

EXPLANATORY MEMORANDUM TO
THE FINANCIAL SERVICES AND MARKETS ACT 2000 (OVER THE COUNTER
DERIVATIVES, CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES)
REGULATIONS 2013

2013 No. 504

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 These Regulations implement in part Regulation (EU) 648/2012 of the European Parliament and of the Council of 4 July 2012 on over the counter (“OTC”) derivatives, central counterparties and trade repositories (OJ no L 201, 27.7.2012, p1), (more commonly known as the European Markets Infrastructure Regulation or “EMIR”) principally by making amendments to the Financial Services and Markets Act 2000 (c.8) (“FSMA”) and the Companies Act 1989 (c.40). These Regulations repeal provisions in domestic law which are inconsistent with EMIR or no longer required, and ensure that EMIR is fully effective and enforceable in the United Kingdom.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Context

4.1 These Regulations implement in part EMIR.

4.2 EMIR is directly applicable, and many aspects of EMIR do not require implementation via domestic legislation. EMIR’s aims include:

- an obligation for central clearing of certain classes of OTC derivatives;
- the application of risk mitigation techniques for non-centrally cleared OTC derivatives;
- the application of organisational, conduct of business and prudential requirements for central counterparties (“CCPs”);
- the application of requirements for trade repositories, including the duty to make certain data available to the public and relevant authorities; and
- an obligation to report to trade repositories.

4.3 The Regulations amend FSMA to repeal provisions which are inconsistent with EMIR or no longer required. Part 18 of FSMA (which applies to recognised clearing houses) is amended to include CCPs authorised under EMIR as a new category of recognised clearing house to be known as recognised central counterparties. Part 18 is adapted in order to disapply provision inconsistent with EMIR, including the procedures for authorising CCPs and withdrawing authorisation in articles 17 and 20 of EMIR

respectively. Similarly, the Financial Services and Markets Act 2000 (Recognition Requirement for Investment Exchanges and Clearing Houses) Regulations 2001 are amended to disapply most of the recognition requirements for clearing houses in the case of CCPs authorised under EMIR, because EMIR contains directly applicable requirements for these institutions.

- 4.4 To ensure that EMIR is effective in the UK, the Regulations also provide for the designation of the Bank of England, Financial Conduct Authority and Prudential Regulation Authority as competent authorities for different purposes. EMIR requires competent authorities to have all the supervisory, investigatory and enforcement powers necessary for the exercise of their functions. Consequently, the Regulations contain provision for the enforcement of EMIR and for sanctions, but further enforcement and sanctions powers in FSMA as amended by the Financial Services Act 2012 are to be applied to EMIR by secondary legislation due to come into force at the same time as these Regulations (on 1 April 2013). These changes largely maintain the same enforcement powers available to the competent authorities from FSMA. EMIR gives the European Securities and Markets Authority (“ESMA”) enforcement powers in relation to trade repositories, and these Regulations ensure that prior judicial authorisation must be obtained for ESMA to gain access to telephone or data traffic records and for on-site inspections.
- 4.5 EMIR also includes requirements relating to the segregation of positions and collateral, and the transfer of positions and collateral on the default of a clearing member to another clearing member (often called “porting”). The Regulations therefore amend Part VII of the Companies Act 1989, the Financial Markets and Insolvency Regulations 1991, the Financial Markets and Insolvency (Settlement Finality) Regulations 1999, and the Financial Services and Markets Act 2000 (Recognition Requirement for Investment Exchanges and Clearing Houses) Regulations 2001 to ensure UK legislation implements and facilitates the operation of these requirements.
- 4.6 Explanatory Memorandum 13917/10 relating to the Regulation on OTC derivatives, central counterparties and trade repositories was sent to both scrutiny committees on 22 September 2010. It was cleared by the House of Lords EU Economic and Financial Affairs and International Trade Sub-Committee on 3 May 2011. The House of Commons EU Economic and Financial Affairs and International Trade Sub-Committee held the document under scrutiny whilst negotiations progressed. The Government was able to secure an outcome that broadly met its and the Committee’s concerns at an Economic and Financial Affairs Council meeting on 4 October 2011, and therefore decided to override scrutiny. The Government wrote to the Commons’ Sub-Committee informing them of this and the reason for the override. The Sub-Committee accepted the Government’s explanation and cleared the documents on 12 October 2011.

5. Territorial Extent and Application

- 5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

- 6.1 The Financial Secretary to the Treasury, Greg Clark MP, has made the following statement regarding Human Rights:

In my view the provisions of the Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013 are compatible with the Convention rights.

7. Policy background

What is being done and why

- 7.1 The financial crisis revealed problems in OTC derivatives markets most notably deficiencies in management of counterparty credit risk, raising systemic risk concerns, and a lack of transparency regarding risk concentrations.
- 7.2 At the G20 meeting in Pittsburgh in September 2009, leaders agreed 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. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”
- 7.3 The EU took large parts of this agreement forward through EMIR. EMIR sets out regulatory and prudential requirements and authorisation and supervision regimes for CCPs and trade repositories in Europe. EMIR also mandates the central clearing of certain standardised OTC derivatives and sets out certain requirements on counterparties that trade OTC derivatives.
- 7.4 EMIR officially entered into force on 16 August 2012. However many of its substantive provisions will not take effect until technical standards relating to them, and developed by ESMA and the European Banking Authority and adopted by the European Commission on 19th December 2012, come into force. The Commission published the technical standards in the Official Journal of the European Union on 23 February 2013. These will enter into force on 15 March 2013. The Regulations being made domestically come into force on 1 April 2013, at the same time as the main provisions of the Financial Services Act 2012.
- 7.5 Typically, there is no need for the UK to transpose EU Regulations into our domestic legislation as they are binding in their entirety and directly applicable in all Member States. However, the UK is obliged to ensure that our domestic law is compatible with such EU Regulations, and that such EU Regulations are enforceable within the UK.

- 7.6 As noted above, EMIR includes requirements relating to the segregation and porting of positions and collateral. It requires CCPs to segregate clearing members' proprietary and client business on an account by account basis, requiring CCPs and clearing members to offer clients the choice between omnibus and individually segregated accounts. It then requires CCPs to commit themselves to attempt to port the client accounts on the failure of their clearing member, in order to minimise the systemic disruption caused by clearing member failure. To implement and facilitate the operation of these requirements, we need to amend the Part VII of the Companies Act 1989, the Financial Markets and Insolvency Regulations 1991, the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 and the Recognition Requirement Regulations. These amendments will, in particular, offer CCPs additional certainty that porting can be achieved without the risk of challenge under UK insolvency law.
- 7.7 The Treasury will also be making amendments to the recognitions requirements for clearing houses in the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 ("2001 Regulations"). The 2001 Regulations set out the requirements that must be met to be authorised as a recognised clearing house (the category CCPs fall into). As EMIR now sets out the requirements that must be met in order to be a CCP, we must amend the 2001 Regulations in order to avoid duplicative requirements and conflict. The changes to the 2001 Regulations do not require a consultation because we are merely ensuring existing domestic legislation is consistent with EMIR.
- 7.8 EMIR also requires competent authorities to have all the supervisory and investigatory powers necessary for the exercise of their functions. The Regulations give the Financial Conduct Authority ("FCA") the power to require information and documents for its functions as a competent authority where FSMA does not provide such a power.
- 7.9 EMIR gives ESMA the power to make on site inspections of trade repositories. Under the Regulations ESMA requires court authorisation before carrying on an on- site inspection. Provisions are made in the Regulations for on-site inspections by means of a compulsory power of entry under warrant from the High Court. The Regulations also require ESMA to obtain authorisation from the High Court before it can exercise its power under EMIR to obtain data traffic or telephone records in relation to trade repositories.
- 7.10 Furthermore, the UK is obliged under EMIR to ensure there are effective, proportionate and dissuasive penalties in place. The Regulations establish power for the FCA to impose penalties for infringement of EMIR, which are effective, proportionate and dissuasive. There are criminal penalties for failure to comply with information requirements on the acquisition and ownership of CCPs, and for refusing to allow ESMA access to inspect premises.
- 7.11 These changes largely maintain the same enforcements available to the FCA and Bank of England from FSMA and in the case of entry to premises by

ESMA, regulation 33 of the Credit Rating Agencies Regulations 2010 (S.I. 2010/906).

Further Statutory Instrument Required

- 7.12 The Treasury proposes to make further specific changes in this area, which will require implementation through a further statutory instrument. This first change is to make amendments following an assessment of whether there is a need for a recognition requirement for recognised clearing houses which are not CCPs authorised under EMIR. This will take into account work carried out by the BCBS/IOSCO working group on margin requirements, which is looking at margin requirements for non-centrally cleared derivatives, and set to report after the laying of this instrument, and any relevant regulatory or market developments.
- 7.13 The further statutory instrument may also make further legislative changes to implement and facilitate segregation and porting requirements for indirect clearing, as set out in a regulatory technical standard adopted by the Commission on 19th December 2012. The Treasury considers that additional engagement with industry is essential in order to assess whether further legislative changes are required and, if so, how they could accurately reflect best market practice.

Consolidation

- 7.14 These Regulations make amendments to domestic legislation to implement in part EMIR. Since the amendments are limited in scope, consolidation of the secondary legislation is not merited. Furthermore, by the time these regulations come into force, aspects of FSMA that are relevant to this instrument will have been amended extensively by primary legislation.

8. Consultation outcome

- 8.1 The Treasury did not formally consult on all aspects of the implementation of EMIR, as the enforcement powers of the competent authorities are largely similar to the powers in relation to the existing regime, which are familiar to market participants. The changes to the recognition requirements for CCPs do not require a consultation because as EMIR is a directly applicable EU Regulation with requirements and obligations which apply without implementation into domestic law, the Treasury needed only to ensure that existing domestic legislation was consistent with it. As there was therefore a very limited way in which a consultation could affect the draft legislation, it was decided that no consultation was necessary on this issue.
- 8.2 With regard to the changes necessary for the provisions in EMIR relating to porting, the Treasury's public consultation in December 2009 on "Establishing resolution arrangements for investment banks" sought views on extending Part VII of the Companies Act 1989 to facilitate porting. As porting was subsequently adopted by EMIR, we decided to build upon this full public consultation with two informal targeted consultations.

8.3 On 27 July 2012, the Treasury launched its first informal targeted consultation with key stakeholders who had been involved in the EMIR process to assess the changes covering segregation and porting and the proposed amendments to Part VII of the Companies Act 1989 and the related changes to the Recognition Requirements Regulations. The Treasury held a meeting with consultees and received several detailed responses by the close of the consultation on 3 September, which we took into account when drafting these regulations. This was followed with a further round of consultation on 8 October 2012 on Part VII of the Companies Act 1989, the Financial Markets and Insolvency Regulations 1991, the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 and the related parts of the Recognition Requirement Regulations. The Treasury received responses to the second round of consultation by 22 October 2012 and took these into account when drafting of the regulations.

9. Guidance

9.1 The Treasury does not propose to produce any guidance in relation to the Regulations. ESMA and the competent authorities within the UK have the power to issue guidance in relation to EMIR and these Regulations.

10. Impact

10.1 The financial impact on UK businesses of the changes contained within this instrument will be negligible, in terms of regulatory impact, the changes to the existing regulatory regime are no more or less onerous on market participants, with many of the changes simplifying the existing legal and regulatory landscape.

10.2 The impact on charities and voluntary bodies is negligible.

10.3 The impact on the public sector is negligible.

10.4 An Impact Assessment was not conducted as the Regulation is purely mechanical, and does not significantly impact individuals or businesses.

11. Regulating small business

11.1 The legislation applies to small business.

11.2 There is no provision to minimise the impact of the requirements on small firms employing up to 20 people. EMIR does not provide any basis for excluding small or micro businesses from regulation. It is also undesirable to exempt smaller firms from EMIR as this would hinder its effectiveness, and run the risk of regulatory arbitrage based on firm size.

11.3 There was no formal consultation of market participants, other than informal consultation throughout negotiations with market participants on the European

Commission's proposals for EMIR, including a number of round table meetings, as well as the European Commission's public consultation which informed EMIR's proposals. Therefore, the Treasury did not formally consult with small firms on possible exemptions for small businesses; such an exemption would not be possible due to the direct applicability of EMIR.

12. Monitoring & review

12.1 The Treasury is required to review the operation and effect of the Regulations within a five year period after the Regulations come into force and within every five years after that.

12.2 Under Article 85 of EMIR the Commission is required to review and prepare a general report on EMIR and submit that report together with any appropriate proposals to the European Parliament and Council by 17 August 2015.

13. Contact

Ola Ajadi at the Treasury, telephone: 020 7270 5912 or email: ola.ajadi@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.