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MEMORANDUM

EMIR: reporting of derivatives transactions and corporate transactions

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world.

This memorandum has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members and their firms advise companies on a wide range of corporate and other transactional activity.

We are aware that a number of issues relating to EMIR are under consideration. This memorandum concerns the potential legal uncertainties which may arise as to the application of EMIR – and specifically its reporting requirements - to ordinary corporate transactions and arrangements (e.g. between companies and their shareholders, when capital raising, with share scheme arrangements for employees). These issues arise because EMIR is based on the concept of a derivative under MiFID, and if the wording of that concept is applied literally to ordinary corporate arrangements it may produce a range of consequences which we believe were not intended and which will not be relevant to achieving the objectives which underlie EMIR.

The Committee has considered these issues and thought that it might be of assistance if we were to share our views more widely as we believe that there are a number of important points which need to be taken into account when considering the application of EMIR in this context.

We set out below our thoughts on conceptual issues relating to the concept of a "derivative" and then address in the light of these thoughts certain specific transactions/arrangements.

Conceptual issues

We accept that the definition of "derivative" in EMIR must be widely-drawn in order to capture a wide range of exchange-traded and OTC derivatives traded between financial institutions and non-financial institutions, both for speculative and hedging purposes. However, we believe that it is necessary to draw a distinction between OTC derivatives traded between corporate entities and financial counterparties for such purposes, in respect of which there is a discernible "market", and those private arrangements entered into by companies with their employees and shareholders or with other non-financial companies, as part of ordinary corporate transactional business and for very different purposes.

For the purposes of EMIR, a derivative or derivative contract is defined as "a financial instrument as set out in points (4) to (10) of Section C of Annex 1 to Directive 2004/39/EC as implemented by Articles 38 and 39 of Regulation (EC) No 1287/2006" (MiFID).

It follows that for an instrument to be caught by EMIR it must be a "financial instrument" as defined in MiFID. There is no general definition of a "financial instrument" in MiFID.

A good starting point, we believe, in assessing whether or not a contract entered into by a non-financial counterparty is a derivative subject to the EMIR reporting obligation is to determine, in relation to that overall transaction, what its "**dominant characteristic**" is and whether it is even a financial instrument for the purposes of MiFID.

An example of such an approach was manifested in the Q&As published by the FCA's predecessor, the Financial Services Authority, in its Q&As on its domestic CFD disclosure regime. In answer to the question "how should underwriting obligations be treated under the new rules?", the FSA replied:

> "A pre-condition for an instrument to be caught by the new regime is that is must be a 'financial instrument' as defined in the Markets in Financial Instruments Directive (MiFID).
>
> We do not consider that 'conventional' underwriting or sub-underwriting contracts in relation to a primary markets rights issue would likely constitute a financial instrument under MiFID".

Although the FSA did not set out its reasoning expressly in this regard, we assume that this was less likely to be on the basis of a strict technical analysis of the instrument (i.e. whether or not there are conditional future obligations to take the shares under the underwriting/sub-underwriting contract that might make it a CFD) but more on the basis that a legal agreement such as this, taken as a whole and in terms of its dominant characteristics, is essentially different from a financial instrument for the purposes of MiFID and that from a policy perspective it should be distinguished from CFDs caught by the disclosure regime.

We believe that the FSA's answer – although given in a specific context - evidences the type of 'holistic' assessment that supervisors will, in all likelihood, have to take in determining the perimeter of the EMIR reporting obligation as it applies to non-financial counterparties. That is assuming that there is a policy desire to avoid a large number of common commercial transactions becoming reportable based on a narrow, technical analysis (in accordance with Annex 1, point (4) to (10) MiFID), as (i) few, if any, of these can have been in the contemplation of either the G20 in Pittsburgh or the European Commission or ESMA in the subsequent development of EMIR and its technical standards and (ii) the submission of data in respect of such transactions would not provide meaningful data to supervisors or transparency to the industry and indeed might serve to obscure the overall picture of the derivatives markets which trade reporting is supposed to provide.

We believe that a similar test, based on the characteristics of a transaction, could be applied to a variety of corporate agreements (see further comments below). It is true that there is no settled test as to what the dominant characteristics of a MiFID financial instrument are. Article 38 of Commission Regulation (EC) No. 1287/2006 sets out the characteristics of "other derivative financial instruments". The provisions of this article are limited to delineating those instruments which are and which are not within section C(7) and Section C(10) of MiFID, but are indicative of a distinction to be made between instruments which are financial instruments for the purposes of MiFID and those which are not.

We believe that such a "dominant characteristic" test should be applied to corporate transactions <u>before</u> conducting a technical analysis of whether a component of the transactions is or is not a derivative for the purposes of EMIR/MiFID.

We believe that such an approach is justified, as a matter of policy, by public pronouncements that have been made throughout the development of EMIR:

- The Communication from the Commission on 3 July 2009 (Ensuring efficient, safe and sound derivatives markets) described derivatives as "*financial contracts that trade and redistribute risks generated in the real economy, and are accordingly important tools for economic agents to transfer risk*". The Communication was accompanied by a Commission Staff Working Paper. Amongst other things, that paper made the following points:

  - By their nature, OTC markets are markets for professional investors and are thus not directly accessible to the general public;

  - As regards transparency, in the "mostly OTC market for derivatives, information available to market participants and supervisors is limited". "*More transparency to regulators, mainly on positions, might improve the resiliency of the financial system*......and might also improve *market efficiency* (in particular through price transparency)..."

- At the G20 Pittsburgh summit on 26 September 2009, the Leaders Statement called (amongst other things) for OTC derivatives to be reported to trade repositories and asked the FSB and its relevant members "to assess regularly implementation and whether it is sufficient to *improve transparency in the derivatives markets*, *mitigate systemic risk*, and protect against market abuse".

- EMIR Recital (41): "It is important that market participants report all details regarding derivative contracts they have entered into to trade repositories. As a result, *information on the risks inherent in derivatives markets* will be centrally stored and easily accessible, inter alia, to ESMA, the relevant competent authorities, the European Systemic Risk Board (ESRB) and the relevant central banks of the ESRB".

- EMIR Recital (43): "In order to allow for a comprehensive *overview of the market* and *for assessing systemic risk*, both CCP-cleared and non-CCP-cleared derivative contracts should be reported to trade repositories".

- In developing its RTS on the details and type of reporting to TRs, ESMA considered one of three key elements was the purpose and content of reporting. As regards the purpose of reporting, ESMA considered the G20 Pittsburgh declaration and the objectives of EMIR, *noting that transparency, protection against market abuse and systemic risk mitigation were central*.

Extrapolating from all of the above pronouncements we draw the following conclusions:

- The types of derivatives contracts to which the legislation is designed to apply involve the redistribution and transfer of risk from one party to another – none of the corporate transactions or arrangements identified below, notwithstanding elements of optionality or futurity, involve the transfer of risk from one party or the assumption of risk by the other, as contemplated by the Commission and they do not constitute risk management instruments. They can be distinguished from the hedging transactions that a non-financial counterparty will enter into, which will likely be with a financial counterparty, such as an investment bank, and which will involve some systemic risk (even if that is lower than in the case of non-hedging, speculative derivatives) and which are (and which, in accordance with the policy aims of EMIR) should be - reportable as risk management instruments.

- It is often impossible to talk of a "market" when one looks at the majority of private corporate transactions (with companies operating off their own capital base): this is in contrast to the recognised OTC derivatives market which is made available by financial institutions to non-financial institutions in order to enable the latter to hedge (i.e. transfer) the risks to which their businesses are subject.

- In the absence of a "market" and without any real transfer of risk, it is difficult, if not impossible, to identify any systemic risk to which the financial markets or the economy generally might be subject resulting from such transactions and it is therefore difficult to see why they should be subject to the systemic risk mitigation provisions of EMIR. In accordance with recital (43) of EMIR one cannot see how information in relation to such corporate transactions, if submitted to TRs, would help in identifying the *risks inherent in the derivatives markets* or otherwise assist preserving financial stability or resiliency. On the contrary, such information, if it were provided, could well contribute to an inaccurate and misleading picture of those markets to ESMA, competent authorities, ESRB and central banks. We therefore do not see how the reporting of such corporate transactions is required to address the concerns regarding lack of transparency identified by the G20 or by the Commission in its Communication of 4 March 2009 (Driving European Recovery) or the Commission Staff Working Paper of 3 July 2009.

- It is simply impossible in almost all cases to disaggregate a "derivative" component from the overall corporate transaction of which it forms an integral part. It is simply not tradable in its own right and the rights attached to the "derivative" do not exist independently from the corporate transaction. There is therefore no financial instrument as such.

- Following on from that, we believe that it is the *substance* of the overall corporate transaction – in terms of its dominant characteristic and viewed holistically – which should be determinative of whether or not it is a financial instrument which is a derivative for the purposes of EMIR/MiFID. It should not be, taken by itself and in isolation, the *form* of an individual component which may have, for example, in terms of its mechanics an element of optionality or futurity about it.

Examples

In the light of the above, we turn to some specific types of examples. In the circumstances we believe that it is very important that some clear and proportionate guidance is given to the NFC corporate sector so that unnecessary and counterproductive confusion is not created and the focus is correctly on those speculative and risk management instruments which *are* reportable.

1. Non-transferable employee options (or any incentive containing a future element) granted by public or private companies.

The dominant characteristic of such instruments is clearly very different from a MiFID financial instrument. While the mechanics of an employee share option are not dissimilar to those of a financial derivative instrument, the rationale behind their issue and the context in which they are issued are entirely different. An employee share option (whether over yet-to-be issued shares (in which case, in any event it would have the hallmarks of a warrant and not a derivative) or over already-issued shares) grants an employee the right to buy shares in the employee company at some point in the future. The company does not issue employee share options to hedge a risk; instead they issue such options as a form of remuneration to incentivise employees. There is no transfer or trading of risk; they are not used for the purposes of risk management, hedging or speculation. An employee share scheme is a private, closed scheme between the company and its employees. There is no derivatives "market" in the share options and the existence of such instruments does not give rise to systemic risk. The reporting of such instruments would not shed any light on the risks inherent in the derivatives markets; on the contrary, it would serve to obscure the true picture of those markets.

2. **Obligations contained in a private company's articles or in a shareholders' agreement to the effect that when an employee shareholder ceases to be employed, he must transfer his shareholding to other existing shareholders or to an employee trust – the other shareholders may be undertakings and may have an option to buy the shares in such circumstances.**

Following on from the previous point, in our view this type of arrangement does not constitute the granting of an "option" under MiFID and is therefore not reportable under EMIR. Such obligations and "options" represent a private, internal arrangement between a private company and its shareholders. The "option" which the other shareholders have (more properly, a right to be offered the securities) cannot be exercised in any circumstances other than when an employee shareholder is leaving employment and is forced by the articles or shareholders' agreement to sell. The right cannot therefore be disaggregated from the overall commercial arrangement and cannot be considered as a separate MiFID "financial instrument". There is no "OTC derivatives" market to speak of and the obligations are imposed in the interests of furthering and continuing the company's employee incentivisation arrangements, and not for the purposes of risk transference.

3. **(a) Convertible share/bond/notes or (b) warrants or options to acquire or to subscribe for such shares etc, issued in each case by a public company; and the secondary trading of such instruments.**

We understand that the view of the European Commission and the UK FCA is that anything which is itself a security but which embeds a "derivative" will clearly be a transferable security (but not a derivative within points (4) to (10) of Section C of Annex 1 of MiFID). CESR's view (for the purposes of determining whether an instrument is complex or non-complex for the purposes of the MiFID appropriateness requirements) was that convertible bonds (and reverse convertible bonds and exchangeable bonds) should be regarded as bonds (i.e. transferable securities) which embed in each case a derivative. We agree with this line of interpretation. It will be true of a warrant (embedding an option exercisable into shares of the company) or a convertible instrument (embedding an option exercisable into the underlying share, bond or note).

In any event, warrants are issued by companies for the purposes of raising equity capital (and not for any hedging, investment or speculative purposes). Similarly, convertible instruments are generally issued by a company as a means of financing (to be distinguished from commercial or treasury financing activity as referred to in Article 10(3) of EMIR and as expanded upon in Commission Delegated Regulation (EU) No. 149/2013). Companies do not issue such instruments for the purposes of hedging risks or speculative investment.

While some warrants may be actively traded in some secondary markets, and have features which are not dissimilar to those of equity derivatives, generally speaking they tend to be private arrangements between the issuing company and the warrant purchasers.

Whatever their deemed complexity for other MiFID purposes, we do not believe that warrants and convertible securities are derivatives for the purposes of MiFID or EMIR. It should be clearly stated that they are not reportable for the purposes of EMIR.

4. (a) Convertible share/bond/notes or (b) warrants or options to acquire such shares etc issued in each case by a private company, the secondary trading of which is limited because of their relative lack of transferability.

Assuming that, as we believe, convertibles or warrants issued by a public company are not reportable under EMIR, there is no justification for submitting private companies to an EMIR reporting obligation in respect of any such instruments which they issue. In common with the previous point, such instruments the derivative element is embedded within a security. In contrast to the previous point, there is often little or no "secondary market" in such instruments.

Either such instruments would fall within the MiFID definition of "transferable securities" (on the basis that, even where they are not as a matter of fact traded on the capital markets, they are "capable of" being traded on such markets); or they would not be "transferable securities" at all (on the basis that they are not capable of being traded on the capital markets) and would not, therefore, be MiFID financial instruments at all. Either way, the securities will not be derivatives for the purposes of points (4) to (10) of Section C of Annex 1 of MiFID. The fact that such securities embed a derivative mechanic, in the form of an optionality, makes no difference.

5. Non-transferable or illiquid warrants or options issued by a start-up EU company (or an existing Mittelsand company) or options granted by existing shareholders in conjunction with an investment by an EU individual (through his EU private investment company or a private equity limited partnership outside the EU).

For the reasons given above a warrant is not a derivative for the purposes of MiFID and is not caught by EMIR. As regards options issued by the start-up company or granted by existing shareholders, these form a component part of the commercial arrangement by which the individual (through his EU private investment company) or a private equity limited partnership outside the EU makes an investment. The embedded "option" component is not tradable in its own right and is provided by way of an additional remunerative incentive to the investor. The "option" component is not entered into for the purposes of trading and transferring risk.

6. Pre-emption rights granted to shareholders under a company's articles or in a shareholder agreement and/or an obligation on shareholders wishing to sell to offer to other existing shareholders first

Pre-emption rights are granted to existing shareholders in a company and essentially give them a "right of first refusal" on the issue of new shares by the company. The articles or shareholders agreement may also contain an obligation on such a shareholder to the effect, in the event that he wishes to sell some or all of his existing shares, he must offer them first to other existing shareholders (and, to that extent, those other existing shareholders have a "pre-emption right" or "right of first refusal"). We do not believe that either such arrangement involves the granting of an "option" for the purposes of Annex 1, Section C of MiFID:

- In the case of the pre-emption right of a shareholder on a new issue of shares by the company, this is more properly described as the right to be offered new shares first (it can only loosely be described as an "option to buy" and only loosely bears the hallmarks of a classic call option). In any event, the right or "option" does not exist independently of the person's status as a shareholder – he must be a shareholder at the time of the new issue in order to be able to receive the pre-emption right offer and to exercise the right. The right cannot be isolated from the contractual arrangements under the articles or shareholders' agreement generally and is not a stand-alone instrument. Furthermore, no "premium" or consideration is furnished by a shareholder for the right. If the shareholder buys the new shares, he does so at market or fair value (or at the proposing seller's price) – i.e. not at a pre-determined "exercise price". Generally, the issue of new shares on a pre-emptive basis involves an offer being made to existing shareholders in proportion to their existing holdings. The purpose behind pre-emption rights is to protect existing shareholders from the dilutive effect that a new issue might have on their existing shareholding: such arrangements are not entered into for hedging or speculative purposes and they do not involve the transfer of risk. There is no concern as to systemic risk affecting the financial markets.

- In the case of the obligation on the part of a selling shareholder to offer his shares first to the other existing shareholders, the right when viewed from the perspective of the other shareholders is very similar to the one outlined in the first bullet point above (except that it relates to existing shares). It is also similar to the right outlined in paragraph 2 above.

We believe that the same analysis applies to "tag along" and "drag along" rights on a change of control of a company. Drag along rights are granted to majority shareholders enabling them to accept a takeover offer to buy their shares by forcing the minority shareholders to accept an offer; tag along rights are granted to minority shareholders as protection in the case that the majority shareholders choose not to exercise their drag along rights. In both cases, the rights are enshrined in the company's articles of association and do not exist or operate independently; they are only exercisable in the event of a potential sale of the company. In neither case can the rights be characterised as "options" or any other derivative instrument.

In terms of their dominant characteristics, all of the rights outlined above are contractual provisions designed, broadly, to protect shareholders and to facilitate corporate issues and transactions. They do not have the characteristics of a financial instrument under MiFID and there is no "market" in such rights.

7. "Options" over shares in a private company exercisable on a buy-back by the company of its own shares, whereby under the "option" a shareholder has the right to put his shares to the company or the company has the right to call for shares from a shareholder.

Again, this is a private, internal arrangement between a private company and its shareholders (and the ability for UK companies to buy back their own shares is subject to strict limitations under companies law). Despite the element of optionality embedded within the company's articles or shareholders agreement as a matter of contract, in our view (i) there is no discrete MiFID financial instrument as such; (ii) there is no "OTC derivatives" market in the "options"; and (iii) the arrangement is often entered into for the purposes of a reduction of capital by the company or other commercial reasons, but not for the purposes of risk transference.

8. As part of the purchase by a public or private company of another company, part of the consideration may involve (a) a cash earn-out (based on future profits) or (b) an earn-out payable in shares.

Despite an element of futurity, this is a private contractual arrangement between a purchaser and a seller. In terms of the dominant characteristic of the arrangement, the earn-out is clearly a method of determining the amount of additional consideration that will be payable for the sale. In neither case is there an instrument that can be identified as a MiFID "financial instrument", let alone an instrument that falls within the categories of derivative under points (4) to (10) of Annex 1, Section C of MiFID

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