

OTC derivatives, central counterparties and trade repositories (EMIR, European Market Infrastructure Regulation)

2010/0250(COD) - 15/09/2010 - Legislative proposal

PURPOSE: to establish common rules with the aim of increasing the security and efficiency of the over-the-counter (OTC) derivatives.

PROPOSED ACT: European Parliament and Council Regulation.

BACKGROUND: in its [Communication of 4 March 2009](#) on “Driving European Recovery”, the Commission committed itself to deliver appropriate initiatives to increase transparency and to address financial stability concerns. In its [Communication of 3 July 2009](#), it examined the role played by derivatives in the financial crisis and, in its [20 October 2009 Communication](#), it set out the future policy actions the Commission intended to propose to increase transparency of the derivatives market, reduce counterparty and operational risk in trading and enhance market integrity and oversight.

In September 2009, G-20 Leaders agreed in Pittsburgh that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest and that OTC derivative contracts should be reported to trade repositories. In June 2010, G20 Leaders in Toronto reaffirmed their commitment and also committed to accelerate the implementation of strong measures to improve transparency and regulatory oversight of OTC derivatives in an internationally consistent and non-discriminatory way.

This initiative is **part of a larger international effort** to increase the stability of the financial system in general, and the OTC derivatives market in particular. Given the global nature of the OTC derivatives market an internationally coordinated approach is crucial.

This proposal for a Regulation delivers the Commission's commitments to proceed rapidly and with determination. It takes also into account the strong support and the many of the measures suggested in Parliament's [Resolution of 15 June 2010](#), on "Derivatives markets: future policy actions". It is also consistent with the recently adopted US legislation on OTC derivatives, the so-called Frank-Dodd Act.

IMPACT ASSESSMENT: the impact assessment concludes that the largest net benefits would be achieved through the adoption of measures that would:

- require the use of Central Counterparty (CCP) clearing for OTC derivatives that meet predefined eligibility criteria;
- set specific targets for legal and process standardisation;
- set specific targets for the bilateral clearing of OTC derivatives transactions;
- require market participants to report all the necessary information on their OTC derivatives portfolios to a trade repository or, if that would not be possible, directly to regulators; and
- require the publication of aggregate position information.

LEGAL BASE: Article 114 of the Treaty on the Functioning of the European Union (TFEU). A uniform process at EU level is needed to determine which OTC Derivatives are eligible for mandatory clearing through CCPs.

CONTENT: the scope of the Regulation is wide and lays down **uniform requirements** covering financial counterparties, non-financial counterparties (exceeding certain thresholds) and all categories of OTC derivative contracts. Its prudential parts apply to central counterparties as a result of the clearing obligation and, for the reporting requirement, to trade repositories.

The authorisation and supervision requirements for CCPs apply irrespective of the financial instrument the CCPs clear - whether OTC or other. Exemptions are explicitly foreseen for the members of the European System of Central Banks, public bodies charged with or intervening in the management of the public debt and to multilateral development banks.

The main features of the proposal are as follows:

Clearing, reporting and risk mitigation of OTC Derivatives: 'standardised' contracts will mean those contracts that are eligible for clearing by CCPs. In order to apply this, the Regulation establishes a process that will take into account the risk aspects connected to mandatory clearing.

In order to establish a process that ensures that as many OTC contracts as possible will be cleared, the Regulation introduces two approaches to determine which contracts must be cleared:

- a '*bottom-up*' approach, according to which a CCP decides to clear certain contracts and is authorised to do so by its competent authority, who is then obliged to inform the [European Securities and Markets Authority](#) (ESMA) once it approves the CCP to clear those contracts. ESMA will then have the powers to decide whether a clearing obligation should apply to all of those contracts in the EU. ESMA will need to base that decision on certain objective criteria;
- a '*top-down*' approach according to which ESMA, together with the [European Systemic Risk Board](#) (ESRB), will determine which contracts should potentially be subject to the clearing obligation. This process is important to identify and capture those contracts in the market that are not yet being cleared by a CCP.

Counterparties that are subjected to the clearing obligation cannot simply avoid the requirement by deciding not to participate in a CCP. If those counterparties do not meet the participation requirements or are not interested in becoming clearing members, they must enter into the necessary arrangements with clearing members to access the CCP as clients.

Furthermore, CCPs should not be allowed to accept only those transactions concluded on execution venues with which they have a privileged relationship or which are part of the same group.

As regards **non-financial (corporate) counterparties**, they will in principle not be subject to the rules of this Regulation, unless their OTC derivatives positions reach a threshold and are considered to be systemically important.

The Regulation sets out a process that helps to identify the non-financial institutions with systemically important positions in OTC derivatives and subjects them to certain obligations specified under the Regulation. The process is based on the definition of two thresholds: a) an information threshold and b) a clearing threshold. These thresholds will be specified by the European Commission on the basis of draft regulatory standards proposed by ESMA, in consultation with the ESRB and other relevant authorities.

Moreover, as not all OTC derivatives will be considered eligible for central clearing, there remains a need to improve arrangements and the safety of those contracts that will continue to be managed on a so-called 'bilateral' basis. The Regulation therefore requires the **use of electronic means** and the existence of risk management procedures with timely, accurate and appropriately segregated exchange of collateral, and an appropriate and proportionate holding of capital.

Lastly, financial counterparties and non-financial counterparty above the clearing threshold must report the details of any derivative contract they have entered into and any modification thereof (including novation and termination) to a registered trade repository. In the exceptional case that a trade repository is not capable of recoding the details of a particular OTC derivatives contract, the Regulation requires that this information should be provided directly to the relevant competent authority. The Commission will need to be empowered to determine the details, type, format and frequency of the reports for the different classes of derivatives, following draft technical standards to be developed by ESMA.

Requirements applicable to CCPs: given that CCPs have to assume additional risks, the Regulation requires that, for security reasons, they are subjected to rigorous organisational, conduct of business and prudential requirements (internal governance rules, increased capital requirements, etc.).

To begin with, a CCP must have in place robust governance arrangements. These will respond to any potential conflicts of interest between owners, management, clearing members and indirect participants. The role of independent board members is particularly relevant.

Secondly, to be authorised to exercise its activity, a CCP is required to have a minimum quantum of capital. The Regulation will require a CCP to have a mutualised default fund to which members of the CCP will have to contribute.

Authorisation and supervision of trade repositories: the Regulation provides for a reporting requirement of OTC derivative transactions to increase the transparency of this market. The information must be reported to trade repositories. In view of the central role of trade repositories in the collection of regulatory information, the Regulation gives ESMA the powers to register trade repositories, withdraw the registration and to perform the surveillance of trade repositories.

Requirements for trade repositories:the Regulation also contains provisions for trade repositories to guarantee their compliance with a set of standards. These are designed to ensure that the information that trade repositories maintain for regulatory purposes is reliable, secured and protected. In particular, trade repositories will be subject to organisational and operational requirements and ensure appropriate safeguarding and transparency of data.

BUDGETARY IMPLICATION: the proposal has no implication for the EU budget.