COMMISSION de SURVEILLANCE du SECTEUR FINANCIER

Luxembourg, 23 January 2013

CIRCULAR CSSF 13/557

Re: 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

Ladies and Gentlemen,

We refer to the 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 (herafter, "EMIR")[1], published in the Official Journal of the European Union No L 201/1 of 27 July 2012 and which has entered into force on 16 August 2012.

The purpose of EMIR is to introduce new requirements to improve transparency and reduce the risks associated with the derivatives market. EMIR also establishes common organisational, conduct of business and prudential standards for central counterparties as well as organisational and conduct of business standards for trade repositories.

As those rules take the legislative form of a Regulation of the European Parliament and the Council, they are legally binding and directly applicable in all Member States without transposition into national law, as from the day of entry into force. Thus, the EMIR framework is binding in its entirety and directly applicable.

However, a number of provisions must still be clarified through additional regulations by the European Commission (delegated and implementing acts based on technical standards to be drafted by the European Securities Markets Authority ESMA and the European Banking Authority EBA). These technical standards have been adopted by the European Commission on 19 December 2012 except for the specific point of colleges for central counterparties. In line with the relevant Union acts, the European Parliament and the

[1] This document is available under:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF. (English version)
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:FR:PDF. (French version)

Council still have a one-month scrutiny period (extendable by one month) within which they may object to any of these technical standards.

The actual date of application of these provisions will depend on the date of entry into force of these additional regulations. Further details thereto are available under

http://www.esma.europa.eu/page/European-Market-Infrastructure-Regulation-EMIR.

1. Scope of application and definitions

EMIR applies to all financial and non-financial counterparties established in the EU that enter into derivative contracts[2]. It applies indirectly to non-EU counterparties trading with EU parties.

EMIR also lays down uniform requirements for the performance of activities of central counterparties ("CCPs") and trade repositories ("TRs").

Article 2(5) of EMIR defines '**derivative**' or 'derivative contract' as a financial instrument as set out in points (4) to (10) of Section C of Annex I to Directive 2004/39/EC as implemented by Article 38 and 39 of Regulation (EC) No 1287/2006;

Article 2(7) of EMIR defines '**OTC derivative**' or 'OTC derivative contract' as 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 Directive 2004/39/EC or on a third-country market considered as equivalent to a regulated market in accordance with Article 19(6) of Directive 2004/39/EC;

Article 2(8) of EMIR defines **'financial counterparty'** as an *investment firm* authorised in accordance with Directive 2004/39/EC, a *credit institution* authorised in accordance with Directive 2006/48/EC, *an insurance undertaking* authorised in accordance with Directive 73/239/EEC, *an assurance undertaking* authorised in accordance with Directive 2002/83/EC, *a reinsurance undertaking authorised* in accordance with Directive 2005/68/EC, *a UCITS* and, where relevant, its *management company*, authorised in accordance with Directive 2009/65/EC, *an institution for occupational retirement* provision within the meaning of Article 6(a) of Directive 2003/41/EC and *an alternative investment fund managed by AIFMs* authorised or registered in accordance with Directive 2011/61/EU;

[2] Article 1.1. of EMIR: " This Regulation lays down clearing and bilateral risk- management requirements for over-the-counter ('OTC') derivative contracts, reporting requirements for derivative contracts and uniform requirements for the performance of activities of central counterparties ('CCPs') and trade repositories."

'Non-financial counterparty' is defined in Article 2(9) of EMIR as "an undertaking established in the Union other than CCPs and financial counterparties".

'CCP' means 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.

'Trade repository' means a legal person that centrally collects and maintains the records of derivatives.

2. What are the requirements?

2.1. Clearing obligation (Article 4)

EMIR requires all financial counterparties, and those non-financial counterparties above the clearing threshold, to clear **all OTC derivative contracts** with a CCP authorised under Article 14 or recognised under Article 25 of EMIR pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation in accordance with Article 5(2).

The clearing obligation will take effect once a CCP is authorised by the competent authority of the EU Member State where it is established (or recognised by ESMA in case of a CCP from a third country) to clear under the EMIR regime.

For that purpose, a counterparty shall become a clearing member, a client, or shall establish indirect clearing arrangements with a clearing member, provided that those arrangements do not increase counterparty risk and ensure that the assets and positions of the counterparty benefit from protection with equivalent effect to that referred to in Articles 39 (segregation and portability) and 48 (default procedures).

The classes of OTC derivatives subject to the clearing obligation, the CCPs that are authorised or recognised for the purpose of the clearing obligation as well as the dates from which the clearing obligation takes effect, including any phased-in implementation, the classes of OTC derivatives identified by ESMA in accordance with Article 5(3); the minimum remaining maturity of the derivative contracts referred to in Article 4(1)(b)(ii); the CCPs that have been notified to ESMA by the competent authority for the purpose of the clearing obligation and the date of notification of each of them will be published in the public register on ESMA's website.

For non-financial counterparties, the clearing thresholds for the different classes of derivatives are specified in the technical standards on the clearing obligation.

Basically, non-financial counterparties are subject to the clearing obligation if their OTC derivative positions are large enough and are not directly reducing risks related to the commercial activity or the treasury financing activity.

2.2. Risk mitigation techniques for OTC derivative contracts not cleared by a CCP (Article 11)

Contracts not cleared by a CCP will be subject to operational risk management requirements and bilateral collateral requirements.

2.2.1 Operational risk management requirements (Article 11.1)

All financial counterparties and all non-financial counterparties (including those below the clearing threshold (as explained under point 2.1.) that enter into an OTC derivative contract not cleared by a CCP are required to comply with risk management requirements.

They shall ensure, exercising due diligence, that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational risk and counterparty credit risk, including at least: (a) the timely confirmation of the terms of the relevant OTC derivative contract; (b) portfolio reconciliation, (c) dispute resolution and (d) portfolio compression. They shall mark-to-market on a daily basis the value of outstanding contracts. Where market conditions prevent marking-to-market, reliable and prudent marking-to-model shall be used.

2.2.2 Exchange of collateral (Article 11.3)

Financial counterparties shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after 16 August 2012.

Financial counterparties shall hold an appropriate and proportionate amount of capital to manage the risk not covered by appropriate exchange of collateral.

Non-financial counterparties shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after the clearing threshold is exceeded.

Basically, non-financial counterparties are subject to bilateral collateral requirements if their OTC derivative positions are large enough and are not directly reducing risks related to the commercial activity or the treasury financing activity.

This requirement of bilateral collateral exchange is applicable from the entry into force of the Regulation. However, the precise level and exact type of collateral to be exchanged will be specified by further regulatory technical standards which will be drafted jointly by ESMA, EBA and EIOPA and adopted by the European Commission by the way of EU regulations.

Before those technical standards enter into force, counterparties have the freedom to apply their own rules on collateral in accordance with the conditions laid down in Article 11(3). As soon as the aforementioned EU regulations enter into force, counterparties will have to change their rules to the extent necessary in order to comply with the rules laid down in the EU regulations. The latter will apply to relevant contracts concluded as of the date that they enter into force.

2.3. Reporting obligation (Article 9)

EMIR requires all financial and non-financial counterparties (including those below the clearing threshold) to report details of their **derivative contracts, whether traded OTC[3] or not,** to a trade repository.

The reporting obligation applies to derivative contracts which:
(a) were entered into before 16 August 2012 and remain outstanding on that date;
(b) are entered into on or after 16 August 2012.

Counterparties and CCPs have to report the details of any derivative contracts they have concluded and of any modification or termination of the contract to a trade repository authorised or recognised under the EMIR regime.

These details must be reported no later than the working day following the conclusion, modification or termination of the contract. Counterparties shall ensure that the details of their derivative contracts are reported without duplication.

A counterparty or a CCP which is subject to the reporting obligation may delegate the reporting of the details of the derivative contract.

Counterparties shall keep a record of any derivative contract they have concluded and any modification for at least five years following the termination of the contract.

Where a trade repository is not available to record the details of a derivative contract, counterparties and CCPs shall ensure that such details are reported to ESMA.

3. Exemptions

3.1. Exemptions from the clearing obligation for pension scheme arrangements (Article 89.1 and 89.2)

For three years after the entry into force of EMIR, pension scheme arrangements as defined in Article 2(10) are exempted from the clearing obligation for OTC derivative contracts that are objectively measurable as reducing investment risks directly relating to

[3] OTC derivative contracts as defined in Article 2(7) of EMIR (See point 1 above).

their financial solvency. The transitional period also applies to entities established for the purpose of providing compensation to members of pension scheme arrangements in case of a default.

No notification or prior approval is needed.

However, the OTC derivative contracts entered into by the above-mentioned entities during this period shall be subject to the risk mitigation techniques for OTC derivative contracts not cleared by a CCP, as specified in Article 11.

In relation to pension scheme arrangements referred to in Article 2(10) (c) and (d), the exemption from the clearing obligation shall be granted by the relevant competent authority for types of entities or types of arrangements after consultation with ESMA.

3.2. Intragroup exemption from the clearing obligation and risk-mitigation techniques for OTC derivative contracts not cleared by a CCP

3.2.1 Intragroup exemption from the clearing obligation (Article 4.2)

Intragroup transactions in OTC derivatives contracts as described in Article 3 are not subject to the clearing obligation. The entity wishing to use this exemption has first to notify its competent authority (the CSSF for financial counterparties established in Luxembourg and under its supervision) in writing of its intent to make use of the exemption for the OTC derivative contracts concluded, not less than 30 calendar days before the use of the exemption.

Within 30 calendar days after receipt of that notification, the CSSF (in the case of financial counterparties established in Luxembourg and under its supervision) may object to the use of this exemption if the transactions between the counterparties do not meet the conditions laid down in Article 3, without prejudice to the right of the CSSF to object after that period of 30 calendar days has expired where those conditions are no longer met.

3.2.2 Intragroup exemption from the exchange of collateral (Article 11.5 – Article 11. 11)

(a) Intragroup transactions between counterparties established in the same Member State

Intragroup transactions referred to in Article 3 that are entered into by counterparties which are both established in Luxembourg are exempted from the exchange of collateral provided that there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties. No notification or prior approval is needed.

(b) Intragroup transactions between financial counterparties established in Luxembourg and another EU Member State

Intragroup transactions referred to in Article 3(2)(a), (b) or (c) are exempted totally or partially from the exchange of collateral on the basis of the prior approval of both the competent authority in the other EU Member State and the competent authority in Luxembourg (the CSSF for financial counterparties established in Luxembourg and under its supervision), provided that the following conditions are fulfilled:

(i) the risk-management procedures of the counterparties are adequately sound, robust and consistent with the level of complexity of the derivative transaction;
(ii) there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties.

(c) Intragroup transactions between non-financial counterparties established in Luxembourg and another EU Member State

Intragroup transactions referred to in Article 3(1) are exempted from the exchange of collateral on the basis of a notification of their intention to apply the exemption to the designated competent authority responsible for supervising the application of the clearing obligation by non-financial counterparties.

The exemption conditions are the same as under point 3.2.2(b)(i) and (ii) above.

(d) Intragroup transactions between a counterparty established in Luxembourg and a counterparty established in a third country jurisdiction, other than intragroup transactions covered by (e).

An intragroup transaction referred to in Article 3(2)(a) to (d) is exempted totally or partially from the exchange of collateral, on the basis of the prior approval of the competent authority in Luxembourg (the CSSF for financial counterparties established in Luxembourg and under its supervision), under the conditions of point 3.2.2 (b)(i) and (ii) above.

(e) Intragroup transactions between a non-financial counterparty established in Luxembourg and a counterparty established in a third country jurisdiction

An intragroup transaction referred to in Article 3(1) is exempted from the exchange of collateral on the basis of a notification by the non-financial counterparty established in Luxembourg of its intention to apply the exemption to the designated competent authority responsible for supervising the application of the clearing obligation by non-financial counterparties.

The exemption conditions are the same as under point 3.2.2(b)(i) and (ii) above.

(f) Intragroup transactions between a financial counterparty and a non-financial counterparty one of which is established in Luxembourg and the other in another EU Member State

Intragroup transactions referred to in Article 3(1) are exempted totally or partially from the exchange of collateral, on the basis of the prior approval of the relevant competent authority responsible for supervision of the financial counterparty (the CSSF for financial counterparties established in Luxembourg and under its supervision), under the conditions of point 3.2.2(b)(i) and (ii) above.

The counterparty of an intragroup transaction which has been exempted from the exchange of collateral has to publicly disclose information on the exemption.

4. CCPs

EMIR introduces conditions and procedures for the authorisation of a CCP as well as organisational, conduct of business, and prudential requirements, and requirements related to interoperability arrangements, for CCPs.

4.1. Authorisation and supervision of a CCP (Articles 14 – 22)

CCPs are authorised and supervised by the authority competent for CCP supervision in the EU member state where the CCP is established, in collaboration with a college of the concerned competent authorities.

Once the authorisation is granted, it is effective for the entire territory of the European Union. The extension of services and activities not covered by the initial authorisation is subject to a request for extension to the CCP's competent authority.

4.2. Requirements for CCPs (Articles 26 – 50)

The articles mentioned in the heading relate among others to the organisational requirements of a CCP such as the setting up of a risk committee, record keeping, organisational and administrative arrangements to identify and manage any potential conflict of interest, business continuity policy and disaster recovery plan as well as outsourcing conditions. They also cover conduct of business rules, segregation and portability as well as prudential requirements.

As CCPs are systemic entities, they should have a sound risk-management framework to manage credit risks, liquidity risks, operational and other risks, including the risks that they bear or pose to other entities as a result of interdependencies. A CCP should have adequate procedures and mechanisms in place to deal with the default of a clearing member. In order to minimise the contagion risk of such a default, the CCP should have in place stringent participation requirements, collect appropriate initial margins, maintain

a default fund and other financial resources to cover potential losses. In order to ensure that they benefit from sufficient resources on an ongoing basis, the CCP should establish a minimum amount below which the size of the default fund is not to fall under any circumstances.

5. Registration and supervision of trade repositories

EMIR also lays down conditions and procedures for registration of trade repositories, requirements for trade repositories including the duty to make certain data available to the public and the competent authorities listed under Article 81.3.

5.1 Authorisation and supervision of trade repositories (Articles 55 – 77)

Trade repositories are authorised and supervised by ESMA.

A legal person that intends to carry out trade repository activities and provide trade repository services has to submit an application for registration to ESMA. Once the authorisation is granted, it is effective for the entire territory of the Union.

5.2. Requirements for trade repositories (Articles 78 – 81)

A trade repository shall have robust governance arrangements, maintain and operate effective written organisational and administrative arrangements to identify and manage any potential conflicts of interest, maintain and operate an adequate organisational structure to ensure continuity and orderly functioning of the trade repository in the performance of its services and activities. (Article 78)

In case a trade repository offers ancillary services such as trade confirmation, trade matching, credit event servicing, portfolio reconciliation or portfolio compression services, the trade repository shall maintain those ancillary services operationally separate from the trade repository's function of centrally collecting and maintaining records of derivatives. (Article 78)

A trade repository shall have objective, non-discriminatory and publicly disclosed requirements for access by undertakings subject to the reporting obligation under Article 9. It has to publicly disclose the prices and fees associated with services provided under EMIR. (Article 78)

A trade repository shall have systems in place to identify operational risks, have an adequate business continuity policy and recovery plan and ensure orderly substitution including the transfer of data to other trade repositories and the redirection of reporting flows to other trade repositories in case of withdrawal of its registration. (Article 79)

It shall ensure the confidentiality, integrity and protection of the information received under Article 9 and shall record the information received under Article 9 for at least 10 years following the termination of the relevant contracts. (Article 80)

A trade repository shall collect and maintain data and shall ensure that the entities listed under paragraph 3 of Article 81 have direct and immediate access to the details of derivatives contracts they need to fulfill their respective responsibilities and mandates. It shall publish aggregate positions by class of derivatives on the contracts reported to it. (Article 81)

6. What should counterparties to derivative contracts do now?

Financial and non-financial counterparties should assess their EMIR readiness. Below are some questions which need to be considered:

- Which trade repository can you report to for the types of derivatives you trade?
- Will you report directly to the trade repository or delegate reporting to your counterparty or a third party?
- Which CCPs accept to clear the types of OTC derivatives you trade? Will you access clearing directly as a 'clearing member'? If not, you will need to be a client of a clearing member.
- Are your existing systems and processes adequate to implement the new operational risk mitigation requirements set out in EMIR?
- Do you have collateral agreements in place and sufficient collateral available to collateralise non-cleared OTC derivative trades?

7. When can entities start applying for exemptions from EMIR to the CSSF?

For intragroup exemptions, counterparties may start applying for exemption when technical standards relevant to the intragroup exemptions enter into force. ESMA and the national competent authorities are still developing the most appropriate process for applications.

Templates for the notifications and applications for exemption will be published on the CSSF's website.

Further information will be made available on the CSSF website as appropriate.

8. Useful links

The European Commission has published an FAQ on EMIR which is available under:
http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/emir-faqs_en.pdf

ESMA has set up a dedicated EMIR page on its website which is available under http://www.esma.europa.eu/page/European-Market-Infrastructure-Regulation-EMIR.

Yours faithfully,

COMMISSION de SURVEILLANCE du SECTEUR FINANCIER

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