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EMIR and the OTC derivatives market

Derivatives are financial contracts, whose price depends on or derives from one or more underlying assets. They are used to manage risk by transferring it from one party to another. Offering flexibility in reducing risk exposure, they play an important role in modern economy. The phrase “over-the-counter derivative” (OTC - derivative) refers to a type of financial derivative, which is directly negotiated between two parties of such contract. Some studies show that OTC derivatives account for almost 90% of the derivatives markets and are worth around €435 trillion.¹ It has to be underlined, that the phrase “over-the-counter” can also be used to describe exchange of securities and other financial instruments traded through a dealer network.² The category of OTC derivatives comprises a wide variety of product types across several asset classes which differ in characteristics and levels of standardization. Such derivatives are used for a variety of purposes, i.e. hedging, investing or speculating. The usual reason to trade “over-the-counter” lies in the size and credibility of a company. Being too small to meet exchange listing requirements, some companies decide to negotiate contracts directly, without any supervision. OTC derivatives offer companies more flexibility, but on the other hand they can lead to some significant risks, such as a default of one party prior to expiration of the trade, which is driven mostly by too much financial leverage. This risk has especially gained an emphasis as the financial crisis hit in 2007. As an effect several countries decided to address this issue by reducing risks and improving transparency via clearing and increased use of so called ‘trade repositories’.

European Union Regulation No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories^{3,4} came into force on 16 August 2012. It introduced new requirements to improve clarity of the market and reduce the risks associated with the derivatives. The content of the regulation reflects the idea, that the OTC derivatives “lack transparency as they are privately negotiated” and, which is obvious, any information concerning their content are “known only to the contracting parties”.⁵ Furthermore, it has been underlined, that the financial crisis has already demonstrated that this feature (together with the creation of complex, mutually dependent contracts) “increase uncertainty in times of market stress and (...) pose risks

¹ http://europa.eu/rapid/press-release_MEMO-10-410_en.htm.

² Financial Times Lexicon; adequate text available on: http://lexicon.ft.com/Term?term=over_the_counter--OTC.

³ Later referred to as “Emir” or “Regulation”.

⁴ Official text available on:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>.

⁵ EMIR point (4) of the preamble.

to financial stability”.⁶ Hence, the aim of EMIR is to mitigate those risks and improve the transparency of the OTC derivatives market. Though, this regulation has to be regarded in a broader, global context. It has been seen as the legacy of the G20 Summit in Pittsburgh, in September 2009.⁷ There have been a number of other international initiatives, both by individual jurisdiction (such as the Dodd-Frank Act⁸ in the USA or some incentives made in Japan) and international bodies (like for example the OTC Derivatives Regulators’ Forum⁹ being established to promote cooperation between regulators), that were trying to address the issue of OTC derivatives. In Europe, the situation has been regarded as slightly more complex, as there are other legal provisions, like those of Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive¹⁰ (commonly known as MiFID 2) or proposed CRD IV¹¹ regulations coinciding with EMIR.

The main obligations under EMIR are: the obligation of Central Clearing for certain classes of OTC derivatives,¹² the application of risk mitigation techniques for non-centrally cleared OTC derivatives,¹³ the obligation to report to trade repositories (TR),¹⁴ the application of organizational conduct of business and prudential requirements for CCPs¹⁵ and the application of requirements for TRs including the duty to make certain data available to the public and relevant authorities.¹⁶

EMIR requires any entity established in the EU, that has entered into (is a legal counterparty to) a derivatives contract to report and risk manage its derivative positions. Furthermore it requires the parties to clear the OTC derivative contracts through a central counterparty (CCP), which means that the CCP will take on the responsibility for guaranteeing the contract.



Scheme no. 1

A CCP shall impose, call and collect margins to limit its credit exposures.¹⁷ Such margins shall be sufficient to cover potential exposure and ensure the sufficient collateralization level of the CCP with all its clearing partners. A CCP shall maintain a pre-funded default fund.¹⁸ Each clearing member shall

⁶ *Ibidem.*

⁷ Statement: <http://www.g20.utoronto.ca/2009/2009communique0925.html>.

⁸ Available on SEC site: <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>.

⁹ <http://www.otcdf.org/>.

¹⁰ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:241:0026:0058:EN:PDF>.

¹¹ New proposals are included here: http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm.

¹² EMIR Title II and point (26) of the preamble.

¹³ EMIR Title III and point (30,31) of the preamble.

¹⁴ EMIR Art. 9.

¹⁵ EMIR Title III, mostly chapters 2 and 3.

¹⁶ EMIR Title VI.

¹⁷ EMIR Art. 41 point 1.

¹⁸ EMIR Art. 42 point 1.

contribute to the default fund.¹⁹ The contributions shall be proportional to the exposures of each clearing member.

As already stated - the EMIR clearing obligations apply mainly to transactions between two EU-based parties. However, under a variety of circumstances, it applies indirectly to non-EU counterparties trading with the EU parties.²⁰ In order to mitigate the wide scope of this obligation, the Regulation constitutes a provision intended to avoid conflicting rules.²¹ Where one party to the transaction, established outside the EU, is subject to the clearing regime regarded as “equivalent” to the Regulation, the party “shall be deemed to have fulfilled the obligations” contained in Articles 4, 9, 10 and 11 of EMIR. This, however, depends on an implementing act on the equivalence, that should be previously adopted by the European Commission. What is more: there is a mechanism for recognizing third-country CCPs for purposes of satisfying the clearing obligation.²² These obligations differ slightly from those of already mentioned Dodd-Frank Act.

Requirements for Trade Repositories²³ include high clearness of lines of responsibility, as well as adequate procedures preventing TR’s from disclosing any information which may be confidential.²⁴ Managing conflicts of interests and operational efficiency are also a matter of this regulation, together with identifying and minimizing potential risks and data misuse, however all technical standards are described in separate legal acts. List of all infringements relating to organizational requirements, conflicts of interest, operational requirements, transparency and the availability of information and obstacles to the supervisory activities is enclosed to the Regulation as an annex. What is crucial Trade Repositories are obliged to record and store the data for at least 10 years following the termination of the relevant contracts. Of course any information provided may not be used for commercial purposes prior to the consent delivered by relevant counterparty. One of the main entities responsible for information security protection and control is ESMA²⁵ (established by the Regulation 1095/2010),²⁶ however also other institutions, such as ESRB²⁷ and other entities enlisted in EMIR art. 81 point (3), can demand access to the data which are necessary to enable them to fulfill their respective responsibilities and mandates.

¹⁹ EMIR point (4) of the preamble.

²⁰ EMIR Title III, mostly chapter 4, but Regulation refers to third countries in many places of the act.

²¹ EMIR Art. 13.

²² EMIR Art. 25.

²³ Mentioned in EMIR’s Title VII.

²⁴ Obviously there are several cases in which the information may, or even have to, be disclosed and professional secrecy does not apply – for example when a CCP has been declared bankrupt or is being compulsorily wound up. In this case confidential information which does not concern third parties may be divulged in civil or commercial proceedings where necessary for carrying out the proceeding (EMIR Art. 83 point 2).

²⁵ European Securities and Markets Authority.

²⁶ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC; official text available on:

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0084:0119:EN:pdf>.

²⁷ European Systemic Risk Board, established by the Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.

Though the technical standards on OTC Derivatives, Reporting to Trade Repositories and Requirements for Trade Repositories and Central Counterparties came into force less than one month ago, on 15th March 2013, Polish (but not exclusively) banks and financial institutions has had required regulations already adjusted. EMIR also influences Polish tax law, which results *inter alia* in changing individual tax interpretations.²⁸ Some of the member states still need to harmonize relevant laws and choose which supervision authorities have the competences granted by the Regulation. As an example Germany adopted the implementing law that also amended provisions in the German Banking Act that were not compliant with EMIR.²⁹

There are six main regulatory technical standards, published on 19 December 2012, which are described in following regulations (which are all supplementing EMIR):

- Commission Delegated Regulation (EU) No 148/2013 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 on the minimum details of the data to be reported to trade repositories³⁰
- Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP,³¹
- 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,³²
- Commission Delegated Regulation (EU) No 151/2013 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 data to be published and made available by trade repositories and operational standards for aggregating, comparing and accessing the data,³³
- Commission Delegated Regulation (EU) No 152/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on capital requirements for central counterparties,³⁴

²⁸ Example: Ministry of Finance note from 30 January 2013, PT8/033/11/64/WCX/13/PK-115.

²⁹ D. Lang, U. Mutschler, *Implementing Law for European Market Infrastructure Regulation (EMIR) Promulgated*, Germany Energy Blog <<http://www.germanenergyblog.de/?p=12303&print=1>>, 22.02.2013 r., p. 1-2.

³⁰ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0001:0010:EN:PDF>.

³¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF>.

³² <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0025:0032:EN:PDF>.

³³ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0033:0036:EN:PDF>.

³⁴ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0037:0040:EN:PDF>.

- Commission Delegated Regulation (EU) No 153/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties.³⁵

These were however questioned by the Economic and Monetary Affairs Committee of the European Parliament. The objection was finally withdrawn on 7th February 2013, because of certain assurances given by the Commission that it would publish frequent ‘questions and answer booklets to cover any matters over which there arose legal uncertainty.’³⁶

From 15 March 2013, non-financial counterparties that enter into positions in OTC derivatives contracts that exceed the clearing thresholds specified by ESMA must notify the competent authority. Notifications are also required when non-financial counterparties no longer exceed the clearing threshold.³⁷ The clearing thresholds are:³⁸

- € 1 billion in gross notional value for OTC credit derivative contracts;
- € 1 billion in gross notional value for OTC equity derivative contracts;
- € 3 billion in gross notional value for OTC interest rate derivative contracts;
- € 3 billion in gross notional value for OTC foreign exchange derivative contracts;
- € 3 billion in gross notional value for OTC commodity derivative contracts and other OTC derivative contracts not otherwise provided for.

It needs to be emphasized, that EMIR encompasses also a wide range of obligations and recommendations for parties, that enter into an OTC derivative contract not cleared by a CCP.³⁹ Although EMIR may well be a valuable step in the right direction of establishing market transparency it also raises questions as regards to its impact on global business and derivatives market or the collateral management infrastructure. It may, in consequence, change the core of business for many companies trying to hedge their internal risks. Firstly, the mandatory clearing will, presumably, result in the increase of the OTC derivative prices. Secondly, the differences between European, American and Asian regulations will result in regulatory arbitrage. Despite best intentions, the different schedules of legislation and more or less restrictive approach resulted in several differences between the adequate legal acts. CCPs operate under different regulations – therefore the potential risk of competition between them (in order to gain most dependable clearing partners) and a “race to the bottom” seem very probable in the long term. Some also argue, that over time regulators will encourage greater direct participation in the CCP framework by lowering capital requirements.⁴⁰ Others

³⁵ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0041:0074:EN:PDF>.

³⁶ S. Goligorsky, *European Parliament Endorses EMIR Technical Standards*, McDermott Will & Emery <<http://www.energybusinesslaw.com/tags/regulation-on-overthecounter-d-1/>>, 12 February 2013, p.1-2.

³⁷ <http://www.lexology.com/library/detail.aspx?g=e1451252-1490-4b92-9a9b-5e25f6f07e42>.

³⁸ Art. 11 Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP, official text: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF>

³⁹ EMIR Art. 11

⁴⁰ http://www.capco.com/sites/all/files/public/T1057_otc_deriv_wp.pdf.

recall the danger of overregulation, which may not only tend to slow the market significantly, but also increase uncertainty, creating new factors of risk and preventing smaller entities to take part in the market transactions, which will only work discriminatively and thus worsen the situation. Finally, EMIR will fundamentally alter the structure of the OTC derivatives markets.⁴¹ Institutions will have to adjust their business models, examine their profitability perspectives, scan through their operational data in order to adapt to the new regulation. On the other hand the outcome of EMIR is (arguably) going to create greater transparency which can in effect lead to facilitating efficient pricing of OTC derivatives contracts and greater financial stabilization.

⁴¹ <http://www.ey.com/GL/en/Industries/Financial-Services/Banking---Capital-Markets/Global-financial-regulatory-reform--OTC-derivatives>.