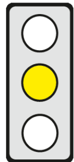
DERIVATIVE RULES (EMIR)

cep**PolicyBrief** No. 23/2017

KEY ISSUES

Objective of the Regulation: The Commission wants to simplify the rules in the EMIR Regulation particularly those relating to over-the-counter (OTC) derivatives.

Affected parties: Counterparties in derivative transactions, central counterparties (CCPs), trade repositories.



Pro: (1) The easing of the clearing obligations for counterparties that only undertake limited derivative transactions is appropriate because these do not represent a serious threat to the stability of the financial markets.

(2) Simplifying the reporting obligations reduces red tape.

Contra: (1) The requirement for clearing members and their clients to comply with "fair, reasonable and non-discriminatory" terms is an unnecessary intervention in the freedom of contract.

(2) Pension funds should, in principle, be subject to the clearing obligation for OTC derivatives. A final transition phase for the clearing obligation is justifiable but the Commission's ability to extend the exemption in the future should be rejected because it distorts competition.

(3) The planned double reporting requirement for the party subject to the reporting obligation is unnecessarily bureaucratic.

CONTENT

Title

Proposal COM(2017) 208 of 4 May 2017 for a **Regulation** of the European Parliament and of the Council **amending** Regulation (EU) No 648/2012 **as regards the clearing obligation**, the suspension of the clearing obligation, **the reporting requirements**, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories **and** the requirements for **trade repositories**

Brief Summary

- **Context, definitions and objectives**
  - Under the EMIR Regulation [European Market Infrastructure Regulation, (EU) 648/2012, s. cep**PolicyBrief**] (Explanatory Memorandum p. 2)
    - the categories of over-the-counter derivatives ("OTC derivatives") specified by the Commission must be "cleared" through central counterparties (CCPs),
    - all OTC and all other derivative contracts must be reported to trade repositories.
  - Derivatives are finance products whose value is derived from an underlying instrument. They serve for example to secure interest and exchange rate risks or are used for the purpose of speculation.
  - CCPs are companies that position themselves between the counterparties of a derivatives contract and reduce the risks for the counterparties. They act for the purchaser as the seller and for the seller as the purchaser. Examples of CCPs are Eurex Clearing AG in Frankfurt and LCH.Clearnet in London.
  - According to the Commission, the EMIR Regulation has largely proven to be a success. The Commission nevertheless wants to "simplify the rules and make them more proportionate" and therefore proposes, inter alia, changes to the clearing obligation as regards access to clearing, transparency, reporting obligations and supervision of trade repositories. (Explanatory Memorandum p. 2-4)

- **Changes to the clearing obligation**

  Non-financial counterparties
  - As before, "non-financial counterparties" - companies outside the finance sector - only have to clear the categories of OTC derivatives specified by the Commission through a CCP where their volume exceeds a clearing threshold (Art. 10 (1)).
  - In future, the threshold will be calculated once a year based on the average volume for the months of March, April and May. Until now, the rolling average position over a period of 30 working days had to be calculated continuously. (Art. 10 (1))
  - Non-financial counterparties will, in future, only have to clear the OTC derivatives of those categories whose clearing threshold they exceed. Until now, exceeding the clearing threshold of a single category would trigger the general clearing obligation for all categories of OTC derivatives specified by the Commission. (Art. 10 (1))

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Financial counterparties

– Until now, "financial counterparties" meant banks, investment firms, insurance companies, reinsurance companies, certain investment funds and institutions for occupational retirement provision. In future it will also include, inter alia, companies which (Art. 2, No. 8)
  - hold and transfer securities ("central securities depositories"),
  - have been set up to carry out securitisation ("securitisation special purpose entities").
– Until now, financial counterparties - irrespective of the derivative volume - have always been obliged to clear all categories of OTC derivatives specified by the Commission. In future, they will only be obliged to do so where they exceed one of the clearing thresholds applicable to non-financial counterparties. Here too, the thresholds will in future be calculated as the average for the months of March to May. (Art. 4 (1) (a) in conjunction with Art. 10 (4) (b))
– As before, exceeding the clearing threshold of a single category will trigger the general clearing obligation for all categories of OTC derivatives specified by the Commission (Art. 4a (1) (b)).

Exemptions for pension funds

– The exemption from the clearing obligation applicable to pension funds that use OTC derivative contracts to reduce investment risks, valid until 16 August 2018, will be extended to three years from entry into force of the Regulation (Art. 89 (1)).
– One year before the expiry of this exemption, the Commission must report on progress in the development of technical solutions which allow pension funds to pay cash and non-cash collateral as additional initial margin to the CCPs (Art. 85 (2)).
– Where no progress can be seen, the Commission may adopt a delegated act to extend the exemption once, by two further years (Art. 85 (2)).

Suspension of the clearing obligation

– Until now, the clearing obligation could be suspended by amending the regulatory technical standards. The European Parliament and Council can block such a change. (Art. 4 and 5)
– In future, the EU Securities and Markets Authority (ESMA) will be able to call for a suspension of the clearing obligation for certain categories of OTC derivatives or certain types of counterparties where (new Art. 6b (1))
  - the derivative category is no longer suitable for central clearing, inter alia due to low liquidity, or
  - a CCP is "likely" to cease clearing that specific class of derivative and no other CCP is available as adequate replacement or
  - this is necessary and proportionate to avoid a "serious threat" to financial stability.
– The Commission decides within 48 hours whether to comply with the ESMA's request. It may in principle, by Decision, suspend clearing obligations for three months in each case up to a maximum of 12 months. (Art. 6b (3), (5) and (6))

► **Access to clearing at fair, reasonable and non-discriminatory conditions**

– Where companies that are connected to a CCP ("clearing members") or their clients offer clearing services, directly or indirectly, to other counterparties, in future they will have to do so under "fair, reasonable and non-discriminatory" conditions ("FRAND conditions") (Art. 4 (3a)).
– The Commission can adopt delegated acts in this regard (Art. 4 (3a)).

► **Transparency regarding level of additional initial margin**

– Additional initial margin serves as a safeguard for the CCPs against default by the counterparties or to even out daily profits and losses.
– In future, CCPs will have to provide their clearing members with (Art. 38 (6)):
  - "simulation tools" allowing members to gain a non-binding idea of the amount of additional initial margin prior to the clearing of a new transaction and
  - information on the models used to determine the initial margin.

► **Reporting requirements and quality of reported data**

– CCPs and counterparties must report the details of any derivative contracts to a trade repository which (Art. 9 (1))
  - were entered into on or before 12 February 2014 or
  - were entered into before 12 February 2014 but remain outstanding on that date.

  16 August 2012 is the current reporting date.
– In future, the reporting obligation will no longer apply to intragroup transactions where one of the counterparties is a non-financial counterparty (Art. 9 (1)).
– In future, responsibility for reporting will lie with (Recital 13-15, Art. 9 (1a))
  - the CCPs on behalf of both counterparties in the case of exchange-traded derivative contracts,
  - the financial counter-party on behalf of the both counterparties in the case of OTC derivative contracts concluded with a non-financial counterparty that is not subject to clearing obligations,
  - the management company on behalf of the investment fund where such investment fund is party to the OTC derivative contract.

– In all other cases, both counterparties to a contract are subject to reporting obligations (Art. 9).
– In future, the trade repositories must establish procedures (Art. 78 (9) and (10))
  - for the "effective" reconciliation of data between different trade repositories,
  - to ensure the completeness and accuracy of the reported data and
  - for the transfer of reported data to other trade repositories where requested by a CCP or a counterparty, e.g. because it wants to use another trade repository.
– As before, CCPs and counterparties can delegate reporting to the trade repositories to third parties (Art. 9 (1a sub-para. 2)). In future, the trade repositories will have to inform CCPs and the counterparties of the data reported by third parties (Art. 81 (3a)).

► **Supervision of trade repositories**
– As before, trade repositories must be registered with ESMA (Art. 55 and 56). In future, where they are already registered under the Regulation on securities financing transactions [Regulation (EU) 2015/2365, see cep**PolicyBrief**], they will only need a simplified extended registration (Art. 56 (1) (b).
– Relevant authorities of third countries - such as USA - in which trade repositories are established, will have direct access to information in trade repositories in the EU provided the Commission has agreed to this in an implementing act (Art. 76a).
– Access will only be granted to authorities of third countries where (Art. 76a)
  - trade repositories established there are duly authorised and effectively supervised,
  - guarantees for the protection of business secrets exist and
  - the trade repositories are subject to a legally binding obligation to grant the EU access to their transaction data.

Statement on subsidiarity by the Commission

According to the Commission, greater standardisation of OTC derivative contracts, improving the transparency of the contracts and the reduction of risks cannot be achieved by the Member States alone.

Policy Context

In 2012, in order to remedy defects in the regulation of the trade in over-the-counter derivatives, the EU passed the EMIR Regulation (EU) 648/2012 (see cep**PolicyBrief**). In 2015, the Commission carried out an evaluation and a consultation on this Regulation. In November 2016, it submitted a report on this and included the assessment of the Regulation in the REFIT Program, which aims to ensure the efficiency and effectiveness of legislation. Also in November 2016, the Commission submitted a proposal for a Regulation to amend EMIR provisions on the recovery and resolution of CCPs [COM(2016) 856]. In June 2017, prompted by Brexit, it also submitted a proposal on the future supervision of CCPs based in third countries [COM(2017) 331].

Legislative Procedure

4 May 2017	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	DG Financial Stability, Financial Services and Capital Markets Union (leading)
Committees of the European Parliament:	Economic and Monetary Affairs, Rapporteur: Werner Langen (EPP - European People's Party)
Federal Ministries:	Federal Finance Ministry (leading)
Committees of the German Bundestag:	Finance (leading);
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Competence:	Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (ordinary legislative procedure)

Economic Impact Assessment

Ordoliberal Assessment

Clearing derivative contracts through CCPs can minimise the default risk for the counterparties involved by compensating numerous reciprocal claims. This also strengthens the stability of the financial markets. **The easing of the clearing obligation** now proposed by the Commission both **for** financial and non-financial **counterparties that** in each case **only undertake limited derivative transactions, is** nevertheless **appropriate because these do not represent a serious threat to the stability of the financial markets**, which would otherwise justify the costs of a comprehensive clearing obligation**.**

The change in the procedure for calculating the clearing threshold, from a continuous year-long procedure to a three-month cycle from March to May, further reduces the costs for the counterparties. However, the proposed methods run the risk of allowing regulatory arbitrage by shifting the time of derivative contracts. The average monthly derivative volume should therefore by calculated once a year. In any case, the regulatory authorities should take account of the said risk when analysing the reported contracts.

Pension funds should, in principle, be subject to the clearing obligation for OTC derivatives. A final transition phase for the application of the **clearing obligation** for pension funds **is justifiable** due to their structure – hardly any liquid funds for initial margin – **but it distorts competition** to the detriment of other market operators who meet the clearing obligations and thus have to bear higher costs. It is therefore essential that the pressure to find solutions to the problem is maintained. **The Commission's ability to extend the exemption in the future should be rejected.**

The existing procedure for suspending the clearing obligation - by amending regulatory technical standards - is time consuming and takes too long in a crisis situation. The fact that, in the future, it will be possible to suspend the clearing obligation more quickly for individual categories of OTC derivatives, is necessary for the stability of the financial markets. This decision should however be made not by the Commission but by ESMA as independent regulatory authority. In addition the legislator needs to specify the requirements for suspension more clearly in order to prevent a weakening of the clearing obligation which normally promotes stability.

The blanket **requirement for clearing members and their clients, as providers of clearing services, to comply with** "**fair, reasonable and non-discriminatory**" **terms** should be rejected. It **is an unnecessary intervention in the freedom of contract** because access to clearing services at competitive prices is also, at least potentially, possible for smaller market operators since there is large number of clearing members and their clients as well as direct clearing access via the CCP.

Simplifying the reporting obligations reduces red tape, for counterparties that are exempt from the reporting requirements, without withholding key information about the derivatives markets from the regulatory authorities. Reports made by only one party – a CCP or a financial counterparty – on behalf of both counterparties, may even increase the quality of the underlying data because the current – bilateral – reports often diverge due to varying standards, formats and forms. **The planned double reporting requirement for the party subject to the reporting obligation is** however **unnecessarily bureaucratic.** This should be left out.

Penalties for deliberately incorrect reports – that are less easy to detect where only one party is reporting – **could prevent the risk of a reduction in data quality.**

Legal Assessment

Legislative Competency

The measures facilitate the functioning of the internal financial services market. The applicable basis for legislative competency is therefore Art. 114 TFEU.

Subsidiarity.

Unproblematic.

Proportionality with respect to Member States

Unproblematic.

Impact on German Law

Unproblematic.

Conclusion

The easing of the clearing obligation for counterparties that only undertake limited derivative transactions is appropriate because these do not represent a serious threat to the stability of the financial markets. Pension funds should, in principle, be subject to the clearing obligation for OTC derivatives. A final transition phase for the clearing obligation is justifiable but the Commission's ability to extend the exemption in the future should be rejected because it distorts competition. The requirement that clearing members and their clients, as providers of clearing services, have to comply with "fair, reasonable and non-discriminatory terms", is an unnecessary intervention in the freedom of contract. Simplifying the reporting obligation reduces red tape. The planned double reporting requirement for the party subject to the reporting obligation is unnecessarily bureaucratic. Penalties for deliberately incorrect reports could prevent the risk of a reduction in data quality.

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