Clients&FriendsMemo

EMIR Refit update

12 June 2019

Regulation (EU) No 648/2012 ("**EMIR**")[1] imposed a range of obligations which can apply to counterparties trading in derivatives, including a clearing obligation, risk mitigation obligations (including the exchange of collateral) and a reporting obligation. In 2017, following a review of the effectiveness of EMIR, the European Commission published a proposal for a new regulation to amend EMIR, with the aim of making the legislation operate in a more proportionate, efficient and effective manner. The new Regulation ("**EMIR Refit**") has now been published in the Official Journal of the EU and the majority of its provisions will come into force on 17 June 2019.

The purpose of this note is to explain some of the key changes resulting from EMIR Refit.

Changes to the definition of financial counterparties

Perhaps the most important change under EMIR Refit is to the definition of a "financial counterparty" ("**FC**"). It brings into the definition all alternative investment funds ("**AIFs**"), that are either established in the EEA or whose investment manager is authorised/registered under Directive 2011/61/EU on Alternative Investment Fund Managers ("**AIFMD**").[2]

Notably, the FC definition will effectively ensnare non-EU AIFs managed by non-EU managers when they are a counterparty to an EU FC. Previously, such funds were usually determined to be third country entities ("**TCEs**") that would be non-financial counterparties ("**NFCs**") if they were established in the EU, meaning that such funds would be out of scope of the clearing obligation and risk mitigation obligations (subject to the fund not exceeding the relevant clearing threshold for NFCs) when dealing with EU FCs. Under the amended definition of a FC in EMIR Refit, such funds will now be regarded as TCEs that *would be FCs* if they were established in the EU, meaning that EU FC will be required to ensure

1 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32012R0648.

2 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32011L0061.

compliance with the clearing obligation and margin requirements for uncleared derivatives in respect of their trading with such funds.

An AIF is defined widely in the AIFMD, as:

"*collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors*" . . . . (and is not an UCITS).

There are, however, two important exemptions from the amended FC definition, for employee share purchase schemes and for securitisation special purpose entities ("**SSPEs**"). SSPEs are defined in AIFMD as:

"*entities whose sole purpose is to carry on a securitisation or securitisations within the meaning of Article 1(2) of Regulation (EC) No 24/2009 of the European Central Bank of 19 December 2008 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions and other activities which are appropriate to accomplish that purpose*"

The classification of any AIF as an FC is significant as it determines the application of key EMIR obligations, such as clearing and margin and other risk mitigation requirements.

Non-EU fund managers can expect to be contacted by their EU broker-dealers to discuss how to deal with a possible change of classification. These changes will also have an immediate impact on AIFs with respect to new OTC derivatives transactions, as EU bank counterparties may need to put in place arrangements satisfy clearing or margin requirements under EMIR.

Clearing Threshold for FCs

Under EMIR, all FCs are subject to the clearing obligation regardless of the volume of derivatives trading they carry on. In recognition of the fact that some FCs have a volume of activity in OTC derivatives that is too low to pose a systemic risk, EMIR Refit introduces clearing thresholds for FCs. The levels of the thresholds are the same as the current NFC clearing thresholds.[3] However, unlike in the clearing thresholds for NFCs, FCs cannot exclude their hedging transactions from the threshold calculations, and once the threshold under one asset class is exceeded, all OTC derivatives become clearable.

FCs can choose not to calculate whether they exceed the clearing thresholds (*i.e.*, institutions with big books of derivatives can choose not to perform those calculations). Those FCs that choose to calculate whether they exceed the thresholds (*i.e.*, entities that wish to be categorised as "small FCs") have to perform such calculations every 12 months, to provide an aggregate month-end average for the previous 12 months. Should the

[3] Euro 1bn in gross notional value for each of OTC credit and equity derivatives and Euro 3bn in gross notional value for each of OTC interest rate, FX, commodity and other OTC derivatives.

relevant thresholds be exceeded, the FC will have to: (i) notify ESMA and the relevant competent authority, (ii) establish clearing arrangements within four months of the notification, and (iii) become subject to clearing for all its OTC derivative contracts entered into or novated more than four months after such notification.

The FC threshold calculations are to be performed at a group level, except that for UCITS and AIFs, the positions have to be calculated at the level of the fund.

A FC remains subject to the current clearing obligation until they demonstrate to the relevant competent authority that the calculation of the aggregate month-end position for the previous 12 months does not exceed the relevant clearing thresholds.

The new clearing thresholds are now effective and FCs that exceed the clearing threshold must, as of 17 June 2019, notify ESMA or the relevant competent authority of the result of their calculation of aggregate month-end notional positions in OTC derivatives for the previous 12 months.

Margin Requirements

The requirement to exchange margin in respect of uncleared OTC derivatives will apply to all FCs, regardless of whether the clearing threshold has been exceeded. As previously, margin requirements will also apply to NFCs which have exceeded the clearing threshold.

Reporting obligation

Under the original EMIR rules, both NFCs and FCs were under an obligation to report their trades to authorised trade repositories. Under EMIR Refit, the FC (or the manager, in the case of an EU AIF) will be solely responsible, and "*legally liable*" for such reporting, albeit NFCs will be under an obligation to provide to their FC counterparty those relevant details that the FC cannot be reasonably expected to hold.

A NFC which is below the clearing threshold does not have to report if:

- it is facing a third country FC;
- the legal regime or reporting to which that third country FC is subject has been declared equivalent;
- the third country FC has reported to a repository that is subject to a legally valid and enforceable obligation to grant EU regulators access to data.

The new reporting provisions will apply from 18 June 2020.

FX forwards and swaps

Given that FX forwards and swaps are within the scope of variation margin, it is notable that recital 21 of the EMIR Refit speaks of the need to restrict mandatory exchange of variation margins on physically settled FX forwards and swaps to transactions between the most

systemic counterparties. EMIR Refit does not contain a rule to that effect, but this recital flags potential regulatory forbearance in this regard.

CCP models; Clearing access

CCPs will have to provide clearing members ("**CMs**") with tools to simulate their initial margin requirements and with an overview of the initial margin model used by the CCP. This rule will apply from 18 December 2019.

CMs will be obliged, under EMIR Refit, to provide clearing services under "*fair, reasonable, non-discriminatory and transparent commercial terms*". The European Commission is empowered to adopt further secondary legislation to specify the requirements for these terms and conditions. CMs will not, however, be required to provide services to all clients on the same terms. These rules will apply from 18 June 2021.

FCA notification forms

In the UK, the following new or amended notifications relating to derivatives will have to be submitted to the FCA (as well as ESMA in some cases):

- **FC clearing obligation notification:** a new notification which relates to FCs exceeding or ceasing to exceed the relevant clearing thresholds, as well as those choosing not to calculate their positions against those thresholds.
- **NFC clearing obligation notification:** an amended notification which relates to NFCs exceeding or ceasing to exceed the relevant clearing thresholds.

Both this and the FC clearing notification above may be submitted using the FCA clearing obligation notification form, which can be used to submit notifications relating to both the NFC and FC clearing obligations.

- **Reporting exemption notification:** a new notification which relates to a reporting exemption for certain intragroup OTC derivatives with an NFC. This notification may be submitted using a new standalone form.

The FCA-required notifications not changed by EMIR REFIT are those relating to:

- disputes notifications;
- intragroup exemptions from clearing; and
- intragroup exemptions from bilateral margining.

In order to simplify the set of FCA systems that firms need to interact with in order to meet their various regulatory obligations, the FCA is moving the current EMIR Portal onto its universal platform, Connect.

Brexit

EMIR Refit will enter into force before the UK leaves the EU. UK entities will be subject to the new rules, but it remains to be seen how they will be treated after the UK leaves the EU. That is because - assuming the UK leaves with a deal - under the EU Withdrawal Agreement, EU laws will continue to apply in the UK until the end of 2020 (subject to possible extensions to the transition period). After that period (or on 31 October 2019 in the case of a "no-deal" Brexit), (i) UK entities will become TCEs for the purposes of amended EMIR, and (ii) UK laws will apply, while EU laws that have been "onshored" may be changed, subject to the outcome of any EU-UK negotiations and any new UK regulatory policy initiatives.

Next steps

Managers of AIFs should reassess their status and:

- prepare to notify ESMA and the relevant national regulator of "small FC" status, if any,
- assess their compliance with margin and other risk mitigation requirements under EMIR;
- revisit their counterparty representations in derivatives documentation, especially if the AIF is a TCE; and
- review any guidance or protocols produced by ISDA address the changes in EMIR Refit.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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