

# The EMIR: only few obligations for “non-financial counterparties”

## Contents

1. Introduction
2. Scope of EMIR and main obligations for NFC-
3. Classification of financial instruments as derivatives

## 1. Introduction

The financial crisis as well as the Lehman Brothers and Bear Stearns' collapses have highlighted that derivatives play an important role in the economy but are also associated with certain risks.

These risks are not sufficiently mitigated in the over-the-counter (OTC) market. Therefore, the European Parliament and the Council have sought an agreement on a Regulation for more stability, transparency and efficiency in derivatives markets and, on 4 July 2012, they have adopted the Regulation on OTC Derivatives, Central Counterparties and Trade Repositories known as "EMIR" (*i.e.* European Market Infrastructure Regulation).

The EMIR lays down clearing and bilateral risk-management requirements for OTC derivative contracts, reporting requirements for derivative contracts and uniform requirements for the performance of activities of Central Counterparties and Trade Repositories, aimed at reducing counterparty and operational risk in the OTC derivatives market, which was identified as a significant factor to the financial crisis.

The EMIR is not limited to regulated entities. It directly applies to any entity established in the European Union that enters into derivative transactions, thus including also the “non-financial counterparties” (*i.e.* entities other than investment firm, credit institutions, insurance, assurance and reinsurance undertakings, UCITS and its management company, etc.).

However, the EMIR does not apply in full to “non-financial counterparties” and this can be considered a fortune for them since the EMIR, implying more paperwork and processes, like all new regulation is making the lives of derivatives traders quite complicated.

In this update, we hereby intend to highlight the EMIR key elements for “non-financial counterparties” and, in particular, for the ones whose levels of trading are relatively small, and to point out the few obligations that EMIR imposes on them.

Moreover, we also wish highlight certain difficulties encountered by those trading foreign exchange forwards and physically settled commodity forwards due to the fact that there is no single, commonly adopted definition of ‘derivative’ or ‘derivative contract’ as a consequence of the different transpositions of MiFID across the European Union which is preventing the convergent application of EMIR.

## 2. Scope of EMIR and main obligations for NFC-

### 2.1. Scope of EMIR

As anticipated above, EMIR lays down new obligations for any entity established in the European Union that enters into derivative transactions, including non-financial counterparties.

Such obligations, as better described below, include clearing and bilateral risk-management obligations for OTC derivative contracts, reporting obligations for derivative contracts and uniform requirements for the performance of activities of Central Counterparties and Trade Repositories.

The Regulation also ensures that information on all European derivative transactions will be reported to Trade Repositories and be accessible to supervisory authorities, including the European Securities and Markets Authority (ESMA), to give policy makers and supervisors a clear overview of what is going on in the markets. Moreover, the EMIR requires standard derivative contracts to be cleared through Central Counterparties as well as margins for uncleared trades and establishes stringent organizational, business conduct and prudential requirements for these Central Counterparties.

A Central Counterparty is 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, whereas a Trade Repository is a legal person that centrally collects and maintains the records of derivatives.

## 2.2. Main obligations for all type of counterparties

There are two main categories of counterparties for the purposes of EMIR:

- (i) financial counterparties: e.g. investment firm, credit institutions, insurance, assurance and reinsurance undertakings, UCITS and its management company, etc. (“FCs”) and
- (ii) non-financial counterparties: i.e. entities other than FCs (“NFCs”).

The main obligations that EMIR imposes on all type of counterparties are:

- (a) to clear OTC derivatives<sup>1</sup> that have been declared subject to the clearing obligation through a Central Counterparty;
- (b) to put in place risk mitigation techniques<sup>2</sup> for non-centrally cleared OTC derivatives;
- (c) to report derivatives<sup>3</sup> to a Trade Repository;

<sup>1</sup> **OTC derivative**<sup>3</sup> or **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 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.

<sup>2</sup> Risk mitigation techniques include: timely confirmation, portfolio reconciliation and compression, dispute resolution, marking-to-market and marking-to-model, the exchange of collateral to cover the exposures arising from OTC derivatives not cleared by a CCP.

<sup>3</sup> **Derivative** or **derivative contract** means “a financial instrument as set out in points (4) to (10) of Section C of Annex I to Directive 2004/39/EC (MIFID) as implemented by Article 38 and 39 of Regulation (EC) No 1287/2006 (MIFID L2)”. For the sake of clarity, we list below the financial instruments set out in points (4) to (10) of Section C of Annex I to MiFID.

(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash.

(5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event).

(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF.

(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls.

(8) Derivative instruments for the transfer of credit risk.

(9) Financial contracts for differences.

(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise

- (d) organisational, conduct of business and prudential requirements for Central Counterparties;
- (e) certain requirements for Trading Repositories, including the duty to make certain data available to the public and relevant authorities.

Different entities are concerned by different obligations set forth under EMIR (see Table A attached below to this update), also depending on whether the relevant counterparty exceeds the "Clearing Threshold" (see Table B attached below to this update).

The Clearing Threshold is an amount set by class of OTC derivative contracts which is set by ESMA Technical Standards and will be reviewed on a regular basis following public consultation<sup>4</sup>.

When the amount for one class of OTC derivative contracts is surpassed, counterparties are considered as exceeding the relevant Clearing Threshold.

### 2.3. Main obligations for NFC-

As anticipated, the EMIR does not apply in full to non-financial counterparties.

As far as non-financial counterparties whose derivatives' gross notional values do not exceed the Clearing Thresholds set forth by EMIR ("NFC-") are concerned, as main obligations under EMIR, only **certain risk mitigation techniques** and the **reporting obligation** result to be of relevance.

Moreover, it is worth noting that NFC- must keep a record of any OTC derivative that they have concluded and of any modification for at least five years following the termination of the relevant OTC derivative contract.

#### 2.3.1 Main Risk mitigation techniques for NFCs-

The obligation of NFC- to implement risk mitigation techniques, which is effective since 15 September 2013, can be fulfilled by including in the relevant OTC derivative contract specific clauses aimed at reducing counterparty and operational risks connected with such derivative.

The clauses must address the following issues: (i) the **timely confirmation** (*i.e.* the obligation for both the parties to confirm the terms of a derivative transaction), (ii) the **portfolio reconciliation** (to ensure that any discrepancies are identified and addressed) and **compression** (to reduce the overall notional size and number of clearing thresholds), (iii) the **dispute resolution techniques** (*i.e.* procedures for the identification, recording and monitoring of disputes regarding the valuation of a contract, for the exchange of collateral between counterparties and for resolving disputed in a timely fashion).

It is worth noting that such goal can be easily achieved also by:

- (a) adhering to the "ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol" ("ISDA Protocol"), which is a set of documents prepared by the International Swaps and Derivatives

---

*mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.*

<sup>4</sup> Not all OTC derivative contracts count towards the clearing threshold. Those OTC derivative contracts entered into in order to reduce risks relating to the commercial or treasury financing activity of the non-financial entity, or of non-financials of the group it belongs to, are excluded from the calculation of the clearing threshold. Criteria to determine those contracts are specified in Technical Standards drafted by ESMA that have been endorsed by the European Commission. All other OTC derivative contracts entered into by the non-financial or other non-financial entities of the group shall be taken into account for the calculation of the clearing threshold.

Association – a trade organization for participants in the derivative markets – whose aim is to allow amendment of derivative contracts with many counterparties without entering into bilateral negotiations; or

- (b) executing, with the relevant counterparties, an “*EMIR Risk Mitigation Techniques Agreement*” (“**ERMTA**”) which is a standard agreement prepared by the European Federation of Energy Traders – an organization of energy trading companies dedicated to promote energy trading throughout Europe – whose aim is to facilitate the implementation in the relevant derivative contract of the clauses mentioned above.

On one hand, the ERMTA is more tailored for energy companies and transactions, particularly for those that already have an EFET General Agreement in place, on the other hand the ISDA Protocol better applies to the generality of companies and transactions operating in OTC derivatives<sup>5</sup>.

### 2.3.2 Reporting obligations for NFC-

NFC- shall also ensure that the details of any derivative contract they have concluded (e.g. details on the counterparty: the date and time of the reporting, the ID of the counterparty, the nature – FC or NFC – of the counterparty as well as common details: the type of derivative) and of any modification or termination of the contract are reported to a Trade Repository no later than the working day following the conclusion, modification or termination of the contract.

The minimum reporting details are specified in ESMA Technical Standards<sup>6</sup>.

OTC derivative contracts concluded before 12 February 2014<sup>7</sup> that were still in force at that date must be reported to a Trade Repository within 90 days of such date (i.e. within 14 May 2014). OTC derivatives that were in place on 16 August 2012 or that have been concluded thereafter and that were no longer in force on 12 February 2014, must be reported within 12 February 2017.

It is worth noting that under the EMIR, the reporting obligations can be delegated to third parties. It means that NFC concluding OTC derivatives, for instance, with a credit institution will be allowed to give mandate<sup>8</sup> to such credit institution to take care of the reporting obligations connected with the relevant OTC derivative contract.

<sup>5</sup> Some of the key differences between the ISDA Protocol and the ERMTA are reported in the Guidance Notes to the EMIR Risk Mitigation Techniques Agreement and recalled below:

(a) a party may adhere to the ISDA Protocol and be bound by its terms by delivering a letter in the form attached to the ISDA Protocol to ISDA whereas the ERMTA is a bilateral agreement which amends and supplements, through a series of elections, the terms of ‘Covered Agreements’;

(b) Timely Confirmation and counterparty status are not addressed in the ISDA Protocol but are the subject of other ISDA documentation whereas the ERMTA contains an elective provision providing for negative affirmation for confirmations and an election enabling parties to designate their respective counterparty status under EMIR;

(c) the ISDA Protocol permits both parties to be ‘Portfolio Data Receiving Entities’, and should this be the case, provides that the parties will agree a suitable process for reconciling ‘Portfolio Data’. On the contrary, as the ERMTA is a bilateral agreement as opposed to a protocol, it places a prohibition on allowing both parties being ‘Portfolio Data Receiving Entities’. If neither Party wishes to send ‘Portfolio Data’, the parties will need to agree a suitable alternative process for reconciling ‘Portfolio Data’ that meets their needs.

<sup>6</sup> Available here: [http://www.esma.europa.eu/system/files/2012-600\\_0.pdf](http://www.esma.europa.eu/system/files/2012-600_0.pdf).

<sup>7</sup> i.e. the reporting start date calculated pursuant to Regulation 1247/2012 as the date falling 90 days after the registration of a trade repository for a particular derivative class under Article 55 of EMIR.

<sup>8</sup> i.e. *Mandato con rappresentanza* pursuant to Section 1704 of the Italian Civil Code.

Therefore, NFC will need to decide whether to report directly to one of the six Trade Repositories currently registered by ESMA (see Table C attached below to this update) or to delegate such activity to a third party.

### 2.3.3 Sanctions

By virtue of Law no. 97 of 6 August 2013, the Italian lawmaker introduced, in accordance with the provisions of EMIR, a specific pecuniary sanction in case of breach of the certain EMIR obligations (e.g. the risk mitigation obligations or the reporting obligations).

Such sanction ranges from Euro 2,500 up to Euro 250,000 and can be inflicted by Consob to directors, managers, statutory auditors and other persons entrusted with supervisory functions of non-financial counterparties.

The actual risk to be sanctioned by Consob in case of failure to comply with the above requirements within the relevant deadlines is unforeseeable at the moment, due to the first time application of the whole discipline as well as to the difficulty in determining the actual ways Consob will deepen its supervision on this matter.

## 3. Classification of financial instruments as derivatives

Although EMIR was adopted almost two years ago, only the recent urge to fulfill its obligations has caused problems to come to surface.

Particularly, the definitions of 'derivative' or 'derivative contract', which is the main scope of EMIR and therefore drive several EMIR requirements, including calculation of the Clearing Threshold, applicability of risk mitigation techniques, etc., do not appear to be fully clear across EU Member States.

In fact, notwithstanding the terms are defined in the MiFID, there is no single, commonly adopted definition of 'derivative' or 'derivative contract' due to the different transpositions of MiFID across the European Union which is preventing the convergent application of EMIR and causing problems to FC and NFC in the fulfillment of EMIR obligations.

On 14 February 2014, ESMA has raised this problem by sending an official letter<sup>9</sup> to the European Commission regarding the classification of financial instruments as derivatives for the purposes of the reporting obligations under EMIR. With such letter, ESMA has invited the EU Commission as a matter of urgency to adopt an implementing act to clarify these definitions. ESMA stresses that this is particularly the case for foreign exchange (FX) forwards and physically settled commodity forwards and, more specifically it requested a clarification on the definition of currency derivatives (in relation to (i) the frontier between 'spot' and 'forward'; and (ii) their conclusion for 'commercial purposes') and the definition of commodity forwards that can be 'physically settled'<sup>10</sup>.

<sup>9</sup> Available here: <http://www.esma.europa.eu/content/Letter-Commissioner-Barnier-classification-financial-instruments-derivatives>.

<sup>10</sup> With reference to physically settled commodity forwards, the interpretation and application of definitions in points (6) and (7) of Section C of Annex I to MiFID (see footnote 3 above) is not convergent across the EU thus leading to the following queries:

- C7 explicitly applies to "futures" and "forwards" whereas C6 omits any reference to "forwards". Consequently, there are divergent views with regard to whether physical forwards traded on a regulated market or a MTF fall within MiFID's scope.
- C6 and C7 apply to instruments which can be "physically settled". However, "physically settled" is not a defined term under MiFID. Further, C5 refers to instruments that "must be settled in cash or may be settled in cash at the option of one of the parties" whereas C6 and C7 refer to instruments that "can be physically settled". Consequently, determining what is meant by "can, may and must be physically settled" should be considered for the identification of the contracts that fall within the definition of derivatives.

This document is delivered for informative purposes only.

It does not constitute a reference for agreements and/or commitments of any nature.

For any further clarifications or research please contact:

**Milan**

**Ottaviano Sanseverino**  
Tel. +39 02 763741  
osanseverino@gop.it

**Giuseppe Velluto**  
Tel. +39 02 763741  
gvelluto@gop.it

**Emanuele Grippo**  
Tel. +39 02 763741  
emgrippo@gop.it

**Filippo Manaresi**  
Tel. +39 02 763741  
fmanaresi@gop.it

**Rome**

**Milan**

**Bologna**

**Padua**

**Turin**

**Abu Dhabi**

**Brussels**

**London**

**New York**

[www.gop.it](http://www.gop.it)

### 3.1. Multilateral trading facility (MTF)

Finally the financial instruments under C6 of MiFID an “MTF” deserve a final quick comment.

According to C6 of MiFID, “*Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF*” are financial instruments.

However, as already voiced by the FCA<sup>11</sup> in September, there is currently no common view among market participants on the correct characterisation of trading taking place on broker-operated systems offering a market in physically settled gas and power forwards.

Discussions took place in the past months among brokers offering a market in gas and power forwards about the appropriate classification of their systems and it seems that brokers are currently reviewing the functionalities offered by their systems to ensure clear distinctions between the MTF and non-MTF services they provide in order to better identify the gas and power forwards that fall within the C6 definition.

---

<sup>11</sup> <http://www.fca.org.uk/news/statement-about-broker-operated-systems-trading-physically-settled-gas-and-power-forwards>.

**TABLES AND LINKS**
**TABLES**
*Table A*

TYPE OF COUNTERPARTY	EMIR OBLIGATIONS
Financial counterparties (FC)	➤ Clearing obligation
Non-financial counterparties above the Clearing Threshold (NFC+)	➤ Risk mitigation techniques ➤ Reporting obligation
Non-financial counterparties below the Clearing Threshold (NFC-)	➤ <b>Reporting obligation</b> ➤ <b>Certain risk mitigation techniques</b> (timely confirmation, portfolio reconciliation and compression, dispute resolution)
Central Counterparties (CCPs)	➤ CCP requirements
Trading Repositories (TRs)	➤ TR requirements

*Table B*

CLEARING THRESHOLDS	
Euro 1 billion	➤ Credit derivative contracts
Euro 1 billion	➤ Equity derivative contracts
Euro 3 billion	➤ Interest rate derivative contracts
Euro 3 billion	➤ Foreign exchange derivative contracts
Euro 3 billion	➤ Commodity derivative contracts and others

*Table C*

TRADE REPOSITORY	DERIVATIVE ASSET CLASS	EFFECTIVE DATE
DTCC Derivatives Repository Ltd. (DDRL)	All asset classes	14 November 2013
Krajowy Depozyt Papierów Wartościowych S.A. (KDPW)	All asset classes	14 November 2013
Regis-TR S.A.	All asset classes	14 November 2013
UnaVista Limited	All asset classes	14 November 2013
CME Trade Repository Ltd. (CME TR)	All asset classes	5 December 2013
ICE Trade Vault Europe Ltd. (ICE TVEL) Commodities	Credit, equities, interest rates	5 December 2013

## LINKS

### MiFID

- EU Commission - Investment Services Directive – Markets in Financial Instruments Directive (MiFID)  
[http://ec.europa.eu/internal\\_market/securities/isd/mifid/index\\_en.htm](http://ec.europa.eu/internal_market/securities/isd/mifid/index_en.htm)
- MiFID Level 1 consolidated text  
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:02004L0039-20070921:EN:NOT>
- MiFID Implementing (Level 2) Directive  
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32006R1287:EN:NOT>

### EMIR

- EU Commission - Derivatives / EMIR  
[http://ec.europa.eu/internal\\_market/financial-markets/derivatives/index\\_en.htm](http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm)
- EMIR - 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  
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32012R0648:EN:NOT>
- ESMA - European Market Infrastructure Regulation (EMIR)  
<http://www.esma.europa.eu/page/European-Market-Infrastructure-Regulation-EMIR>
- ESMA – Quick guide for non financial companies  
[http://www.esma.europa.eu/system/files/emir\\_for\\_non-financials.pdf](http://www.esma.europa.eu/system/files/emir_for_non-financials.pdf)
- ESMA – Letter to Commissioner Barnier on classification of financial instruments as derivatives  
<http://www.esma.europa.eu/content/Letter-Commissioner-Barnier-classification-financial-instruments-derivatives>

#### INFORMATION PURSUANT TO ARTICLE 13 OF LEGISLATIVE DECREE NO. 196/2003 (Data Protection Code)

The law firm Gianni, Origoni, Grippo, Cappelli and Partners (hereafter "the Firm") only processes personal data that is freely provided during the course of professional relations or meetings, events, workshops, etc., which are also processed for informative/divulcation purposes. This newsletter is sent exclusively to those subjects who have expressed an interest in receiving information about the Firm's activities. If it has been sent you by mistake, or should you have decided that you are no longer interested in receiving the above information, you may request that no further information be sent to you by sending an email to: [relazionisterne@gop.it](mailto:relazionisterne@gop.it). The personal data processor is the Firm Gianni, Origoni, Grippo, Cappelli & Partners, whose administrative headquarters are located in Rome, at Via delle Quattro Fontane 20.