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A New Panorama for the Clearing and Recording of Over-the-Counter Derivatives in Europe: the Proposed European Market Infrastructure Regulation

Background

On 15 September 2010, exactly two years after the collapse of Lehman Brothers, the European Commission has published a proposal for a new Regulation on OTC derivatives, central counterparties and trade repositories, known as the European Market Infrastructure Regulation ("**EMIR**"). The EMIR proposal follows a communication that the Commission issued in July 2009 in which it identified existing problems in the OTC derivatives markets and suggested ways of reducing systemic risk in such markets. The communication was followed by a consultation exercise in which the Commission set out a draft text and its views on reforming the OTC derivatives markets. It is proposed that certain OTC contracts be required to be cleared by a central counterparty ("**CCP**") and that there be reporting of OTC derivatives trades to trade repositories. There is also a proposal for a pan-European regime for CCP authorisation and supervision.

EMIR comprises various proposals including:

- requiring CCP clearing of certain OTC derivatives and proper risk management of non-centrally cleared derivatives;
- a new regime for authorising and supervising CCPs;
- organisational and prudential requirements for CCPs;
- legislative support for interoperability arrangements between CCPs for cash products;
- requirements to report transactions to trade repositories; and
- organisational and transparency requirements for trade repositories.

A lot of work has already happened in this area and, in some ways, EMIR is merely catching up with industry-led solutions to improving financial infrastructure for OTC products. For example, ICE U.S. Trust and ICE Clear Europe have established successful facilities for the clearing of credit default swaps, with several trillion dollars worth of these contracts now cleared. Also, LCH.Clearnet has expanded its OTC interest rate product clearing. In relation to interoperability, x-clear recently established the first commercially successful interoperability arrangements with LCH.Clearnet in relation to shares traded on the London Stock Exchange. Finally, DTCC has established a new European trade repository for equity derivatives which is currently being expanded to include CDS. Shearman & Sterling has advised ICE, x-clear and DTCC in relation to these important initiatives.

The Clearing Obligation for OTC Derivatives

EMIR will impose an obligation on "financial counterparties" to clear all eligible OTC derivatives with a CCP, whether by becoming a member of the CCP or a client of such a member. "Financial counterparty" is defined as including investment firms, credit institutions, insurers, undertakings for collective investment in transferable securities ("**UCITS**") and alternative investment fund managers.[1]

The proposal envisages a two-pronged approach to determining the clearing eligibility of OTC derivatives, combining what is being termed a "bottom-up" approach and a "top-down" approach. Under the "bottom-up" approach, when a Member State competent authority authorises a CCP to clear a class of derivatives, it will inform the European Securities and Markets Authority ("**ESMA**") and request a decision on the eligibility of that class of derivatives for the clearing obligation. ESMA will then make a decision on whether that class of derivatives should be subject to the clearing obligation, taking into account, among other things, the liquidity of the contracts, availability of pricing information, and the ability of the CCP to handle the likely volume of contracts.

The "top-down" approach will enable ESMA to decide, on its own initiative, whether a particular class of OTC derivatives for which no CCP has yet received authorisation should be subject to a clearing obligation. Once a CCP receives authorisation for such a class of OTC derivatives, the clearing obligation will be triggered for the rest of the market. To facilitate market participants' access to clearing services, EMIR will impose an obligation on CCPs that have been authorised to clear eligible OTC derivative contracts to accept such contracts for clearing on a non-discriminatory basis, regardless of the venue of execution.

Exposures to a CCP will be assigned a zero risk weighting for the purposes of the credit risk capital charge under the Capital Requirements Directive.[2] This should encourage CCP clearing, once a product becomes eligible, because non-cleared products will attract a capital requirement, based on the exposure of the party to the contract and the credit risk of its counterparty. However, there is no proposal in EMIR for counterparty credit risk ratings to be set at penal levels for non-cleared trades.

Non-financial counterparties will be subject to the clearing obligation in relation to an eligible OTC derivative if they take positions in such derivatives exceeding a certain threshold. Any positions that are directly linked to the commercial activity of the non-financial counterparty (such as an oil company hedging its exposure to oil prices) would not be taken into account in determining if the threshold is reached. In addition, non-financial counterparties who take positions in OTC derivatives in excess of a (lower) "information threshold" will be required to notify their competent authority, providing justification for taking those positions. There will be no exemption from this reporting obligation for positions directly linked to the counterparty's commercial activity. The clearing threshold and the information threshold will be set out in technical standards to be adopted by the Commission under delegated powers.

[1] In the case of alternative investment fund managers, the provisions in EMIR should be interpreted as applying primarily to the fund entities rather than the fund managers.

[2] Directive 2006/48/EC (Banking Consolidation Directive) and Directive 2006/49/EC (Capital Adequacy Directive).

Financial and non-financial counterparties who enter into OTC derivatives contracts that are not subject to central clearing will be under an obligation to ensure appropriate procedures and arrangements are in place to measure, monitor and mitigate operational and credit risk, including at least:

- where possible, electronic means of ensuring the timely confirmation of the terms of the OTC derivative contract; and
- robust, resilient and auditable processes in order to reconcile portfolios, manage the associated risk and identify disputes between the parties early and resolve them, and to monitor the value of outstanding contracts. The value of outstanding contracts must be marked to market on a daily basis and risk management procedures must require the timely, accurate and appropriately segregated exchange of collateral or the appropriate and proportionate holding of capital.

The Commission will adopt technical standards under delegated powers specifying the arrangements and levels of collateral and capital required in relation to bilaterally cleared OTC derivatives.

Member states are required to adopt penalties, including at least administrative fines, to punish non-compliance with the clearing obligation.

Reporting Obligations

Financial counterparties will be required to report to a registered trade repository the details of any OTC derivative contract they have entered into and any modification or termination of that contract. The report must be made no later than the working day following the execution, clearing or modification of the contract. If a trade repository is unable to record the details of an OTC derivative contract, the report must be made directly to the relevant competent authority.

Authorisation and Supervision of CCPs

EMIR establishes a new regime for the authorisation of CCPs. Applications for authorisation are to be made to the competent authority of the Member State where the CCP is established and may only be made by persons with access to "adequate liquidity". Under the current draft proposal, such liquidity will result either from access to central bank facilities or to the facilities of creditworthy and reliable commercial banks or a combination of both. Under previous drafts of EMIR, there had been a proposed requirement for central bank liquidity, which is impracticable for CCPs which clear in multiple currencies. Thankfully, such a rigid requirement appears to have been watered down in the new proposal for EMIR. However, a troubling provision requiring mandatory use of central bank money settlement 'where available' remains in place and is of uncertain scope.

Once granted, authorisation will be effective for the entire territory of the European Union. An application for authorisation will be determined within a time period of six months. Member State competent authorities will be required to review annually the arrangements, strategies, processes and mechanisms established by a CCP with respect to compliance with EMIR and evaluate the market, operational and liquidity risks to which the CCP is or might be exposed.

A CCP that has been authorised in its Member State of establishment to provide services before the date of entry into force of EMIR[3] must seek authorisation pursuant to EMIR by two years after that date at the latest.

In the UK, the criteria and process for recognition applications by clearing houses is currently governed by Part XVIII of the Financial Services and Markets Act 2000 ("**FSMA**"), the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001[4], and the 'REC' sourcebook of the Financial Services Authority's ("**FSA**") handbook of rules and guidance. Once EMIR enters into force, this regime is likely to require amendments to bring it into conformity with the authorisation and supervision scheme set out in EMIR. At least, some of the provisions relating to regulatory authorisation will require amendment for OTC clearing houses. It remains to be seen whether the recognition requirements for clearing houses that clear exchange-traded instruments will be amended.

CCPs will be required to have minimum capital of at least €5 million. Pursuant to a separate requirement, capital (including retained earnings and reserves), must at all times be sufficient to ensure an orderly winding-down and restructuring of the CCP's activities over an appropriate time span. The current UK capital rules for clearing houses are similar to the latter requirement and the general approach has been to require six months' core operating expenses' worth of capital to be held. It remains to be seen how ESMA will interpret the "orderly run down capital" requirement.

Each Member State is required to designate the competent authority responsible for authorising and supervising CCPs. In the UK, if the Coalition Government's plans to replace the FSA with a new Consumer Protection and Markets Authority and a Prudential Regulation Authority are implemented, CCPs will fall within the jurisdiction of the Prudential Regulation Authority. There will be obligations on competent authorities to co-operate with each other and with ESMA and to exchange information with other authorities, ESMA and, where relevant to their exercise of their duties, the central banks of the European System of Central Banks ("**ESCB**").

ESMA is also given a power to recognise CCPs established in third countries if the Commission has determined that the legal and supervisory arrangements of the third country ensure that CCPs authorised in that third country are equivalent to the requirements resulting from EMIR. Third country CCPs are permitted to provide clearing services to entities established in the European Union only after they have been recognised by ESMA.

The new scheme for recognising third country CCPs may require amendments to the UK's current regime for recognising overseas clearing houses under sections 288 and 292 of FSMA. There is no transitional provision in EMIR that would enable third country CCPs already recognised in any Member State (such as a recognised overseas clearing houses, or ROCHs, granted recognition by the FSA) to continue to offer services in the European Union following the date of entry into force of EMIR. It would appear that such CCPs, if they clear OTC derivatives, will need to re-apply to ESMA. It remains to be seen whether the ROCH regime will remain in place for CCPs that clear exchange-traded instruments.

[3] EMIR will enter into force on the 20th day following its publication in the Official Journal.

[4] SI 2001/995.

Organisational, Conduct of Business and Prudential Requirements for CCPs

EMIR imposes a comprehensive set of requirements on CCPs relating to systems and controls, governance, risk management, acquisition of control, record keeping, conflicts of interest, and notifications, as well as conduct of business and prudential requirements. Many of these requirements already apply to clearing houses recognised by the UK's FSA or which comply with the U.S. Commodity Futures Trading Commission's core principles or CPSS-IOSCO standards. The following requirements may, however, give rise to difficulties for CCPs:

- CCPs will be required to maintain and operate effective written organisational and administrative arrangements to identify and manage any potential conflicts of interest between the CCP and its clearing members or their clients or between them. CCPs in the UK and elsewhere are already required to manage conflicts between clearing members. This requirement is problematic in that it also applies to clients of clearing members. Under the Markets in Financial Instruments Directive (MiFID: Directive 2004/39/EC) the management of conflicts of interest between an investment firm's clients is a matter for the investment firm to manage. CCPs will ordinarily have no role in policing or monitoring the relationship between clearing members and their clients. Clearing houses typically only have contractual obligations with their clearing members and often will not know who the clients of clearing members are. As a matter of law, most clearing houses have no 'duty of care' to their clients. This obligation may therefore be impossible to comply with, as regards clients of members of CCPs.

- CCPs must require each clearing member to distinguish and segregate in accounts with the CCP the assets and positions of that clearing member from those of its clients. Most clearing houses operating in the European Union receive at least cash assets by way of a title transfer financial collateral arrangement under the Financial Collateral Directive (Directive 2002/47/EC). Some clearing houses receive both cash and non-cash assets pursuant to a title transfer financial collateral arrangement. As a result, upon receipt, under such a model, all initial margin will belong legally and beneficially to the CCP. Assets provided to a CCP are not therefore assets "of" clearing members or their clients. These requirements are therefore of limited scope or alternatively, depending on how they are interpreted by ESMA, could disrupt widely used practices of taking collateral.

- EMIR contains a provision that is intended to enable the 'porting' of client positions of a defaulting clearing member (i.e. the transfer of those positions and related margin to a solvent clearing member). In the UK, special insolvency law treatments for CCPs are set out in the Companies Act 1989, pursuant to which, among other things, the default rules and arrangements of a CCP are protected from interference by an insolvency official. There is currently no legal basis in UK law or, indeed, European Union law for a CCP to transfer the customer contracts of an insolvent clearing member to a solvent clearing member. Unfortunately, EMIR does not require Member States to modify national insolvency laws. EMIR does require Member States to ensure that 'porting' is operative but this requirement is potentially of uncertain scope and effects.

- CCPs will be required to impose, call and collect margin which is sufficient to cover losses that result from at least 99 per cent of the exposures to movements over an appropriate time horizon at least on a daily basis. The Commission is given powers to adopt technical standards specifying the appropriate percentage and time horizon. Prescriptive margin requirements may turn out to be counterproductive if the end-result is similar to that for banks in relation to capital requirements under the Basel Accords, where 'minimum' standards were rarely topped up either voluntarily or by regulators in some Member States.

- There is a provision that requires a CCP to use, where available, 'central bank money' to settle its transactions. Where central bank money is not available, steps must be taken strictly to limit credit and liquidity risks. This provision should be given a broad interpretation in the light of existing international standards so that settlement using central bank money (i.e. balances in accounts with the central bank) is only required where this is convenient and participation by CCPs in settlement systems that use central bank money is possible. In this context, the CPSS-IOSCO Recommendations for Central Counterparties[5] contain a similar provision recommending the use of a risk-free medium of settlement such as central bank money where possible.[6] However, further guidance in the Recommendations recognises that (a) use of the central bank of issue as the single settlement agent may not always be practicable, given that most CCPs will not have any accounts with the central bank, and (b) even if access to central bank facilities is possible, in a multi-currency environment the CCP will seldom have access to all the central banks of issue of the currencies in which transactions are settled. Even if a CCP does have a central bank in its payment system, central bank payment systems often do not operate (or provide finality) at the times and frequencies when a CCP needs to make money settlements. Given that the EMIR provision on settlement is drafted in similar terms to those of the CPSS-IOSCO Recommendations, it is hoped that the EMIR provision will not be interpreted so as to require use of central banks for settlement of all transactions. Such an interpretation would result in a clandestine nationalisation of CCP payment banking services, with significant commercial ramifications.

- EMIR does not distinguish between initial margin and variation margin. As a result, it is necessary to take particular and differing interpretations of the term "margins" in different instances where the term is used. Initial margin is the collateral held by a clearing house to be applied against losses. Variation "margin" is not collateral in the traditional sense, but rather is the cash payment received or paid when cleared contracts are "marked to market". A variation margin call does not result in a CCP holding any net assets, given that it will pay out equal amounts of money to participants who are "in the money" to those amounts which it receives from participants who are "out of the money". Variation margin and initial margin are very different forms of payment and collateral. EMIR would be easier to interpret were it to specify which of its requirements applied to different sorts of margin.

Interoperability

To facilitate interoperability between clearing houses and hence strengthen competition in the clearing services market, EMIR recognises and protects interoperability arrangements between clearing houses. Interoperability occurs where two clearing houses jointly provide clearing services to the same market. Where both parties to a trade use the same CCP, upon the trade being accepted for clearing, they will each have a cleared contract with that same CCP. However, if two parties to a trade use different CCPs, then each of those parties will have a cleared contract with the CCP it has chosen. There is then a third "inter-CCP contract" between the two CCPs.

At present, interoperability has been limited to cash equity markets, where clearing infrastructure is relatively well developed already, settlement is typically within three days and the amount of collateral to be taken is relatively low. Such an arrangement has been successfully established by x-clear and LCH.Clearnet for the clearing of shares traded on the London Stock Exchange. There is no proposal in EMIR that interoperability between CCPs be extended to derivatives, let alone OTC

[5] Established jointly by the Committee on Payment and Settlement Systems, the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions.

[6] Recommendation 9.

derivatives at present. Rather, the issue has been made subject to a study to be undertaken by ESMA to be completed by September 2014.

This approach has been adopted because there are a number of difficulties that could result should interoperability be allowed or required for derivatives. Notably, the collateral requirements for derivatives are much higher than for cash equities, given that contracts may have expiry dates of many years into the future, rather than just three days. Further, interoperability requires CCPs to harmonise their systems (as any technology enhancements must apply to all CCPs). As a result, such arrangements could stifle competition and innovation. Finally, regulators are concerned that inter-connected CCPs are exposed to the insolvency risk of other CCPs. The failure of one CCP could cause major systemic risk and financial ramifications if it led to the failure of other, inter-connected CCPs. This is a much greater risk for derivatives than for cash products, both in terms of actual insolvency risks and the amounts at risk.

Trade Repositories

EMIR sets out a registration regime for trade repositories. A trade repository, also known as a data warehouse, is an entity that receives reports of transactions from market participants and makes available data in relation to such transactions.

Applications for registration will be submitted to ESMA and a registration will be effective throughout the European Union. There are provisions enabling ESMA to recognise third country trade repositories where they are subject to requirements and supervision similar to the ones set out in EMIR. Only those trade repositories that have been recognised by ESMA may offer their services to entities established in the European Union for the purposes of enabling those entities to comply with reporting obligations in EMIR.

EMIR will impose a number of systems and controls, operational and transparency requirements on trade repositories. In particular, a trade repository must publish aggregate positions by class of derivatives on the contracts reported to it, and must make necessary information available to ESMA, various competent authorities and the ESCB central banks.

Implications

Implications for CCPs

Apart from the problematic provisions relating to margin, settlement and conflicts of interest, EMIR is unlikely to pose any significant difficulties for clearing houses that have been recognised in the UK, given that the recognition requirements that already apply to such clearing houses are broadly similar to the requirements under EMIR. However, various changes to rulebooks and systems of CCPs will be needed in order to comply with some of the provisions of EMIR which go beyond previously accepted standards, notably in relation to conflicts of interests between clients of clearing members, client clearing and, depending how the relevant requirement is interpreted, central bank settlement.

There is no transitional period for recognised overseas clearing houses ("**ROCH**"). This has the potential to cause serious disruption to their ability to continue to provide services to entities within the European Union after EMIR enters into force. It is therefore imperative for ROCHs currently offering services to entities within the Union to persuade the European authorities to include a transitional provision for ROCHs so that ROCHs too are given a period of time within which they must apply for recognition to ESMA.

Implications for Trade Repositories

EMIR is likely to trigger significant growth in the establishment and use of trade repositories. The requirement for third country repositories to obtain recognition before providing services is liable to cause the same problems that third country

CCPs currently providing services to entities in the Union are likely to face. Furthermore, there is no transitional period for trade repositories established in the Union.

Implications for Dealers and Market-makers

Existing dealer activity in derivatives that was premised on exploiting the more lenient capital treatment accorded to the trading book is likely to diminish as the new capital regime under Basel III is implemented. One of the key aims of this regime is to eliminate any incentives for holding assets in the trading book rather than the banking book. As a result, OTC contract structures which were devised primarily to take advantage of trading book capital treatment, are likely to become less prevalent.

As discussed above, dealers making markets in derivatives primarily used for corporate hedging purposes are likely to find themselves constrained in their ability to offer customised hedges.

That said, central clearing will reduce counterparty credit risks and the operation of multilateral netting will facilitate portfolio compression and netting of exposures. This will have the salutary effect of reducing overall exposures of banks, decreasing systemic risk, increasing transparency in the market and eliminating the uncertainty about exposures and links between institutions that froze the inter-bank credit markets in the last quarter of 2008.

Dealers will need to engage with the market in developing new documentation to take into account CCP clearing. Most dealers will already have arrangements in place for the central clearing of trades. Standard terms for client clearing documentation has been and will be provided by CCPs themselves. However, dealers may wish to revise their existing terms of business with their clients to ensure that they are sufficiently protected and will need to choose between various options for the holding or accounting for collateral within CCP documentation structures. In addition, dealers will need to consider the impact of clearing on their non-cleared contracts. New middle-office and back-office systems and personnel may be required to deal with central clearing and reporting to trade repositories.

Implications for Corporate End-users

Higher capital charges for bilaterally cleared derivatives transactions will affect the pricing of derivatives and other terms on which dealers are prepared to enter into transactions with corporate end-users. Higher collateral requirements and costs, due to mandatory CCP clearing or higher requirements applicable to bilaterally cleared trades, may result in increased working capital requirements for corporate end-users. Already, many corporate end-users have voiced concerns that, at a time when bank lending is constrained and access to capital markets impaired, it is imprudent to require end-users to post higher collateral for their hedging transactions. Much will depend on the clearing threshold that is set by the European authorities and how liberally the exemption for genuine commercial hedges is interpreted. Also, it remains to be seen how prescriptive the rules are on collateral requirements for bilaterally cleared and CCP cleared transactions. For example, a commercial oil extractor's hedge on the price of a barrel of oil would obviously be exempt, but the extent to which that person's interest rate hedges would be exempt remains to be clarified.

Corporate end-users who take positions that will require to be cleared will need to enter into appropriate arrangements with clearing members as well as arrangements to report transactions to trade repositories where required. They will also need to install systems to monitor transaction levels and determine whether reports need to be filed if the information threshold is crossed or whether a trade needs to be centrally cleared if the clearing threshold is crossed. Judgment will need to be exercised on whether to classify trades as genuine commercial hedges for the purposes of the exemption from the clearing obligation.

Implications for Other Buy-side Firms

Buy-side firms may be subjected to higher collateral requirements by dealers, due to the increase in dealers' regulatory capital and collateral requirements and costs. This may in turn reduce participation by some investment funds focused on OTC derivatives that rely upon leverage for their trading and investing strategies.

Buy-side firms will also need to establish appropriate clearing arrangements, sign CCP documentation relating to client clearing and establish systems to connect to clearing members and trade repositories.

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