations. For portfolio reconciliation purposes, the PRDR Protocol provides for portfolio data to be sent either "one-way" or to be exchanged. Portfolio data is that information which the counterparties require in order carry out the reconciliation process, i.e. the effective date, the scheduled maturity date, any payment or settlement date, the notional value and the underlying. Under the one-way system, a "Portfolio Data Sending Entity" (sender) sends all its portfolio data to a "Portfolio Data Receiving Entity" (receiver). The onus is then on the Portfolio Data Receiving Entity to reconcile the data sets held by the sender and itself as receiver and identify any potential discrepancies. If, after five business days, the receiver does not inform the sender of any discrepancies, it will be deemed that the two sets of portfolio data have been affirmed. The approach taken by market participants is that the sell-side entities will act as senders, with the buy-side entities acting as receivers. When portfolio data is exchanged, each counterparty is both a sender and a receiver.

The PRDR Protocol set out a mechanism for dealing with and recording disputes relating to an OTC derivatives contract. The PRDR Protocol requires that the counterparties exchange relevant information which will be helpful in resolving the dispute and have a process in place to resolve the dispute or escalate the dispute if it is still outstanding after five business days.

The main issue with the PRDR Protocol is the broad "confidentiality waiver" contained within it. This confidentiality waiver can be read as requiring the disclosure of information, in order to meet EMIR's reporting obligation, even to the extent that this may potentially conflict with local data protection laws. This language has been a cause for concern for many market participants who are based in or deal with jurisdictions that have strict data protection and transmission laws.

In relation to protection of collateral, financial counterparties and NFCs+ must have risk management procedures in place in order to ensure "appropriately segregated exchange of collateral with respect to OTC derivative contracts".[204] Additionally, financial counterparties must have adequate capital reserves "to manage the risk not covered by appropriate exchange of collateral".[205] The draft technical standards for both the exchange of collateral and capital requirements have not yet been published and, as such, there is no indication of when these requirements will enter into force.

Although the risk mitigation obligations will increase operational cost and impose additional administrative burdens on the market, they are lesser burdens than the clearing obligation. This White Paper submits that these extensive risk-mitigation requirements, when coupled with EMIR's reporting obligation, provide similar regulatory outcomes as the clearing obligation without the level of complexity added by the clearing obligation. This is the case particularly when it is considered that these requirements, both generally and in respect of collateral, will impose significant costs on market participants.

IX. EMIR'S REPORTING OBLIGATION

In accordance with article 9 of EMIR, the reporting obligation will apply to all OTC derivatives which are outstanding as of 16 August 2012 or are entered into on or after 16 August 2012.[206] The reporting obligation is broader in scope than the clearing obligation, as it applies to "any" derivatives contract.[207] This means that those derivatives trades which are exempt from the clearing obligation by virtue of: the derivative not being an "eligible" derivative; the trade involving a NFC-; or the derivative trade being an article 3 intragroup transaction, must still be reported.

The start date for the reporting obligation, in respect of all classes of derivatives contracts, is currently expected to be February 2014.[208] This is represents a delay to the start of the reporting obligation and is because no trade repositories registered with ESMA within the time frame envisaged.[209] Indeed, if a trade repository is not registered by 7 November 2013, the expected February start date will be further delayed.

The reporting obligation will apply to both the counterparties and the CCP, whenever negotiations of an OTC derivatives contract are concluded or the contract is modified or terminated[210] (each, a "Reporting Event"). It is not clear what is meant by "modified", but it is to be hoped that a report will only need to be made when a material modification is made to an OTC derivatives contract.

The reporting obligation also extends to include what can be described as "historical transactions". These historical derivatives transactions are:

- All those OTC derivatives contracts which are currently outstanding (including those entered into before 16 August 2012) will need to be reported within 90 days of the reporting obligation entering into force;[211] and
- All those OTC derivatives contracts which were entered into before 16 August 2012 and were still outstanding on or after 16 August 2012 but are no longer outstanding will need to be reported within three years of the reporting obligation entering into force.[212]

Failure to report these historical transactions, even those that have ceased to be outstanding, will be a breach of EMIR. Accordingly, counterparties need to ensure that their recordkeeping systems are rigorous in order to facilitate the reporting of these historical transactions.

With the exception of historical transactions, all reports must be made to a trade repository no later than one working day after the Reporting Event.[213] A "trade repository" is defined as "a legal person that centrally collects and maintains the records of derivatives".[214] The purpose of a trade repository is to "collect data for regulatory purposes that are relevant to authorities in all Member States".[215] Trade repositories must either be established in the EU and registered with ESMA or established outside the EU and recognised by ESMA.[216] Where a trade repository is not available, the report must be made directly to ESMA.[217]

Counterparties or the CCP may delegate the making of a report to a third party and both counterparties and the CCP must ensure that they do not produce duplicate reports.[218] However, EMIR's subordinate legislation does not state that the counterparties and CCP can make contractual arrangements with each other or a third party which relieve them of their reporting duty. In practice this will mean that even if a counterparty outsources its reporting obligation, it will not be able to take comfort from this and will still have to monitor that reports are made. In accordance with article 1(3) of Delegated Regulation 148/2013, where a counterparty (or a third party) makes a report on behalf of both counterparties, this must be clearly identified in the report. As a practical matter, market participants should be aware that contractual provisions which seek an indemnity from a third party for the principal's breach of regulation are void under the UK regulatory regime. Therefore, market participants who intend to delegate their reporting obligations (either to a counterparty or a third party) will need to think carefully as to how to structure the contractual relationship so as to be provided with some recompense in the event that the reporting obligation has been breached and the counterparty which outsourced its obligations receives a fine from the FCA.

The information that is required to be reported under EMIR is extensive. The format of the reports to be submitted to trade repositories is found in Commission Implementing Regulation (EU) No 1247/2012, and the minimum details which are to be reported are contained in Commission Delegated Regulation (EU) No 148/2013 (together, the "Reporting Standards"). Between them, the Reporting Standards set out an extremely detailed set of criteria as to what needs to be reported in accordance with EMIR. A very limited list of the information that needs to be reported includes: name of the counterparty; corporate sector of the counterparty; whether the counterparty is a financial counterparty, NFC+ or NFC-; identification of the underlying; deliverable currency; price multiplier; delivery type (e.g., cash or physical); and maturity date. Given the large amount of information to be reported under EMIR, market participants may consider (in spite of the fact that they will retain liability for breach of the reporting obligation) that the most effective means of compliance is through delegation to a third-party service provider.

Transaction reporting is already an obligation under MiFID and the possibility arises that dual reporting obligations will be required under both EMIR and MiFID. Reporting requirements are more extensive under EMIR as MiFID requires reporting to take place only at the time of the transaction,[219] whereas EMIR requires reporting to take place whenever a Reporting Event occurs. As ESMA states, the type of data required under EMIR is also more extensive than that required under MiFID.[220] It therefore seems likely that in some circumstances counterparties will be required to make reports under both EMIR and MiFID.

EMIR's reporting requirement will make reporting of OTC derivatives mandatory whenever a Reporting Event occurs. Making the market transparent will assist regulators by giving them the detail necessary "to carry out effective supervision and oversight".[221] Mandatory reporting enables regulators to have a clear view of what is happening and what potential risks are arising in the OTC derivatives market:

> *By having unfettered access to detailed data through global trade repositories, regulators are in a better position to monitor risk taking by individual market participants as well as concentrations of exposures to individual market participants or to specific asset classes. This would better enable regulators to detect a firm that creates large market positions with OTC derivatives.*[222]

An additional advantage of reporting is that it will enable regulators to identify instances of financial crime or other forms of unethical behaviour, which will further add to the stability and efficacy of the OTC derivatives market. Given the seeming concern of the general public as to the ethics of financial institutions, any measures that focus on preventing and punishing financial crime are likely to be a positive step in rehabilitating the reputations of both regulators and financial institutions. Greater transparency may well have avoided the fraud and misselling cases that occasionally surround OTC derivatives. There have been several cases, frequently unsuccessful, where clients have alleged that brokers, through either fraud or misrepresentation, induced them into entering into derivatives transactions.[223] It is to be hoped that greater transparency would reduce this litigious tendency. However, one of the most significant English fraud cases of recent years which involved derivatives, *Parabola Investments Ltd v Browallia Cal Ltd*, concerned a client being fraudulently induced into entering a series of on-exchange contracts for differences transactions.[224]

Parabola Investments Ltd suggests that transparency may not be enough to prevent dissatisfied clients making allegations of fraud and misrepresentation. Further, FCA regulated firms are already required to communicate information to their clients in a manner "which is clear, fair and not misleading"[225] so there is an argument to be made that perhaps transparency will not greatly aid clients as a market participant's firm/broker should already be providing it with the relevant information. However, as the recent judgment of England's Court of Appeal, *Green v The Royal Bank of Scotland plc,*[226] demonstrates the protections currently offered to unsophisticated market participants are in practice limited. In *Green*, Lord Justice Tomlinson held that firms had no positive duty to ensure that a client understands the nature of the risks involved when selling a swap on a non-advised basis. Additionally, actions for damages for breach of the FCA's rules are restricted to "private persons"[227] (thus excluding corporates). As such transparency will benefit clients of broker-dealers by providing the clients with an independent source of information, whether or not clients choose to take advantage of this new source of information is entirely up to them.

EMIR provides that trade repositories "shall regularly, and in an easily accessible way, publish aggregate positions by class of derivatives on the contracts reported to it".[228] The publication of aggregate data will better enable market participants to make informed decisions and cause the OTC derivatives market to be more transparent. In accordance with article 1 of Delegated Regulation 151/2013, trade repositories will publish the following breakdowns on, at least, a weekly basis: aggregate open positions per derivative class; aggregate transaction volumes per derivative class; and aggregate values per derivative class. These breakdowns are at a high level and if data was provided at a more granular level (to the extent possible, bearing in mind data protection and confidentiality issues) more could be accomplished. Greater transparency would increase market stability by reducing the chance of market participants reacting through fear caused by a lack of information at a time of financial crisis. Further, transparency would make the OTC derivatives market more efficient as it would become easier for participants to determine the correct "going price" for any given derivative. By enabling market participants to be able to assess the fair value of a class of derivatives, non-financial counterparties would be better placed to assess the risks involved and would place less reliance on their banks or broker-dealers.[229]

It may be argued that too much transparency may pose a risk to counterparties, as by having to reveal all their positions the rivals of a counterparty may be able to prevent or manipulate intended derivatives trading activity. However, aggregate information should not be susceptible to such abuse.

Whereas more information should be made publically available, from a data protection perspective it is possible that too much information will be provided to the regulators. Article 2(1) of Delegated Regulation 151/2013 requires "all transaction data" to be provided to ESMA. Further, trade repositories must also pass data to third country regulators where an agreement between the EU and the third country has been entered into.[230] The transfer of data from recognised trade repositories outside the EU to ESMA and the sending of data to regulators globally has obvious potential to cause data protection issues. ESMA has been unable to provide adequate assurances that these arrangements do not breach the data protection laws of third countries.

X. PENALTIES FOR BREACHES OF EMIR'S OBLIGATIONS

Article 12 of EMIR requires that each EU member state sets out the rules for penalties when a market participant that is subject to clearing, reporting or risk mitigation obligations infringes upon that obligation. The penalties should "include at least administrative fines" and be "effective, proportionate and dissuasive".[231] Where a market participant has breached the clearing or risk mitigation obligations, the relevant competent authority (for the UK this is the FCA) should publish the penalty imposed, "unless such disclosure would seriously jeopardise the financial markets or cause disproportionate damage to the parties involved".[232]

The FCA has stated that it will take action for any breaches of EMIR in line with existing penalties procedure, as set out in Chapter 6 of the FCA's Decision Procedure and Penalties Manual ("DEPP 6"). This means that when deciding to take action for a breach of EMIR, the FCA will have regard to the following factors (amongst others): whether the breach was deliberate or reckless; the duration and frequency of the breach; how quickly and effectively the breaching firm alerted the breach to the FCA; and whether the FCA has previously had to take disciplinary action against the firm in question.[233]

If the FCA does decide to take action for a breach of EMIR, it has the option to either impose a financial penalty or public censure.[234] Given that article 12 of EMIR states that breaches of EMIR should be punished by "administrative fines" it is to be presumed that the FCA will prefer to impose financial penalties. When setting a financial penalty, the FCA will make its decision on the basis of the following principles:

- Disgorgement: A firm or individual should not benefit from any breach;
- Discipline: A firm or individual should be penalised for wrongdoing; and
- Deterrence: Any penalty imposed should deter the firm or individual who committed the breach, and others, from committing further or similar breaches.[235]

These three principles are then applied by the FCA through a five-step framework, which can be summarised as:

Step 1: The removal of any financial benefit derived directly from the breach;

Step 2: The determination of a figure which reflects the seriousness of the breach;

Step 3: An adjustment made to the Step 2 figure to take account of any aggravating and mitigating circumstances;

Step 4: An upwards adjustment made to the amount arrived at after Steps 2 and 3, where appropriate, to ensure that the penalty has an appropriate deterrent effect; and

Step 5: If applicable, a settlement discount will be applied. This discount does not apply to disgorgement of any financial benefit derived directly from the breach.[236]

The FCA has the power to impose significant fines, with financial penalties being partially based on a percentage of "relevant revenue" ("relevant revenue" being "revenue derived by the firm during the period of the breach from the products or business areas to which the breach relates"[237]). For instance, in September 2013 a leading investment bank was fined GBP 137,610,000 (after a 30 per cent settlement discount) in respect of its derivatives losses.

Although we cannot be sure as to the level of fines the FCA will impose as a result of breaches of EMIR, the FCA (and before it the FSA) has "form" for imposing significant fines on firms that breach their reporting obligations. The Royal Bank of Scotland plc and The Royal Bank of Scotland N.V. (together, "RBS") were recently fined GBP 5,620,300 for failing to properly report approximately 44,800,000 transactions that ought to have been reported in accordance with MiFID.[238] The reporting failures largely arose from RBS's incorrect use of reference codes to identify transaction counterparties. Other inaccuracies identified by the FCA included: incorrect venue identification, duplicate reporting and incorrect instrument description for OTC derivatives. The FCA also identified systems and controls failures, particularly the lack of adequate training for staff and lack of senior management oversight. This is not the only fine that the FCA/FSA has imposed in recent years for failure to make accurate reports (another major investment bank was fined £ 1,750,000 in 2010 for similar breaches). Accordingly, companies should be aware that the FCA may impose financial penalties for breaches of EMIR when it considers it necessary.

Clients should have in place stringent systems and controls to ensure that they are ready to meet EMIR's requirements. The FCA has noted that, to begin with, it will adopt a risk based approach to enforcement "taking into account the position of particular firms and the markets in which they operate".[239] As such, FCs and larger NFCs+ should be particularly focused on ensuring that their OTC derivatives operations are EMIR compliant.

XI. CONCLUSION

This White Paper has sought to provide an initial guide to enable market participants to start considering their obligations under EMIR. As EMIR is entering into force gradually, with the most significant obligations (reporting and clearing) coming into force last, the OTC derivatives market will not change overnight. Nevertheless, change is coming and all market participants need to be prepared. The fact that ESMA is yet to specify those classes of derivatives which will be subject to the clearing objection and the technical standards relating to collateral and capital risk mitigation obligations is of concern. This is because it adds to the uncertainty of EMIR's scope as market participants put in place systems, controls and documentation to manage their EMIR compliance.

As stated at the beginning of this White Paper, we are uncertain as to the necessity of introducing a clearing obligation. It remains to be seen if the clearing obligation will reduce systemic risk or simply give rise to unintended consequences that are lurking in the future. What is certain is that the clearing obligation is likely to impose additional costs on counterparties.

Further, centralised clearing will, by necessity, impose standardisation which will undermine this bespoke system and has the potential to lead to the end of the laboratory conditions which have made the OTC derivatives market so successful as an incubator. Market participants and the financial system as a whole have a need for bespoke derivatives which accurately manage counterparty risk. The OTC derivatives market is an incubator for financial innovation; the bilateral negotiations that take place on the OTC market allow counterparties to create derivatives that entirely fit their purposes and in the process create a new financial product. The OTC derivatives market has been described as an "engine of financial innovation".[240]

Ultimately it could be argued that the reporting and risk mitigation obligations accomplish the same goal as clearing without the added risk of future uncertainty and increased cost on market participants. However, the clearing obligation is not going anywhere and market participants need to consider their compliance obligations under EMIR and the most effective way of addressing these obligations. Over the course of the next few years, EMIR will alter the regulatory landscape of the OTC derivatives market, and those market participants that are prepared will be best placed to navigate this new terrain.

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ANNEX
EMIR IMPLEMENTATION TIMETABLE

DATE	OBLIGATION	IMPACT
From 16 August 2012	Recordkeeping obligation	Since August 2012 financial and non-financial counterparties have been required to maintain a record of all OTC derivatives contracts that have been concluded and modified since that date. The records are to be retained for at least five years following the termination of the contract.
From 15 March 2013	Non-financial counterparties (NFCs+) must notify the FCA if they exceed the clearing thresholds.	If the average position of a non-financial counterparty's OTC derivatives contracts exceeds the clearing thresholds (article 11 of Commission delegated regulation (EU) No 149/2013) over a rolling 30 working day period, the FCA must be informed.
From 15 March 2013	For uncleared OTC derivatives trades, counterparties will have to:	
	• Provide confirmation details for trades that are not subject to clearing; and	**TRADE CONFIRMATIONS** Trades must be confirmed in a "timely" manner. What constitutes timely confirmation varies with the type of derivative that is being traded.
	• Calculate, on a daily basis, the value of outstanding contracts using either a mark-to-market or mark-to-model valuation process—***Note: this obligation applies only to financial counterparties and NFCs+.***	**MARKING-TO-MARKET** Marking-to-market entails tracking the current market value of an OTC derivatives contract so that losses or gains on a position can be calculated. One of the main reasons for marking-to-market a derivatives contract is to ensure that sufficient margin is exchanged to reflect any change in the value of the contract so that losses or gains on a position can be calculated. **MARKING-TO-MODEL** Marking-to-model is where a financial model is used to price a position instead of using market prices to calculate values (mark-to-market). Marking-to-model will be used where a derivatives contract lacks the necessary liquidity for the value of the contract to be determined on a mark-to-market basis.

DATE	OBLIGATION	IMPACT
15 September 2013	For uncleared OTC derivatives trades, counterparties will have to perform:	
	• Portfolio reconciliation to cover the valuation of each derivatives contract; and	**PORTFOLIO RECONCILIATION** Portfolio reconciliation is the process by which counterparties check that they have a consistent record of the terms of their transactions with each other by comparing descriptions of their portfolios. Counterparties must agree the terms on which portfolios shall be reconciled before entering into the derivatives contract. This can be done by the parties themselves or by a qualified and duly mandated third party. Portfolio reconciliation must cover key trade terms that identify each particular contract and include at least the valuation attributed to each contract. The times at which reconciliation must take place will vary: • Where a counterparty has 500 or more outstanding trades with the same counterparty, reconciliation must be done every business day; • Where a counterparty has 51 to 499 outstanding trades with the same counterparty, reconciliation must be done once per week; • Where a counterparty has 50 or less outstanding trades with the same counterparty, reconciliation must be done once a quarter.
	• Portfolio compression: *"Financial counterparties and non-financial counterparties with 500 or more OTC derivative contracts outstanding with a counterparty which are not centrally cleared shall have 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".*	**PORTFOLIO COMPRESSION** Portfolio compression entails terminating equal and offsetting trades with the same counterparty. It reduces the gross notional size and number of trades in a party's portfolio without changing the overall risk profile or value of the portfolio. Benefits include reduced operational risk and cost, reduced counterparty credit risk and, under some regimes, possibly reduced regulatory capital charge. All parties with 500 or more bilateral (uncleared) contracts outstanding with a counterparty to have procedures in place to regularly (at least twice a year) determine whether to conduct a portfolio compression exercise in order to reduce their counterparty credit risk.
	• Counterparties will be required to put in place dispute resolution procedures for disputes arising out of an OTC derivative contract.	
February 2014	All OTC derivatives contracts to be reported to trade repositories (subject to trade repositories being authorised).	Whenever a Reporting Event occurs a report must be made to a trade repository (no later than one working day after the Reporting Event occurs).
Summer 2014	Clearing obligation expected to start, but will be phased in by derivative class and counterparty type.	The article 4 EMIR clearing obligation will enter into force.

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- Commission Implementing Regulation (EU) No 1248/2012 of 19 December 2012 laying down implementing technical standards with regard to the format of applications for registration of trade repositories according to Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories;
- Commission Implementing Regulation (EU) No 1249/2012 of 19 December 2012 laying down implementing technical standards with regard to the format of the records to be maintained by central counterparties according to Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories;
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- Commission Delegated Regulation (EU) No 150/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards specifying the details of the application for registration as a trade repository;
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214 *ibid* article 2(2).

215 *ibid* at recital 74.

216 *ibid* article 9(1).

217 *ibid* article 9(3).

218 *ibid* article 9(1).

219 *ibid*.

220 ESMA Technical Standards (n 7) page 55.

221 Alessandro Giustiniani & John Thornton, 'Post-crisis financial reform: where do we stand?' (2011) 19 J. Fin. Reg. & Compliance 323, 332.

222 Duffie, *et al*. (n 51) page 16.

223 *See*, *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd* [2005] EWHC 830 (Comm), overturned on appeal *Peekay Intermark Ltd v Australia & New Zealand Banking Group Ltd* [2006] EWCA Civ 386 (CA); *JP Morgan Bank v Springwell Navigation Corp* [2008] EWHC 1186 (Comm); and, *Titan Steel Wheels Ltd v Royal Bank of Scotland plc* [2010] EWHC 211 (Comm).

224 *Parabola Investments Ltd v Browallia Cal Ltd* [2011] Q.B. 477 (CA).

225 PRIN 2.1.1 R, Principle 7.

226 Case No. A3/2013/0138.

227 FSMA 2000, s 138D(2).

228 EMIR (n 1) article 81(1).

229 *See* Christine Cuccia, 'Informational asymmetry and OTC transactions: understanding the need to regulate derivatives' [1997] 22 Del. J. of Corp. L. 197, 201.

230 Delegated Regulation 151/2013, at article 3.

231 EMIR (n 1) article 12(1).

232 *ibid* article 12(2).

233 DEPP 6.2.1 G.

234 DEPP 6.4.

235 DEPP 6.5.2 G.

236 DEPP 6.5.3 G.

237 DEPP 6.5A.2 G (2).

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