Financial Services 2 October 2012

EMEA Centre for Regulatory Strategy

European Market and Financial Infrastructure Regulation (EMIR)

The jigsaw is nearly complete

The next milestone has passed in the EU's long journey to implement the G20 commitment to reform OTC derivative markets.

Both the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) have passed their proposed EMIR implementing rules - the binding technical standards - to the EU Commission for their anticipated adoption by the end of this year. In practical terms this means that firms now have a much higher degree of clarity and should be stepping up their implementation plans ahead of the looming compliance dates.

The recently published requirements span the following important areas:

- the requirements that will be placed on firms which offer client clearing;
- what constitutes eligible collateral for margin payments;
- the levels of capital that central counterparties (CCPs) will need to hold;
- the exact information that will need to be reported to a trade repository;
- the details of how and when firms should perform risk mitigation techniques such as portfolio reconciliation and compression; and
- the thresholds for determining whether non-financial firms will need to clear and exchange margins for derivative trades.

These reforms will radically transform how OTC derivatives are risk managed and reported. Every participant will be affected in some shape or form. They come at a time of vast regulatory change where business resources are already very stretched. Firms in the process of implementing the US requirements under Title VII of the Dodd-Frank Act should look to leverage the synergies between the two pieces of regulation where possible.

Areas of change

Many of the areas covered do not differ significantly from the June consultation papers but some areas have been revised; in some areas materially. This is largely a helpful development for firms as the authorities seek to take on board issues raised during the consultation process.

Three significant developments are:

1. **Indirect clearing** : This is essentially the set of requirements which the Regulation places on a clearing member in relation to the clients of their clients. The initial proposals from ESMA were extremely burdensome and were widely opposed by the industry. On reflection ESMA has made some helpful amendments and clearing members will no longer be required to provide indirect clearing. Even more significantly, clearing members will no longer be required to manage the positions of a defaulted indirect client for a period of at least 30 days. Instead, the new proposals require clearing members to have robust procedures in place to manage t he defa ult of a client that provides indirect clearing including transferring positions to another clearing member. The segregation requirements are unchanged. Overall these developments should be viewed positively by the industry.
2. **Capital requirements for CCPs** : These have also been modified. This will be welcome news not only for CCPs but also their members who would almost have certainly borne some of the costs arising from the proposals. Specifically, a CCP must hold an additional 25% of its minimum capital requirements as a contribution to the CCP's default waterfall, the so-called 'skin in the game'. This has significantly reduced from the initially proposed 50% requirement but nevertheless points to a step change in the way CCPs are capitalised. CCPs will also need to hold capital equal to the value of operational wind-down expenses for a minimum period of six months, lowered from the initial 12 month proposal .
3. **Trade reporting** : The data fields and format remain largely unchanged but there have been some helpful developments. In particular trade reporting requirements will now be phased in and will initially apply to interest rate and credit derivatives. Other asset classes will follow six months later. Compliance start dates have also been extended (90 days after the registration of a trade repository as opposed to 60 days) as too has the deadline for back-loading historical contracts (now three years). Firms will also have an additional six months to report information on collateral. Overall a number of helpful developments which recognise some of the challenges these wide-ranging reporting requirements will bring.

What do firms need to do now?

The proposed technical standards now give firms enough clarity to take action to get ready for EMIR compliance.

Specifically firms should be thinking about:

- **Clearing**: Which parts of the derivatives book are likely to be subject to clearing requirements; making sure the necessary arrangements are in place to access the clearing house/s; the practical challenges around segregation requirements; consideration of the intra-group exemption; analysis of treasury demands from meeting initial and variation margin requirements.
- **Reporting**: Establishing connectivity to trade repositories; identifying data sources; planning around user-acceptance testing; consideration of data protection issues.
- **Non-cleared derivatives**: Roll-out of collateralisation programmes; review operational arrangements to meet confirmation, reconciliation and compression requirements; ensure daily mark to market capabilities.
- **Business conduct**: Wide ranging documentation review including existing ISDA agreements; compliance

check on record keeping requirements.

But there is still more to come….

There is, though, still a gaping hole in the package of requirements. Firms are still lacking clarity as to the exact shape and form of the margins for non-cleared derivative transactions. Here firms will need to await the outcome of the work from the Basel Committee and IOSCO (the International Organisation of Securities Commissions), expected later in the year, and then a further consultation from the European Supervisory Authorities (ESAs) to be in a position to fully implement the requirements for non-cleared trades.

There is also still some ambiguity for firms which operate both inside and outside of the EU. The ESMA consultation on how the EMIR requirements will dovetail with corresponding requirements in other jurisdictions is outstanding and the subject of much conjecture. Further developments in this area are expected shortly.

What happens next?

The EU Commission will now conduct its own analysis of the ESAs' recommendations and has three months to decide whether to endorse the proposed draft technical standards. This is by no means a certainty and firms who fall under the remit of the Alternative Investment Fund Manager Directive will know first-hand that this is not a foregone conclusion.

The timeline for implementation is complex with requirements kicking in throughout next year.

Please click here for a detailed summary of the key EMIR requirements as well as a detailed overview of compliance dates.

Please see our website for further information on the **EMEA Centre for Regulatory Strategy** or on the **European Market and Financial Infrastructure Regulation (EMIR)**.

Best regards,

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