GIBSON DUNN

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THE IMPACT OF EMIR ON FINANCIAL COUNTERPARTIES

To Our Clients and Friends:

On **16 August 2012**, The European Market Infrastructure Regulation ("**EMIR**")[1] came into force with immediate and wide-ranging consequences for firms dealing in derivatives related to or affecting the European Economic Area (**"EEA"**).[2] A wide range of entities and derivatives fall within the scope of EMIR, as discussed further below.

This note summarises the effects of EMIR specifically on **financial counterparties** and contains suggested immediate next steps for ensuring EMIR-compliance. Gibson Dunn has a separate client briefing note in relation to the impact of EMIR on non-financial counterparties.

WHAT IS EMIR?

EMIR is the European Union's ("**EU**") answer to Title VII of the US Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[3] These laws share the same origins in the 2009 G20 post-crisis reform agenda, and introduce requirements aimed at reducing counterparty risk and improving transparency within over-the-counter ("**OTC**") derivative markets. In EU terms (or EEA terms given the text has EEA relevance), this translates into extensive clearing, risk mitigation and reporting obligations for counterparties that will enter into force on a phased basis over the next couple of years.

Scope - Type of derivative

EMIR applies to all derivatives identified in Annex 1 Section C (4) to (10) of The Markets in Financial Instruments Directive ("**MiFID**").[4] This is an expansive list that includes:

- most options, futures and swaps on interest rates, securities, credit (including CFDs) and indices;
- commodity derivatives if cash settled or traded on a regulated market or MTF; and

[1] EMIR is legally binding on and directly applicable in the courts of all EEA member states, and needs no transposition into national law.

[2] This comprises of the countries within the European Union, plus Iceland, Liechtenstein and Norway.

[3] Please contact Michael Bopp and Jeffrey Steiner at Gibson Dunn for further information on Title VII of the Dodd-Frank Act.

[4] Article 2(5) EMIR.

- derivatives on underlyings such as inflation rates, freight rates, emission allowances, climatic variables, subject to certain conditions set out in MiFID.[5]

However, commodity derivatives that are strictly OTC (*i.e.*, not settled in cash, traded on a regulated market or MTF) are unlikely to fall within the scope of EMIR. Spot FX is also excluded.[6] We refer in this note to contracts that fall within the scope of EMIR as **EMIR Derivatives**.

Scope - Type of entity

EMIR applies to a wide range of firms and it categorizes such firms as follows:

- A financial counterparty ("**FC**")[7], which is an investment firm, bank, insurer, registered UCITS fund, pension fund or an alternative investment fund managed by an alternative investment manager (as defined by the applicable EU legislation authorising or regulating those entities).
- A non-financial counterparty ("**NFC**"), which is an entity established in the EEA, other than a FC, that is a party to an OTC EMIR Derivative.
- A third-country equivalent, which is an entity established outside the EEA that would have been subject to certain obligations under EMIR if established in the EEA, and that is a party to an OTC EMIR Derivative.

The treatment of NFCs under EMIR is described in another note.

It is important that FCs identify the type of counterparty they are entering into derivatives contracts with, as very different consequences flow under EMIR depending on whether the counterparty is another FC or an NFC (and, if it is an NFC, whether the NFC is above or below the clearing threshold).

EMIR OBLIGATIONS FOR FCs

In this section, we provide details of the obligations introduced by EMIR and corresponding subordinate legislation that specifically apply to FCs. The following table provides an overview of these obligations:

[5] See Annex 1 Section C (10) of MiFID.

[6] There is ongoing debate as to whether FX forwards are excluded from the scope of EMIR. Unless and until ESMA provides definitive guidance on this matter, FCs and NFCs may consider it prudent to assume that they are included.

[7] Article 2(8) EMIR.

Obligation	***Expected entry into force***
Record-keeping obligation	16 August 2012
Risk mitigation techniques	16 August 2012 /15 March 2013 / 15 September 2013
Reporting obligation	Some apply from 1 July 2013
Clearing obligation	Early-mid 2014

There is an exception to some of the obligations, which is referred to as the Intragroup Exemption. This is discussed in detail at the end of this section.

Obligation 1 - Record-keeping

From 16 August 2012, FCs have been required to keep a record of any derivative contract they have concluded, and of any modification thereto, for a period of at least five years following the termination of the contract.[8]

As a matter of prudence, and due to the 'backloading' reporting obligation, all counterparties may wish to confirm that they currently hold records sufficient to complete the minimum standards required under the reporting obligation.

Obligation 2 - Risk mitigation techniques

FCs are required to put in place certain procedures and arrangements to mitigate the risks associated with OTC derivative contracts (which are referred to as **risk mitigation techniques**).[9] The risk mitigation techniques must be observed in respect of all OTC EMIR Derivatives that are not centrally cleared. As discussed above, a contract may not need to be cleared either because it is with an NFC– or because the clearing obligation does not apply to that type of contract.

[8] Article 9(2) EMIR.

[9] Article 11 EMIR and Chapter VIII 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.

In terms of geographical scope, although the relevant technical standard ("**Technical Standard**")[10] that contains the principal obligations in relation to risk mitigation techniques only purports to place obligations on NFCs and FCs (*i.e.* entities established in the EEA), EMIR states that, as with the clearing obligation, the obligations in respect of risk mitigation techniques also apply to contracts entered into between third country entities that would be subject to those obligations if they were EEA entities, "*provided that those contracts have a direct, substantial and foreseeable effect within the Union or the obligation is necessary or appropriate to prevent the evasion of any provisions of [EMIR]*".[11] Additional legislation will be introduced to provide further guidance on the extraterritorial effect of certain aspects of EMIR, including the risk mitigation techniques.

The table in Annex A of this note sets out, in detail, the risk mitigation techniques that FCs must observe.

Obligation 3 - Reporting

Under EMIR, all counterparties and central counterparties ("**CCPs**") must ensure that details of any derivative contract are reported to a registered trade repository ("**TR**")[12] within one working day of its conclusion, modification or termination. The purpose of reporting is to ensure that information on the risks inherent in OTC derivatives markets will be centrally stored and easily accessible to ESMA, regulators and relevant central banks.

Scope of reporting obligation

- ***Derivatives***: The reporting obligation applies to all EMIR Derivatives contracts whether cleared or non-cleared, OTC or exchange-traded (including, for the avoidance of doubt, intragroup transactions).
- ***Counterparties***: "Counterparty" is not a defined term in EMIR, so it is not clear which entities will be required to comply with this obligation. This may refer to all market participants or, more narrowly, to only FCs and NFCs. Further guidance is expected.
- ***Backloading***: There is an obligation to backload data onto a TR[13] from date of entry into force of EMIR. Trades outstanding on 16 August 2012 and still outstanding on the reporting

[10] 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.

[11] Article 11(12) EMIR.

[12] Where no relevant TR is in place, a report should be made to ESMA. A counterparty will need to choose a TR that is authorised or recognised by ESMA and that accepts the type of contract that the counterparty needs to report. These trade repositories, as well as the type of contracts they accept, will be available on ESMA's website. US clients who need to report to repositories in the US under Dodd-Frank should check to see whether these repositories will be seeking "recognition" under EMIR by ESMA.

[13] This is a legal person that centrally collects and maintains records of derivatives.

start date have to be reported within 90 days of the reporting start date. Trades outstanding on 16 August 2012 or entered into thereafter but not outstanding on the reporting start date have to be reported within 3 years of the reporting start date.

Details to be reported

A technical standard setting out the minimum details of data required to be reported to TRs contains a table setting out data to be provided in respect of each counterparty, and a separate table setting out 'common data' to be provided in respect of the derivative contract itself. [14]

Cooperation and delegation encouraged to avoid duplication

EMIR encourages counterparties to cooperate in the reporting process and agree upon the 'common data' table to avoid inconsistencies. EMIR specifically states that reports should be made without duplication and permits one counterparty, or a CCP, to report on behalf of both counterparties to the trade, or indeed for the reporting duty to be delegated to a third party. In all cases, however, the original counterparty or CCP subject to the reporting obligation remains legally responsible for ensuring the reporting obligation is met.

Timetable for reporting obligation

The reporting obligation is expected to come into effect on 1 July 2013 for credit and interest rate derivatives, provided a TR has been registered for that particular derivative before 1 April 2013, or 90 days after registration of the TR.

For other types of derivative, the reporting obligation would come into effect on 1 January 2014 if the relevant TR has been registered by 1 October 2013. If no TR has been registered for that particular derivative before 1 October 2013, the obligation will come into effect 90 days after the registration of any such TR.

In both cases, there is a long stop date of 1 July 2015 for reporting directly to ESMA derivatives for which a TR is still not available.

Obligation 4 - Clearing

The clearing obligation, which is expected to enter into force in early 2014, [15] will require FCs (as well as NFC above the clearing threshold) to clear all OTC EMIR Derivatives that are

[14] It will not be necessary to send copies of each derivative contract entered into to authorised/recognised TRs.

identified by the European Commission as "eligible" for clearing through CCPs. The concept of an "eligible" EMIR Derivative is discussed below.

Rationale of reducing risk

CCPs are regulated financial institutions, and will be subject to stringent prudential and risk management requirements under EMIR. [16] By interposing CCPs in bilateral trades, counterparties will be 'insulated' from one another with the CCP alone bearing the counterparty risk. This regime is intended to reduce systemic risk and contagion in OTC derivatives markets generally, and to improve oversight and transparency for financial authorities. CCPs can also assist in reducing counterparties' credit exposure through the use of multilateral netting. [17]

Scope of clearing obligation

The clearing obligation applies to "eligible" OTC EMIR Derivatives entered into between:

- two FCs;
- an FC and an NFC+;
- two NFCs+;
- an FC or an NFC+ (or third-country equivalent of an FC or NFC+); or
- two entities established in one or more third countries that would be subject to mandatory clearing obligations if they were EEA entities, provided that the EMIR Derivative that they have entered into has "*a direct, substantial and foreseeable effect within the Union*", or the obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR. [18]

It follows that EMIR Derivatives with an NFC below the clearing threshold are not required to be cleared, even where the other counterparty is an FC or an NFC above the clearing threshold.

[15] Note that before the clearing obligation procedure can begin, CCPs must first be authorised (or recognised in case of a CCP from a third country) to clear under the new EMIR regime, and the list of "eligible" derivatives defined.

[16] Including capital and margin requirements and liquidity risk controls. CCPs are dealt with at Articles 14 to 54 EMIR.

[17] Multilateral netting does not itself remove credit risk, but reduces credit exposure between participants to the extent that it reduces the number and size of each party's transactions.

[18] The technical standards specifying the contracts that have a direct, substantial and foreseeable effect within the EU and the cases where it is necessary or appropriate to prevent evasion of EMIR are still under review and have not yet been published.

“Eligible” EMIR Derivatives traded OTC

The clearing obligation will only apply to those classes of EMIR Derivatives that a CCP has been authorised or recognised to clear and that ESMA has determined should be cleared. ESMA can also identify derivatives for clearing in circumstances where no CCP currently clears them.

Once the clearing obligation is declared to apply to a particular class of EMIR Derivatives traded OTC, it will apply to each transaction within that class entered into either (i) on or after the date which ESMA has established as the effective date for the obligation to clear that class; or (ii) on or after the (earlier) date on which ESMA receives notification from a national regulator that a CCP has become authorised to clear that derivatives class.

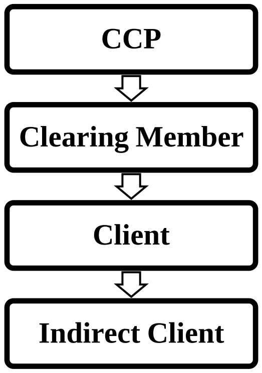
In accordance with Article 6 of EMIR, ESMA must establish and maintain a public register (which it shall publish on its website) identifying those classes of OTC derivatives subject to clearing. Identification of “eligible” EMIR Derivatives traded OTC will follow a two-fold approach:

- ***Top down***: ESMA can identify certain derivatives contracts to be cleared by an authorised CCP. Relevant factors include standardization of contracts, liquidity and reliability of available pricing. The effective date from which clearing is mandatory will be determined by the expected volume and the ability for CCPs to manage the volume.
- ***Bottom up***: Competent authorities of each member state must notify ESMA of contracts authorized for clearing in their member state. ESMA will then determine whether to require mandatory clearing of such contracts in all member states.

Indirect clearing

EMIR requires CCPs to impose strict requirements on market participants wishing to use their clearing services in order to ensure that CCPs can maintain their high levels of financial soundness. Typically, however, counterparties subject to the clearing obligation will be unable or unwilling to meet these CCP criteria. In such cases, EMIR provides for indirect clearing via the services of a CCP’s existing clearing member.

The Technical Standard defines an indirect clearing arrangement as "*the set of contractual relationships between the CCP, the clearing member, the client of a clearing member and the indirect client that allows the client of the clearing member to provide clearing services to an indirect client*".



The indirect client may clear its transactions provided that the arrangements do not increase counterparty risk and provided that it ensures that the assets and positions of the counterparty benefit from the protection enshrined in Articles 39 (account segregation and portability) and 48 (procedures on default of a clearing member) of EMIR.

The relevant technical standards only permit indirect clearing to take place where:

- the client of the clearing member is an authorised credit institution, investment firm or an equivalent third country credit institution or investment firm;
- the contractual terms of the indirect clearing arrangement have been agreed between the client of the clearing member and the indirect client following consultation with the clearing member on matters which may impact the clearing member's operations. The client must be contractually obliged to honour all obligations of the indirect client towards the clearing member;
- each of the CCP, clearing member and client maintains separate records and accounts to enable the client to distinguish its assets and positions from those held for an indirect client; and
- a clearing member has robust procedures in place to manage the default of a client that provides indirect clearing services. These procedures must include a credible mechanism for transferring an indirect client's positions and assets to an alternative client or clearing member.

Intragroup Exemption

EMIR permits intragroup transactions (described in Article 3 of EMIR) to qualify for exemptions from the clearing obligation[19] and specific risk mitigation techniques[20] when certain conditions are met. In particular:

- An FC wishing to use the ***clearing exemption*** for transactions with ***an affiliate established in the EEA*** must notify its relevant local regulator;
- An FC wishing to use the ***clearing exemption*** for transactions with ***an affiliate established outside of the EEA*** must first apply to its relevant local regulator;
- an FC wishing to use the exemption from ***margin requirements*** for transactions with ***an affiliate established in the same country*** may do so, provided that there is no legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties;

[19] Article 4(2) EMIR.

[20] Articles 11(4) to (10) EMIR.

- in all other instances, ***an FC wishing to use the exemption from margin requirements*** for transactions ***with an affiliate (either established in the EEA or a third country)*** will need to notify, or seek the prior approval of, its local relevant regulator.[21]

The relevant criteria is essentially that:

- the risk management procedures of the counterparties are adequately sound, robust, and consistent with the level of complexity of the transactions; and
- there is no current or foreseeable practical or legal impediment to the prompt transfer of own funds and or repayment of liabilities between counterparties.

As mentioned above, although qualifying intragroup transactions may no longer be subject to clearing and certain risk mitigation techniques if the intragroup exemption applies, they will still be subject to the reporting obligation.

PENALTIES

EMIR provides that Member States must lay down penalties applicable to infringements of EMIR. The penalties must be effective, proportionate and dissuasive and include at least administrative fines. An infringement of EMIR will not affect the validity or enforceability of an OTC derivative contract, nor will it give rise to any right of compensation from a counterparty. We await details of such penalties from local relevant regulators, including the FSA.

[21] We await additional guidance on the notification process.

RISK MITIGATION TECHNIQUES

	What?	***When?***	***How?***
A	***Timely confirmation[22] - Implementation date: 15 March 2013[23]***		
	FCs must confirm trades by set deadlines. Confirmation is defined as the documentation of the agreement of the counterparties to all the terms of the OTC derivative contract[24] (*Requirement 1)*. FCs must implement a procedure to report the number of unconfirmed OTC derivate contracts that have been outstanding for more than five business days to their relevant local regulator (*e.g.*, the FSA in the UK) (*Requirement 2)*.	*Requirement 1*: As soon as possible and at the latest: -for CDS/IRS with an NFC–: T+5 until 31 August 2013, then T+3 until 31 August 2014, then T+2 -for other types of contracts with an NFC–: T+7 until 31 August 2014, then T+4 until 31 August 2014, then T+2 - for CDS/IRS between FCs/NFCs+: T+2 until 28 February 2014, then T+1 -for other types of contracts between FCs/NFCs+: T+3 until 31 August 2013, then T+2 until 31 August 2014, then T+1 (*n.b.*, If a transaction is concluded after 16.00 local time, or with a counterparty located in a different time zone which does not allow confirmation by the set deadline, the counterparties may enjoy a one business day extension.)	Confirmation should be by electronic means, where available. In terms of documenting the requirements, ISDA has released standard form wording.[25]

[22] Article 12 Technical Standard.

[23] Article 21 Technical Standard.

[24] Article 1(c) Technical Standard.

[25] See http://www2.isda.org/functional-areas/protocol-management/protocol/11.

RISK MITIGATION TECHNIQUES			
	What?	***When?***	***How?***
		Requirement 2: Monthly reporting required	
B	***Portfolio reconciliation[26] - Implementation date: 15 September 2013[27]***		
	FCs must: - agree in writing or other electronic means with each of its other counterparties to the arrangements under which portfolios shall be reconciled (*Requirement 1*); and - perform portfolio reconciliation on the key trade terms that identify each particular OTC derivative contract (including the mark-to-market / mark-to-model valuation[28]) (*Requirement 2*). It should be noted that portfolio reconciliation is not currently defined in EMIR or the Technical Standard.	*Requirement 1*: Before entering into the OTC derivative contract *Requirement 2*: For an FC or NFC+, portfolio reconciliation must be performed at least: -daily if the counterparties have 500+ OTC derivative contracts outstanding with one another; -weekly if the number of outstanding contracts is between 51 and 499; or -quarterly if the number of outstanding contracts is 50 or less. For an NFC−, portfolio reconciliation must be performed at least: -quarterly if the counterparties have more than 100 OTC derivative contracts outstanding with one another; or -annually if the number of outstanding	*Requirement 1*: ISDA is set to release guidance/standard wording in relation to this risk mitigation technique. *Requirement 2*: This process may be outsourced to a duly qualified third party.

[26] Article 13 Technical Standard.
[27] Article 21 Technical Standard.
[28] See section E below.

RISK MITIGATION TECHNIQUES

	What?	***When?***	***How?***
		contracts is 100 or less.	
C	***Portfolio compression[29] - Implementation date: 15 September 2013[30]***		
	If it has 500 or more OTC derivative contracts outstanding with a single counterparty, an FC must have in place procedures to analyse the possibility of conducting a portfolio compression exercise in order to reduce its counterparty credit risk and engage in such portfolio compression exercise if warranted (*Requirement 1*). All NFCs must ensure that they are able to provide a reasonable and valid explanation to their relevant local regulator for concluding that a portfolio compression exercise is not appropriate (*Requirement 2*).	*Requirement 1*: At least bi-annually *Requirement 2*: Ongoing	ISDA is set to release guidance/standard wording in relation to this risk mitigation technique.
D	***Dispute Resolution[31] – Implementation date: 15 September 2013[32]***		
	FCs must agree to maintain detailed procedures and processes in relation to: -the identification, recording, and monitoring of disputes relating to the recognition or valuation of the contract and to the exchange of collateral between counterparties (the procedures must at least record the length of time for which the	*Requirement 1*: When concluding an OTC derivative contract with another counterparty *Requirement 2*: Ongoing	ISDA is set to release guidance/standard wording in relation to this risk mitigation technique.

[29] Article 14 Technical Standard.
[30] Article 21 Technical Standard.
[31] Article 15 Technical Standard.
[32] Article 21 Technical Standard.

	RISK MITIGATION TECHNIQUES		
	What?	***When?***	***How?***
	dispute remains outstanding, the counterparty and the amount which is disputed); and -the resolution of disputes in a timely manner with a specific process for those disputes that are not resolved within five business days (*Requirement 1*). FCs must report to their relevant local regulator any disputes between counterparties relating to an OTC derivative contract, its valuation or the exchange of collateral for an amount or a value higher than EUR 15 million and outstanding for at least 15 business days (*Requirement 2*).		
E	***Mark-to-Market (or-Model)*** [33] ***– In force from 16 August 2012***[34]		
	FCs must mark-to-market the value of outstanding contracts. Where market conditions prevent marking-to-market[35], reliable and prudent marking-to-model shall be used.	Exercise to be undertaken daily on an ongoing basis.	The Technical Standard sets out specific criteria in relation to models for marking-to-model.[36]
F	***Segregated Exchange of Collateral***[37] ***– In force from 16 August 2012***[38]		
	FCs must implement and maintain procedures for the timely, accurate and appropriate segregated	Ongoing requirement	The precise level and exact type of collateral to be exchanged will be

[33] Article 11(2) EMIR.

[34] Article 91 EMIR.

[35] The circumstances in which marking to model is acceptable are set out in Article 16 of the Technical Standard.

[36] Article 17 Technical Standard.

[37] Article 11(3) and (4) EMIR.

[38] Article 91 EMIR.

RISK MITIGATION TECHNIQUES			
	What?	***When?***	***How?***
	exchange of collateral, other than in respect of certain intragroup transactions[39] (*Requirement 1*). FCs shall hold an appropriate and proportionate amount of capital to manage the risk not covered by appropriate exchange of collateral (*Requirement 2*).		specified by further subordinate legislation, which is not due to come into force until next year. Until then, counterparties have the freedom to apply their own rules on collateral.[40]

[39] Article 3, Article 11(5) and Article 11(6) of EMIR. The exemption is discussed in the *Intragroup Exemption* section above.

[40] See ESMA's EMIR: Frequently Asked Questions (Updated: 08 February 2013).