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# ***FS Regulatory Brief***

## ***Derivatives – Enter EMIR***

### **You're going to need a bigger boat**

March 2013

Global entities struggling to navigate Dodd-Frank's derivatives requirements are about to be hit by a second wave of regulation. European legislators will soon complete the first set of implementation rules for the European Markets and Infrastructure Regulation ("EMIR"), triggering the first EMIR compliance dates for firms as early as this month.

Although similarities exist between Dodd-Frank and EMIR, there are several significant differences with respect to scope and timing. Global firms will need to identify core processes and procedures that can be leveraged across compliance regimes while identifying those areas that will require unique solutions. Building programs that satisfy both sets of rules – as well as rules from other global market centers – will be a challenge, but industry participants who successfully navigate change across their global organizations have the opportunity to establish themselves as market leaders.

The bottom line: Get ready for an expensive undertaking as you conform to at least two sets of global derivatives rules.

This **FS Regulatory Brief** (a) analyzes the key overlaps and differences between EMIR and Dodd-Frank, and (b) suggests where separate effort will be needed to meet EMIR's additional requirements.

### ***EMIR vs. Dodd-Frank – similarities, differences and consequences***

In September 2009, the G20 made a commitment to regulate the over-the-counter ("OTC") derivatives market to enhance transparency and reduce risk. Both the European Union and the US have addressed these commitments through separate regulatory reforms – the US through Dodd-Frank and underlying regulations, and the European Union through EMIR and the revised Markets in Financial Instruments Directive ("MiFID II").<sup>1</sup>

Like Dodd-Frank, EMIR includes clearing, transaction reporting and risk mitigation provisions that apply, to varying degrees, to both financial and non-financial firms engaged in derivative transactions. EMIR became effective on August 16, 2012, which triggered reporting of historical trades for all entities required to report. However, EU legislators delegated detailed implementation rules, known as technical standards, to various European Supervisory Authorities ("ESAs"), including the European Securities and Markets Authority ("ESMA") and the European Banking Authority ("EBA").

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<sup>1</sup> MiFID II describes amendments to the original MiFID and introduces new Markets in Financial Instruments Regulation. MiFID II introduces derivative execution requirements, trade reporting, additional transaction reporting requirements, market structure rules and other trading related requirements, and is estimated to be in effect starting in late 2015.

Legislators recently completed and published the first set of EMIR technical standards in the Official Journal of the European Union, triggering EMIR compliance dates twenty days after publication.

Global firms attempting to meet several Dodd-Frank regulatory deadlines associated with clearing, reporting and business conduct obligations will have to begin implementing EMIR simultaneously. In so doing, they will be forced to confront and resolve a number of differences between the two regulatory regimes.

### **Product scope**

Both EMIR and Dodd-Frank apply to a range of derivative transactions. EMIR applies to derivatives defined under MiFID, including both listed and OTC, and covers the range of interest rate, commodity, equity, credit and FX swaps and derivatives. Spot foreign exchange and some physically settled commodity swaps are excluded. Under Dodd-Frank, regulation is bifurcated; “security-based swaps” are regulated by the SEC and generally include single name and narrow-based security indices and single name credit derivative swaps (“CDS”), while the CFTC has jurisdiction over all other “swaps.” The two regulators share jurisdiction for certain “mixed” swaps. Thus, under the US regime, the scope of regulation, and which regulations apply to a given transaction, are determined by definitions of instruments, and the regulations themselves include a number of exclusions or partial exclusions from the transactions treated as “swaps” and “security-based swaps.”

*Global firms trading derivatives in multiple jurisdictions must be able to fully catalogue all derivatives activity by transaction-type and region to understand the full regulatory impact to their derivatives business. Strategies that rely upon certain product exemptions to limit exposure to Dodd-Frank requirements may not be applicable under EMIR and vice versa.*

### **Entities subject to regulatory requirements**

While the two regulatory regimes potentially reach many of the same types of entities, the path each takes is distinct. EMIR obligations are set by derivative counterparty status containing two top level counterparty classifications: financial counterparties (“FCs”) and non-financial counterparties (“NFCs”). The FC definition contains a narrow list of EU regulated investment firms, banks, insurer/assurance/re-insurance undertakings, registered UCITS funds and their managers, alternative investment funds and their managers and pension providers. The NFC classification is a broad catch-all category which captures any other type of derivative trading entity established in the EU. Generally, both FCs and NFCs will be required to report their derivatives contracts to a trade repository, clear OTC derivative contracts and apply risk mitigation techniques (subject to exceeding certain thresholds), with certain exemptions for NFCs that deal in derivatives below the EMIR threshold.

Dodd-Frank, on the other hand, defines certain entities that must register by dint of their activities. Entities that hold themselves out as dealers or make a market in swaps must register as swap dealers (“SDs”) or security-based swap dealers, unless their dealing activities in “in scope” swaps fall below *de minimis* thresholds. Entities with substantial positions in swaps must register as major swap participants (“MSPs”) and major security-based swap participants.<sup>2</sup> The lion’s share of regulation applies to these registered entities, including recordkeeping, reporting, internal and external business conduct, clearing, trade execution and capital requirements. Entities not required to register under the Dodd-Frank scheme shoulder a smaller regulatory load, but do not escape entirely. Even unregistered swap participants have recordkeeping, potential reporting, clearing and execution related

<sup>2</sup> While there is no analogue to the Dodd-Frank SD/MSP registration scheme in EMIR, EMIR sits atop multiple home country regulatory schemes which, themselves, impose various registration requirements.

responsibilities. Moreover, as to these entities, Dodd-Frank draws a distinction between financial and non-financial entities. So, for example, non-financial end-users who use swaps to hedge commercial risk may elect to opt out of mandatory clearing.

*While conceptually similar in distinguishing between financial and non-financial counterparties, the two regimes do not completely overlap with regard to the compliance obligations of similarly situated entities. As a result, an “entity” analysis performed to determine regulatory status under one regime will not suffice to fully determine a firm’s status under the other. Global firms will need to know where they sit under both regimes.*

*Under Dodd-Frank, global enterprises might choose to consolidate their swaps dealing activities in a single regulated entity. But, because in scope “derivatives” under EMIR include both listed and OTC instruments, ring-fencing derivatives activity in a single entity in the Euro zone may be more difficult; a global firm may have several entities that qualify as “Financial Counterparties” under EMIR, making them subject to all applicable EMIR obligations.*

### **Central clearing**

EMIR requires both FCs, and NFCs who exceed certain thresholds (known as “NFC+” firms), to centrally clear OTC contracts with an EMIR authorized central counterparty (“CCP”). ESMA is tasked to develop a list of contracts subject to mandatory clearing, which must then be endorsed by European regulators and passed into law. Clearing requirements are not expected to come into force until 2014. EMIR provides a clearing exemption for intra-group transactions for both FC and NFC+ entities, but firms must still report any clearing exempt trades and apply full risk management requirements.

Under Dodd-Frank, the CFTC and SEC will determine which swaps must be cleared but, unlike EMIR, volume thresholds are not triggers for mandatory clearing. Once an instrument is subject to mandatory clearing,

all participants will be required to clear that instrument, unless one of the counterparties to the transaction is eligible for an exemption, such as the end-user exemption for swaps used to hedge commercial risk. The CFTC has already made one set of determinations requiring the clearing of categories of interest rate and credit default swap indices and released an implementation schedule under which the most sophisticated entities, including SDs and MSPs, would be required to clear swaps amongst themselves as soon as March 11, 2013. CFTC clearing requirements for rates and credit swaps will continue to be phased in by type of counterparty through September 2013.

*Despite the similarities of the clearing mandates in both regimes, the differences related to thresholds, types of counterparties, exemptions and timing will require firms to employ different processes to determine which transactions are subject to mandatory clearing under each regime. Depending on how data is managed across a global enterprise, there may be ways to leverage centralized systems to identify swaps and other derivative contracts subject to mandatory clearing.*

*Without such systems, global firms will have to develop separate processes for identifying transactions and submitting them for clearing under EMIR and Dodd-Frank. Moreover, the identification of which CCPs are authorized to clear a particular swap, and among those, which is selected by the counterparties, will test the adaptability of a global firm’s systems and will require additional, complex layers of system integration.*

*The timing differences for mandatory clearing under the two regimes may raise temporary competitive issues, as well. In the short term, because the first Dodd-Frank clearing mandate will become effective close to a year before EMIR, counterparties may choose to avoid entering into swaps with US persons.*

*Market participants should take heed, however, because the CFTC has warned against efforts to avoid the Dodd-Frank clearing requirements. In recent testimony, the CFTC Chairman identified a particular concern that swap dealers may be routing to their foreign affiliates' trades with hedge funds organized offshore, even though such hedge funds' principal places of business are in the United States or they are majority-owned by US persons. Consultation with legal counsel will help guide firms on questions of "evasion." In the longer run, however, once the broader EMIR clearing mandate is in effect, the competitive balance may shift back to the US.*

### **Reporting**

Under EMIR, both counterparties will be responsible for reporting all derivatives trades, including listed derivatives and historical swaps, to a trade repository. The detailed data reporting requirements are set out in EMIR technical standards and include:

- Historical data reporting (from August 16, 2012);
- End-of day reporting (but no real-time reporting); and
- Each counterparty must report its own counterparty data (but each party is free to delegate to an agent or agree submission by one counterparty).

Under Dodd-Frank:

- Only one counterparty has to report;
- No requirement to report listed derivatives; and
- Real time reporting is required.

Dodd-Frank employs a hierarchy to determine which of the two counterparties is required to report. The reporting obligation generally falls to the registered firm (if one of the counterparties is registered as an SD or MSP), although the clearing of swaps in registered clearinghouses and/or the trading of swaps on registered trading facilities does shift some reporting obligations from the counterparties

to the clearinghouse or trading platform. Timing requirements are phased in with narrowing windows for reporting over time and certain allowances are provided for depending on the regulatory status of the reporting party.

*As with clearing, the reporting requirements of EMIR and Dodd-Frank are similar, but the differences will require separate processes to identify transactions subject to reporting requirements and related data implications. Again, firms with centralized data management systems will be able to leverage those systems in building processes to meet the different reporting requirements.*

*One caution for Dodd-Frank compliant firms: some global entities have found that reporting processes built to comply with "real time" reporting requirements may not be compatible with EMIR's end of day reporting standard.*

### **Extraterritoriality**

Under any regime, the issue of who assumes regulatory responsibility for cross-border transactions looms large. Conceptually, EMIR and Dodd-Frank are similar: both have extraterritorial reach, and both allow regulators to recognize comparable regulatory regimes to avoid duplicative regulation. Both US and international regulators have expressed their intention to accept foreign regulatory requirements as sufficient substitutes for certain counterparties. However, neither regime has fully addressed the parameters and processes for assessing comparability. As a result, global entities subject to both sets of rules are left to speculate whether, and if so, how they will be able to leverage critical resources to meet their obligations until regulators finalize their guidance. For example, the industry solution designed to meet Dodd-Frank documentation requirements (i.e., the ISDA Protocol) will be different than the European protocol solution. Firms are at risk of doing too much, or too little.

*Whatever the regulators decide, it is likely that substituted compliance will not be a complete solution for global firms because of the nature of their businesses and the scope and timing differences in the two regimes. As a result, global enterprises will probably be subject to differing requirements for the foreseeable future, no matter the commitment to international coordination by regulators.*

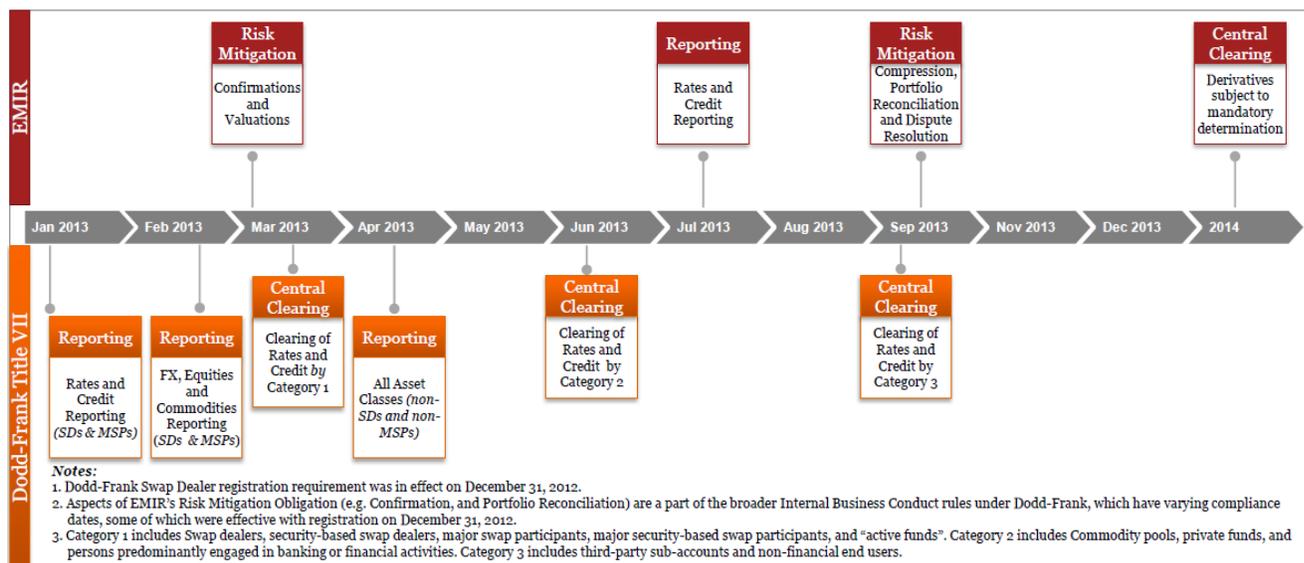
*While US and EU legislators are deciding how they will fit the two systems together, global firms should look for flexible solutions that can position them to respond to a changing regulatory environment. For example, firms should evaluate whether their systems and processes, like those used for client on-boarding and reference data management, are sufficiently flexible to capture the information needed to meet multiple regulators' requirements.*

*Any system or process changes undertaken to comply with Dodd-Frank should be carefully analyzed for areas where the requirements may coincide or conflict with EMIR to avoid costly implementation errors.*

### Timing

In addition to these key differences and consequences outlined above, the timing of compliance under the two regimes may add to the uncertainty and costs faced by global entities. Once EMIR enters into force, certain obligations must be met as early as March 2013. Meanwhile, compliance with Dodd-Frank Title VII requirements is subject to its own timeline.

The timeline below, although not comprehensive, depicts some key compliance dates for common areas under both Dodd-Frank and EMIR and reflects the staggered and overlapping nature of compliance obligations under the two regimes.



## **What are the broader implications for global entities?**

**It will be expensive.** As global firms ramp up to design and implement compliance programs for EMIR while continuing to meet Dodd-Frank requirements, the OTC derivatives market will experience unprecedented change. Increased transparency and regulation, along with standardization of products are likely to impact costs, particularly in the short run, and profitability. Global business strategies will have to factor in the costs and benefits associated with conducting a derivatives business in particular locales based in part on the ability to leverage compliance across differing regulatory regimes.

**It is not over yet.** While global firms continue to make progress on Dodd-Frank requirements and ramp up on EMIR obligations, detailed reform rules in other jurisdictions are only just beginning to emerge. EU OTC reforms will start this year under EMIR, and more derivatives rules will be introduced from 2015 as the MiFID II amendments and new rules take hold.

**Global services for clients may be a firm's key competitive advantage.** While the costs of implementation will be significant and profit margins may be squeezed, there may be competitive advantages for well-positioned global firms. Regulatory requirements associated with Dodd-Frank and

EMIR impact not only the dealers, but also “buy-side” investment firms. They are subject to obligations under both regimes, and may meet certain obligations through an agent. However, clients are expecting their dealers to understand and implement regulatory change as well as provide global services to meet clients' requirements.

The ability to offer differentiating, and value-add services like collateral transformation, single-currency margining and liquidity solutions can attract investment firms operating globally. A service-oriented model could allow firms to offset some of the impact to profitability from increased regulatory requirements and related operational costs.

In addition to the specific OTC derivatives reform, additional financial regulatory reform will continue to impact business strategies going forward. In this climate, global readiness should not be viewed as a series of discrete compliance builds and will require a comprehensive understanding of regulatory impact across jurisdictions and on an enterprise level. Firms must balance tactical/regional compliance solutions developed to meet immediate requirements with the need for more permanent strategic solutions that are adaptable to global regulatory change. Those who develop sustainable, global compliance solutions that are aligned with other large institutional change initiatives within their firms will be better positioned to meet the demands of an increasingly complicated regulatory landscape.

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# Additional information

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