

EMIR: A Primer for Non-Financial Counterparties Using Derivatives

NFCs face a number of reporting, risk mitigation and clearing deadlines from the European Market Infrastructure Regulation.

The purpose of the European Market Infrastructure Regulation (EMIR¹) is to increase transparency and reduce systemic risks associated with the derivatives markets. EMIR applies to various market participants; this summary sets out the application of EMIR specifically to non-financial counterparties.

This *Client Alert* highlights various considerations a non-financial counterparty should take into account when determining whether it is obliged to clear, report and/or engage in certain risk mitigation techniques regarding derivatives entered into.

This *Client Alert* also includes a table setting out key dates for compliance with these EMIR obligations.

What is a non-financial counterparty (an NFC)?

An NFC is an undertaking established in the European Union other than:

- A legal person that interposes itself between the counterparties to the contracts traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer (a CCP)
- An investment firm authorised in accordance with Directive 2004/39/EC (MiFID)
- A credit institution authorised in accordance with Directive 2006/48/EC (CRD)
- An insurance undertaking authorised in accordance with Directive 73/239/EEC (First Non-Life Insurance Directive)
- An assurance undertaking authorised in accordance with Directive 2002/83/EC (Recast Life Assurance Directive)
- A reinsurance undertaking authorised in accordance with Directive 2005/68/EC (Reinsurance Directive)
- A UCITS and, where relevant, its management company, authorised in accordance with Directive 2009/65/EC (UCITS Directive)
- An institution for occupational retirement provision within the meaning of Article 6(a) of Directive 2003/41/EC (IORP Directive)
- An alternative investment fund managed by alternative investment fund managers authorized or registered in accordance with Directive 2011/61/EU (AIFMD) (a financial counterparty)²

Even if an entity is not established in the European Union, it is worth noting that certain provisions of EMIR may still apply if it enters into a derivative contract with another entity that qualifies as an NFC, or a financial counterparty, or in a scenario that could be considered as an artificial arrangement captured by

the proposed anti-evasion rules. A first draft of these anti-evasion rules has been issued by the European Securities and Markets Authority (ESMA) which is the subject of a separate *Client Alert*³.

To which contracts does EMIR apply?

Some of the EMIR requirements (such as clearing and the risk mitigation techniques) apply only to “OTC derivative contracts”. The reporting obligation, however, applies to “any derivative contract”.

- ‘derivative’ or ‘derivative contract’ means a financial instrument as set out in MiFID under points (4) to (10) of Section C of Annex I⁴.
- ‘OTC derivative contract’ means a derivative contract the execution of which does not take place on a regulated market as within the meaning of Article 4(1)(14) of MiFID, or on a third- country market considered as equivalent to a regulated market in accordance with Article 19(6) of MiFID⁵.

Neither the definition of “OTC derivative contract” nor the definition of “derivative contract”, as set out above, was created specifically for EMIR. The substance of these definitions has been borrowed from MiFID and covers, by way of an example, foreign exchange (FX) forwards, interest rate swaps, cross-currency swaps, commodity futures, credit default swaps, total return swaps, options, and a number of other derivative instruments that non-financial entities regularly use to manage risks relating to their commercial activities and treasury transactions. The substance of these definitions does not, however, cover FX spot transactions, stock loans and repurchase agreements.

In the future NFCs may be required to trade in certain derivatives that currently fall within the definition of OTC derivative contract on a regulated trading venue. EU legislation proposing such requirement is currently in draft form⁶.

NFC clearing threshold conditions set out in Article 10 of EMIR

An NFC will be classified as an NFC+ if all OTC derivative contracts entered into by it and/or other NFC(s) within its group — but excluding in each case OTC derivatives objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the NFC or of that group — exceed the relevant clearing threshold, provided the rolling average position over 30 working days also exceeds the threshold.

An NFC must only exceed one clearing threshold to become an NFC+.

If an NFC+ demonstrates to its competent authority that its rolling average position over 30 working days no longer exceeds the clearing threshold, it will no longer be considered an NFC+⁷.

The gross notional value clearing thresholds are as follows:

- EUR 1 billion for OTC credit derivative contracts
- EUR 1 billion for OTC equity derivative contracts
- EUR 3 billion for OTC interest rate derivative contracts
- EUR 3 billion for OTC foreign exchange derivative contracts
- EUR 3 billion for OTC commodity derivative contracts and other OTC derivative contracts not provided for under points (a) to (d)⁸

What obligations does EMIR impose on an NFC (and additionally on an NFC+)?

Reporting

By the reporting start date (currently expected to be 1 January 2014), all counterparties (as well as CCPs) must report to a trade repository the details of outstanding derivative contracts entered into on or after 16 August 2012⁹.

By 90 days following the reporting start date outstanding derivative contracts entered into before 16 August 2012 must also be reported.

If a derivative contract was (i) entered into before 16 August 2012 and was outstanding on 16 August 2012; or (ii) entered into on or after 16 August 2012, but is not outstanding on the reporting start date, the deadline is 3 years following the reporting start date.

The deadline for reporting derivative contracts concluded, modified or terminated after the reporting start date is the working day immediately following the date of such entry into, modification or termination of the derivative contract. The term "modification" is likely to be interpreted fairly widely.

Reporting may be delegated. It is likely that many financial counterparties will offer a form of reporting.

In addition to reporting, counterparties must keep their own record of any derivative contract they have concluded, and any modification to such derivative contract, for at least five years following the termination of the contract¹⁰.

Risk Mitigation for uncleared OTC derivative contracts

NFCs that enter into an uncleared OTC derivative contract must comply with the following risk mitigation techniques. It is worth noting that a written agreement is only required for portfolio reconciliation and not for the other risk mitigation techniques highlighted below. Where this (or any other) risk mitigation technique is agreed to within a derivative contract, an NFC should consider the consequences on termination provisions, and may wish to carve out failure to comply with risk mitigation techniques from the termination provisions (as is done in the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol, mentioned further below).

Timely confirmation

Confirmation, where available, by electronic means, must be entered into within the following number of business days from the date of execution of the derivative transaction (NFC+s need to comply with the shorter deadlines set out in the second table below)¹¹.

OTC Derivative type	Interim period		Final deadline
	To and including 31 August 2013	From 31 August 2013 to and including 31 August 2014	From 31 August 2014
Credit default and interest rate derivatives	5	3	2

All other derivatives	7	4	2
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NFC+s must comply with the following, stricter deadlines¹².

OTC Derivative type	Interim period		Final deadline
Credit default and interest rate derivatives	To and including 28 February 2014: 2		From 28 February 2014: 1
All other derivatives	To and including 31 August 2013: 3	From 31 August 2013 to and including 31 August 2014: 2	From 31 August 2014: 1

Portfolio reconciliation

Arrangements for portfolio reconciliation must be agreed to in writing before entering into an OTC derivative contract¹³.

Portfolio reconciliation must be performed by an NFC on a quarterly basis when it has more than 100 OTC derivative contracts outstanding in place with another entity, and on a yearly basis when this threshold is not met (NFC+s need to comply with the more onerous requirements set out below).

Portfolio reconciliation must be performed by an NFC+ each business day when it has 500 or more OTC derivative contracts in place with another entity, weekly when the number of contracts is between 51 and 499 and quarterly when 50 or fewer OTC derivative contracts are outstanding between such parties¹⁴.

Portfolio compression

An NFC with 500 or more OTC derivative contracts outstanding with a single counterparty must analyse on a bi-annual basis the possibility to conduct a portfolio compression to reduce counterparty credit risk. The NFC must engage in such portfolio compression unless it can provide a reasonable and valid explanation to the relevant competent authority¹⁵.

Dispute resolution

NFCs must have agreed dispute resolution processes for the recording and resolution of disputes when concluding OTC derivative contracts¹⁶.

NFC+s that enter into an uncleared OTC derivative contract must additionally comply with the following:

Daily valuation

NFC+s must mark-to-market (or, where market conditions prevent this, mark-to-model) the value of outstanding contracts on a daily basis¹⁷.

Collateral exchange

EMIR contains a requirement regarding timely, accurate, and appropriately segregated exchange of collateral with respect to OTC derivative contracts entered into by NFC+s with either a financial counterparty or another NFC+. This requirement is supported by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions policy paper on "Margin requirements for non-centrally cleared derivatives" (the Policy Paper). The Policy Paper states the view that "margin requirements need not apply to non-centrally cleared derivatives to which non-financial entities that are not systemically-important are a party"¹⁸.

Subject to certain conditions, intragroup transactions will not need to be collateralised¹⁹.

Further requirements relating to collateral exchange are due to be published in regulatory technical standards expected in 2014.

Clearing

Clearing is likely to be the most fundamental change to the derivatives market introduced by EMIR.

Notification

An NFC must immediately notify both ESMA and the relevant competent authority if it exceeds the clearing threshold²⁰.

Clearing

An NFC will become subject to the clearing obligation for future contracts only if its rolling average position over 30 working days also exceeds the clearing threshold. All relevant future contracts must then be cleared within four months of becoming subject to the clearing obligation. It is expected that a phase-in period may be allowed per type of counterparty, and that the phase-in periods will be specified in the draft regulatory technical standards regarding clearing obligation (Draft Clearing RTS) as and when those Draft Clearing RTS are proposed.

The clearing obligation may be satisfied by an NFC+ becoming a clearing member, becoming a client of a clearing member, or by establishing indirect clearing arrangements with a clearing member²¹. NFC+s should consider how they will comply with the clearing obligation. There are likely to be cost and collateral consequences.

Only OTC derivative contracts of a class declared by the Commission will be subject to the clearing obligation.

Subject to certain conditions, intragroup transactions will not be subject to the clearing obligation²².

When do NFCs need to act?

What is the obligation?		By when do NFCs need to comply?
Reporting	Reporting	The reporting start date is currently expected to commence on 1 January 2014
	Record keeping	From 16 August 2012
Risk Mitigation for uncleared OTC derivative contracts	NFCs that enter into an uncleared OTC derivative contract must comply with the following:	
	Timely confirmation	From 15 March 2013, with tighter deadlines specified for the future
	Portfolio reconciliation	From 15 September 2013
	Portfolio compression	From 15 September 2013
	Dispute resolution	From 15 September 2013
	NFC+s that enter into an uncleared OTC derivative contract must additionally comply with the following:	
	Daily valuation	From 15 March 2013
	Collateral exchange	From 16 August 2012. Regulatory technical standards providing more detailed requirements are expected in 2014
Clearing	Notification if clearing threshold is exceeded	From 15 March 2013
	Clearing	The first clearing obligation is expected to apply in the second quarter of 2014. No CCPs are authorised yet.

ISDA Protocols

The International Swaps and Derivatives Association, Inc. (ISDA) has published the below protocols and form of agreement, which may be useful to NFCs in meeting EMIR obligations.

ISDA 2013 EMIR NFC Representation Protocol

This protocol allows parties to amend their ISDA Master Agreements to represent their classification under EMIR so as to determine whether the clearing obligation or the higher level risk mitigation techniques apply to their transactions²³.

The protocol provides a mechanism for updating counterparties as to a change in classification (which would be useful, for example, in determining whether NFCs need to start posting collateral) and a mechanism to address the situation where parties have originally transacted on an incorrect classification.

ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol

This protocol allows parties to amend their ISDA Master Agreements and other relevant derivative agreements to provide for portfolio reconciliation and dispute resolution mechanisms and to include a confidentiality waiver relating to EMIR.

The confidentiality waiver in this protocol is drafted to relate specifically to EMIR and is otherwise similar to the more generic confidentiality waiver set out in the ISDA 2013 Reporting Protocol.

The confidentiality waiver comes with a disclaimer from ISDA as to the waiver's sufficiency in relation to the laws of any jurisdiction. NFCs should also note that confidentiality waivers from related third parties may be necessary to make the necessary EMIR reports, and NFCs must deal with those confidentiality waivers by way of separate bilateral agreements.

Form of amendment agreement relating to timely confirmation

This amendment agreement may be used to introduce provisions into an ISDA Master Agreement regarding the mechanism of complying with the EMIR timely confirmation requirements.

Conclusion

Non-financial counterparties must determine whether or not their existing policies and procedures and their trading documentation complies with the EMIR requirements.

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Endnotes

- ¹ REGULATION (EU) No 648/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, which came into force on 16 August 2012
- ² See Article 2(9) of EMIR
- ³ See *Client Alert* 1568 [ESMA Publishes Draft Regulatory Technical Standards on Cross-border Application of EMIR](#) available on LW.com
- ⁴ See Article 2(5) of EMIR
- ⁵ See Article 2(7) of EMIR
- ⁶ The proposed Markets in Financial Instruments Regulation and the proposed second Markets in Financial Instruments Directive
- ⁷ See Article 10 of EMIR
- ⁸ See Article 11 of 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
- ⁹ See Article 9 of EMIR and 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 repositories and Commission Implementing Regulation (EU) No 1247/2012 of 19 December 2012 laying down implementing technical standards with regard to the format and frequency of trade reports to trade repositories according to Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories
- ¹⁰ See Article 9(2) of EMIR
- ¹¹ See Article 11(1)(a) of EMIR and Article 12(2) of 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
- ¹² See Article 12(1) of 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
- ¹³ See Article 11(1)(b) of EMIR

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- ¹⁴ See Article 13 of 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
- ¹⁵ See Article 14 of 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
- ¹⁶ See Article 11(1)(b) of EMIR and Article 15 of 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
- ¹⁷ See Article 11(2) of EMIR and Articles 16 and 17 of 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
- ¹⁸ See Article 11(3) of EMIR and Part B, Element 2 of the Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions policy paper on Margin requirements for non-centrally cleared derivatives, issued for comment in September 2013
- ¹⁹ See Article 11(5)-(11) of EMIR
- ²⁰ See Article 10(1) of EMIR
- ²¹ See Article 4(3) of EMIR
- ²² See Article 10 of EMIR
- ²³ OTC Answer 4 in the 20 March 2013 ESMA Questions and Answers <http://www.esma.europa.eu/system/files/2013-324.pdf> states that financial counterparties may rely on representations from non-financial counterparties as to their status. It is reasonable to suppose that non-financial counterparties may also rely on such representations from other non-financial counterparties.