

Notes on the ESMA EMIR Questions and Answers published on 4th June 2013 (with a focus on Energy and Commodity Trading)

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Introduction

On 4th June 2013 ESMA¹ updated their “Questions and Answers” document relating to EMIR². It can be downloaded at http://www.esma.europa.eu/system/files/2013-685_qa_ii_on_emir_implementation_final_for_publication_20130604.pdf.

This short set of notes provides some commentary on some of the answers, particularly as they relate to the energy and commodity trading industry, although the notes may also be applicable to other market participants.

The notes first focus on the “OTC” answers, which relates of a derivative and also how hedge trades are defined. They then focus on the answers to questions on trade reporting. Finally they provide a list of answers that may also particularly interest energy and commodity traders.

Only those answers updated on 4th June have been addressed in the detailed notes.

Italics show the original question and answer, with our comments in non italics.

Of Particular Interest

We feel that the following will be of particular note to market participants in energy and commodities:

- The potential for intra group trades **to count twice** towards the thresholds.
- The requirement to **keep evidence** that a trade is a hedge, for audit purposes.
- Needing to generate Unique Transaction Identifiers (UTI) for **historic traces**.

These are analysed in the following sections.

¹ European Security and Markets Authority

² European Market Infrastructure Regulation

“OTC” – What is a Derivative? + Hedging Definitions

Question 3b – Calculation of threshold

Should the following OTC derivative transactions be counted against the clearing threshold:

1. *intragroup transactions ?*

*Answer: If two NFC group entities enter into an intragroup transaction with each other which does not fall within the hedging definition³, both sides of the transaction should be counted towards the threshold. The total contribution to the group-level threshold calculation would **therefore be twice the notional of the contract**. For non-hedging intragroup transactions between one NFC and one FC, only the NFC side of the transaction needs to be counted.*

Counting a non hedged intra group deal **towards the threshold twice**, could have a huge impact on market participants being over or under the threshold. Supplier trading units will need to be very careful to mark hedges properly as the consequences of not doing so are high are high. They are even higher for those who transfer risk across group boundaries (those deals are unlikely to count as hedges)..

2. *contracts which are cleared on a voluntary basis ?*

Answer: OTC contracts cleared on a voluntary basis are included in the calculation of the clearing thresh-old.

This reduces flexibility in terms of going over the threshold, thus removing another lever available to market participants to stay under.

3. *Positions taken by the financial subsidiaries of the non-financial counterparty?*

Answer: As per Article 10(3), only the positions taken by non-financial entities of the same group count for the calculation of the clearing threshold.

This could open up an interesting route to deal with Treasury.

4. *Positions taken by third-country non-financial entities in the same group as the EU non-financial counterparty?.*

Answer: Positions taken by third-country non-financial entities in the same group as the non-financial counterparty, which would be non-financial counterparties if they were in the EU, count for the calculation of the clearing threshold.

Once again, this will potentially push a few more energy and commodity traders over the threshold.

Question 5a - Timely confirmation

Does confirmation refer to (1) the sending part (i.e. each party must meet the deadline to send the confirmation to the other party) or (2) the signature or matching part (i.e. both parties must meet the deadline to sign or match the confirmation). Is negative affirmation allowed?

Answer: The term 'confirmation' is defined in Article 1(c) of the Commission Delegated Regulation (EU) No 149/2013 (RTS on OTC derivatives): it means the documentation of the agreement of the counter-parties to all the terms of an OTC derivative contract.

Therefore, to comply with the confirmation requirements, the counterparties must reach a legally binding agreement to all the terms of an OTC derivative contract. The RTS implies that both parties must comply with it and agree in advance on a specific process to do so.

Note that the measurement of "timely", is the agreement the confirm, not when it is sent out. This is a different interpretation to that of many of those we are seeing in the energy market.

Question 10 a – Hedging definition

How to demonstrate compliance with the hedging definition? Are policies adopted by non-financial counterparties or audited accounts sufficient to demonstrate compliance with hedging definition?

Answer (Partial):

The policies adopted by a counterparty, in particular when they are audited, provide an indication of the nature of the OTC derivative contracts this counterparty can conclude. This indication should be comforted by the analysis of the OTC derivative contracts actually concluded and the effective hedging that need to take place when the contract is concluded and during the life time of the contract.

*Therefore, neither audited accounts nor internal policies per se are sufficient to demonstrate that the relevant contracts are for hedging purposes, but **need to be supplemented by evidences of the actual risk***

Note that this gives rise to quite a serious auditing requirement. The consequences of a lack of audit are a potentially expensive breach of threshold.

Trade Reporting

Questions 3d and e – Reporting of collateral and valuation

(d) *Shall change in the amount of collateral be reported as modification (M) or as valuation update (V) in field No. 58?*

Answer:

Valuation update (V) in field No. 58 refers to any change in fields 17 to 26 of table 1. Therefore, changes in the amount of collateral should be reported as a (V) in field 58.

This does not answer the question. If a trade is modified leading to an 'M', the valuation will surely also change, which would lead to a 'V', as it would every day as most values change. Therefore the question must be asked again.

(e) *e - In the case of OTC derivatives not cleared by a CCP, do counterparties have to agree on the valuation reported?*

Answer: Since the valuation is part of the Counterparty data, in the case of a derivative not cleared by a CCP, counterparties do not need to agree on the valuation reported.

While this answer is sensible (since agreeing a valuation between counterparties will lead to an excessive process increase), it will create a great deal of interesting data on the difference in valuation methodologies between counterparties.

Question 4c – Reporting of outstanding positions following the entry into force of EMIR (Backloading)

Is an agreed Trade-ID also necessary for backloaded trades?

*Answer: To the extent that a backloaded contract is still outstanding at the time of reporting, **a Trade-ID needs to be agreed between the two counterparties** and reported, together with the other information on that contract.*

This is going to be very hard. The UTI now needs to be agreed retrospectively between counterparties going back to August 16th 2012. That is deals that were *live* then, so they may have been stuck years earlier. Expect a huge piece of work to follow from this answer.

Question 7a – Avoidance of duplication

In order to avoid the duplication of reported details (according to Article 9(1) of EMIR), could the CCP impose on its clearing members (and, consequently, on counterparties represented by the clearing members in clearing) that transactions accepted by the CCP for clearing are re-reported only by the CCP to the TR selected by the CCP?

Answer: Under Article 9 of EMIR, both the counterparties and the CCP have an obligation to ensure that the report is made without duplication, but neither the CCP nor the counterparties have the right to impose on the other party a particular reporting mechanism. However, when offering a report-ing service the CCP can choose the TR to be used and leave the choice to the counterparty on whether to accept or not the service for its trade to be reported by the CCP on its behalf.

This is worth noting. When picking a CCP, or indeed any other service, you have the choice of whether to use their reporting service.

Question 10b – LEIs

What code should be used to identify counterparties (LEIs, interim LEIs or BICs)?

An interim LEI meeting the conditions indicated by the LEI Regulatory Oversight Committee (ROC) is expected to be used for reporting purposes under EMIR. Please refer to the annex to the first progress not on the Global LEI Initiative: http://www.leiroc.org/publications/gls/roc_20130308.pdf

ESMA expects participants to use LEIs, from day one, according to this answer. We recommend that market participants keep a close eye on this.

Other answers of interest

We recommend that market participants become familiar with the entire ESMA document. Here we list the QAs that we feel will be of most interest to those in the energy market in addition to the ones we have analysed. We have only listed the answers that were updated in the 4th June document.

Section	Number	Topic
OTC	1 (all)	Definition of OTC derivatives in the context of the notification of the classes of OTRC derivatives cleared by CCP.
OTC	3(all not covered above)	Calculation of the clearing threshold
OTC	5(all not covered above)	Timely confirmation
OTC	9(all)	Notional amounts
OTC	10(all not covered above)	Hedging definition
OTC	11(all)	Portfolio compression
CCP	13(all)	Margin requirements
TR	3(all not covered above)	Reporting of collateral and valuation
TR	4(all not covered above)	Reporting of outstanding positions following the entry into force of EMIR (Backloading)
TR	5(all)	Reporting to TRs – ETDs
TR	7(all not covered above)	Avoidance of duplication
TR	8(all)	Delegation
TR	11	Frequency of reports
TR	12	Maturity

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