European Financial
Markets Lawyers Group

- THE VICE-CHAIRMAN -

Mr Steven Maijoor
Chair of the European Securities and Markets Authority (ESMA)

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Dear Mr Maijoor
Dear Ms Ross

Issues of Legal Uncertainty and the European Market Infrastructure Regulation ("EMIR")

The European Financial Markets Lawyers Group (www.efmlg.org) is a body established in 1998 and composed of senior lawyers from the major banking institutions of the European Union. The EFMLG is active in wholesale and investment markets and discusses legal matters of common interest, both regulatory and contractual in nature, with the aim of contributing to the furtherance of the integration of financial markets in Europe.

The purpose of our letter is to highlight a number of legal uncertainties as well as practical implications that we, as financial market participants, have identified in implementing EMIR. We note that there is an increasing trend towards the use of directly applicable Regulations[1] instead of Directives in European financial services legislation. With this in mind, our comments are set out below under three main headings (1) Legal uncertainty issues relating to the text of the legislative measures (2) issues relating to sources of guidance and/or interpretation of the legislative texts and (3) some practical implications and difficulties that market participants face in implementing EMIR.

Finally, we have some suggestions as to how these issues could be improved in the future.

1. ***Legal Uncertainty Issues relating to the text of the legislative measures:*** As a Regulation is directly applicable in all Member States (Article 288 of the Treaty on the Functioning of the European Union), it is important that the text is clear and unambiguous both as to Level 1 obligations as well as matters delegated to be the subject of Regulatory Technical Standards ("RTS"). We set out below some examples from EMIR where we believe the text fails to achieve the required clarity:

   (i) a "Non-Financial Counterparty" is defined as "an undertaking established in the Union....". However, there is no definition of "undertaking" nor "established" in EMIR. With respect to "undertaking", some Member States may have domestic legislation which defines this term. In

[1] Short Selling Regulation, CRD/R, MiFID/R, MAD/R

the absence of clarity in the Level 1 text, this would seem to lead to the outcome that "undertaking" will be interpreted differently throughout the Union. A similar issue may also arise in relation to "established" where varying interpretations may be applied throughout the Union. In relation to the latter, it is also not clear to what extent the legislation applies to branches.

(ii) The EMIR text in some places cross-refers to definitions in Directives[2]. There appears to be an inherent contradiction in drafting legislation in this way. Directives often permit a degree of discretion for local regulators to interpret and adapt certain matters in their home jurisdiction. Cross-referencing provisions in Directives in this way does not appear to be consistent with the use of a Regulation.

(iii) The scope of the delegated powers is not always free from ambiguity. For example, the risk mitigation obligation in relation to confirmations (Article 11(1)(a)) requires counterparties to have "appropriate procedures and arrangements" for the "timely confirmation, where available, by electronic means of the terms of the relevant OTC derivative contract". However, when the draft RTS were published, many market participants interpreted Article 12 of the RTS as a requirement that they had to adhere to specific deadlines for trade confirmations. Subsequently, the European Commission confirmed in its FAQs on timely confirmations that the interpretation should be that firms should have procedures to achieve these deadlines.

2. ***Sources of guidance and/or interpretation of legislative texts:*** Whilst the European Court of Justice is the ultimate authority on interpretation of European legislation, there does need to be a more immediate and accessible source of guidance and interpretation. The issues we have identified so far in this respect are as follows:

(i) The "Frequently Asked Questions" and the "Questions and Answers" published respectively by the European Commission and ESMA are a welcome source of clarification. However, it is inevitable that these will tend to address the more general industry-based questions. Individual institutions will have specific questions applicable to their structure and client base that will need clarification. In addition, it is important that ESMA should not in these Questions and Answers go beyond what is stated in the regulation and thereby impose more stringent requirements than those contained in the legal text.

(ii) It is not clear to what extent financial institutions can rely on advice or discussions with their local regulator when they are implementing a Regulation. It is possible that local regulators may give different interpretations which will not lead to a consistent approach throughout the Union. This risk is especially relevant with respect to the newly developed Questions and Answers published by ESMA, which are based upon Article 29(2) of Regulation (EU) No 1095/2010 of 24 November 2010 ("ESMA Regulation"). The preferred instrument would be guidelines issued by ESMA in accordance with Article 16 of the ESMA Regulation, which are enforced by the "comply-or-

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[2] Article 2(5) EMIR refers to the definition laid out in points (4) to (10) of Section C of Annex I to the Directive 2004/39/EC ("MiFID").

explain mechanism" and which are binding on all competent authorities that have confirmed its application.

(iii) Institutions can be exposed to additional litigation risk if a counterparty takes a differing view on implementing a provision of EMIR.

3. ***Practical Implications:*** Some examples of the practical implications and difficulties faced by market participants in implementing EMIR are as follows:

(i) The extraterritorial scope of EMIR is still not clear e.g. application to branches, the extent of the clearing obligation where one or both parties are outside the Union[3] and to what extent the trade reporting obligation applies outside the Union. Further, there is a growing tendency to extend the extraterritorial scope of the new regulatory requirements beyond the text of EMIR. An example is the answer given by ESMA in its Questions and Answers (as updated on 4 June, 2013) on the application of risk mitigation techniques to counterparties in third countries. OTC Answer 12 implies that European counterparties have to ensure that certain risk mitigation techniques specified in Article 11 of EMIR are met "*even though the third country entity would not itself be subject to EMIR*". This statement conflicts with Article 11 of EMIR which specifies organisational requirements only and which does not provide authority to the European Commission only in circumstances where both counterparties are established in third countries (Article 11(12) of EMIR).

There is the additional problem here in that the European counterparty cannot meet the Article 11 obligations unilaterally and may potentially not be compliant with EMIR through no fault on its part. There is a lack of certainty as to how institutions should handle this issue when the Article 11 obligations arise on 15 September, 2013 in situations where the third country entity does not agree or respond despite the best efforts of the European counterparty.

(ii) The trade reporting obligation in Article 9 of EMIR applies to both parties – there is no hierarchy of reporting responsibilities as there is under the U.S. Dodd-Frank Act. In reality, many non-financial institutions will not have the infrastructure to report their trades to a trade repository and they will therefore look to financial institutions to report on their behalf. There needs to be sufficient time before the legal obligation becomes effective for institutions to build the necessary connectivity as well as to document the legal terms of any delegated reporting process.

(iii) Some counterparties, particularly those who do not use standard market documentation such as ISDA, will need time to document proposed changes under Article 11 of EMIR which relate to portfolio reconciliation, portfolio compression and dispute resolution.

(iv) In relation to the introduction of mandatory clearing under Article 4, the process should allow adequate time for institutions to become connected to authorised CCPs in addition to allowing sufficient time for client clearing documentation to be signed.

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[3] Article 4(1)(iv), (v) and Article 11(11) of EMIR

(v) Whilst the bilateral collateral requirements of Article 11(3) have yet to be published, it is important that financial institutions are not inadvertently required to post collateral in jurisdictions where they cannot obtain a robust legal opinion as to the enforceability of their rights in respect of the collateral.

4. *Suggestions to deal with the issues above:*

(i) Legal drafting specialists should be proactively engaged throughout the legislative process in order to ensure that the final text of a Regulation is coherent and consistent.

(ii) The legislative intent of a Regulation should be more clearly stated in the Recitals. This would be useful in the context of drafting the RTS.

(iii) The drafting of a complex piece of legislation such as EMIR should acknowledge that there may be industry-wide issues that need to be addressed in the implementation process. The text should therefore allow for the European Commission to delay implementation in such circumstances.

(iv) In order to ensure the common, uniform and consistent application of European law throughout the Union, European Supervisory Authorities should exclusively use the instrument of guidelines and recommendation. This would ensure both the desirable public consultation and the competent authorities' duty to either comply with the guidelines and recommendation or to give reason for non-compliance.

We would welcome the opportunity to discuss these issues in more detail with you.

Yours sincerely,

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