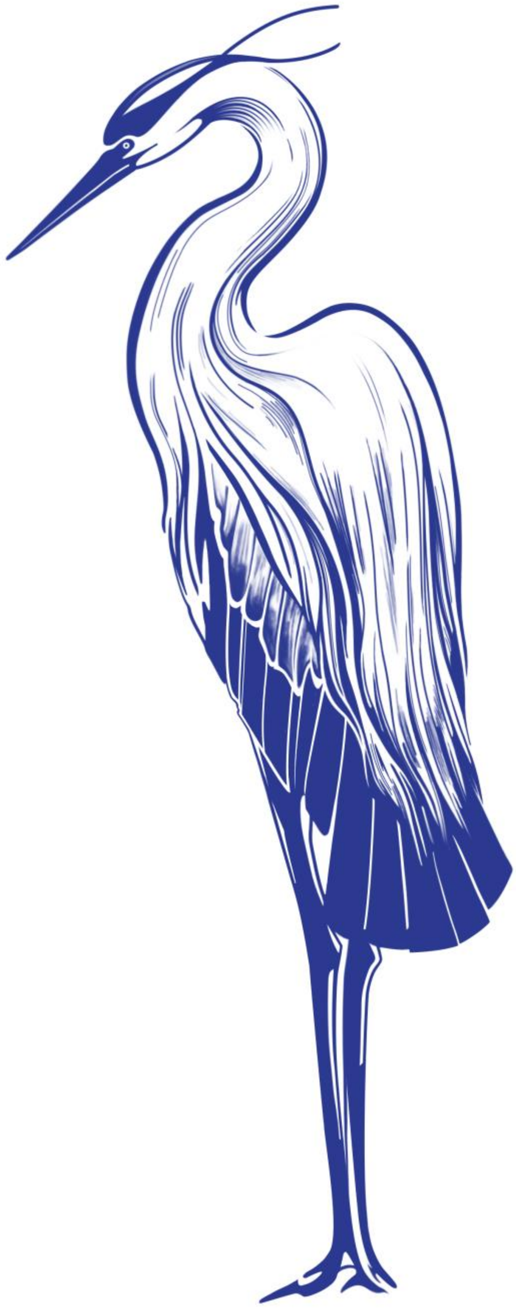

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THE EU DISCUSSES CHANGES TO EMIR

May 2019

Following discussions among the European Commission (the "**Commission**"), Council and Parliament, a political agreement on the amendments to be made to the European Market Infrastructure Regulation ("**EMIR**") was reached on 5 February 2019.

This should enable the legislative text to be formally adopted before the end of the term of the current Commission in May 2019, with publication in the Official Journal and entry into force expected by the Summer.

Based on the documents currently available (which do not include the final legislative text), a number of the key changes will result from the amendments. As a consequence, below is an overview of the most important changes proposed by the new legislation.

Background

EMIR is a body of legislation within the European Union ("**EU**") for the regulation of over-the-counter-derivatives ("**OTC**"), implementation of risk management standards, establishment of common rules for central counterparties and trade repositories. EMIR was originally adopted and came into force by the EU legislature in 2012, with its full technical standards coming into effect in March 2013.

The objective of EMIR was to reduce systemic counterparty and operational risk, and help prevent future financial system collapses. Since early 2017, the EU has been discussing draft legislation (the "**EMIR Refit**") in order to amend EMIR, with the aim of making some of its requirements simpler and more proportionate, particularly for non-financial counterparties ("**NFCs**").

NFCs

An NFC is defined within Article 2(9) EMIR as an undertaking established in the EU that is not a financial counterparty ("**FC**") or a Central Clearing Counterparty ("**CCP**"). A differentiation frequently used within the NFCs applies the criterion of being above or below the clearing threshold, splitting this category into NFCs- and NFCs+.

Consequently, NFCs are natural or legal persons that do not qualify as:

- an investment firm authorised in accordance with Directive 2004/39/EC (MiFID);
- a credit institution authorised in accordance with Directive 2006/48/EC (BCD);
- an insurance undertaking authorised in accordance with Directive 73/239/EEC (First Non-Life Directive);
- an assurance undertaking authorised in accordance with Directive 2002/83/EC (Consolidated Life Directive);
- a reinsurance undertaking authorised in accordance with Directive 2005/68/EC (Reinsurance Directive);
- a UCITS and, where relevant, its management company, authorised in accordance with Directive 2009/65/EC (UCITS IV Directive);
- an institution for occupational retirement provision within the meaning of Article 6(a) of Directive 2003/41/EC (Occupational Pension Funds Directive); and
- an alternative investment fund managed by AIFMs authorised or registered in accordance with Directive 2011/61/EU (Alternative Investment Fund Managers Directive).

FRONTLOADING OBLIGATION TO BE REMOVED

The controversial concept of 'frontloading' under EMIR became popular as a unique requirement to the EU's approach of migrating derivatives trades from bilateral to central clearing.

Certain OTC derivatives trades were captured under the scope of being centrally cleared by a CCP after a certain date, even before new clearing rules under EMIR applied in practice.

Under the EMIR Refit, this has been amended so that when any type of entity becomes subject to mandatory clearing for new classes of derivatives, there will be no requirement for any pre-existing transactions to become cleared.

CLEARING OBLIGATION FOR NFCS+ TO BE LIMITED

Under EMIR, if (for example) the clearing threshold for credit derivatives is exceeded by an NFC, that NFC becomes subject to the clearing obligation for interest rate products, even though its activities relating to interest rate products are below the relevant clearing threshold. Ahead of the mandatory clearing for NFCs+ with respect to certain interest rate products that came into effect in December 2018, the European Securities and Markets Authority ("**ESMA**") issued a statement providing that National Competent Authorities ("**NCAs**") were not required to enforce from that date the central clearing of interest rate transactions with NFCs+ that not exceeded the clearing threshold for interest rate products (or that don't exceed the threshold for the Market in Financial Regulation ("**MiFIR**") trading obligations to apply). Whilst neither the European Supervisory Authorities nor NCAs have formal waiver powers, this is one of a number of examples of what is commonly referred to as "regulatory forbearance" in the context of the EMIR Refit.

Given the anticipated timing of the EMIR Refit, it is to be hoped that this comfort will be extended to NFCs+ that do not exceed the clearing threshold for credit derivatives, as their phase-in date for these products is 9 May 2019.

EXTENSION OF CLEARING EXEMPTION FOR RISK REDUCING TRANSACTION CARRIED BY PENSION SCHEMES

Under EMIR, pension schemes carrying out transactions objectively measurable as reducing their investment risks were granted a temporary exemption from central clearing. However, ESMA issued a statement to the effect that it did not expect NCAs to require such transactions to be cleared (or to be subject to the MiFIR trading obligation) pending the EMIR Refit coming into force. In essence, another example of regulatory forbearance being granted.

The new exemption would initially apply for two years, and may be extended thereafter, up to two times, for 12 months at a time (i.e. maximum aggregate extension of 4 years). There are some fairly detailed provisions mandating ongoing work to develop technical solutions to facilitate clearing by pension schemes as quickly as possible.

Some pension schemes will be "small financial counterparties" and therefore, able to rely on the clearing exemption for these entities (please see below paragraph).

EXEMPTION FROM CLEARING OBLIGATION FOR SMALL FINANCIAL COUNTERPARTIES

This will apply to FCs whose positions at group level (and with no carve-out for hedging transactions) do not exceed any of the clearing thresholds set for NFCs.

In light of the fact that these amendments are not expected to be in force in time to apply when the clearing obligation for Category 3 financial counterparties is phased-in, that is 21 June 2019, ESMA has granted further regulatory forbearance providing comfort for those Category 3 FCs expected to fall within the new exemption for small FCs.

While this is to be welcomed, concerns remain as to the practicality of small FCs being able to carry out the calculations to demonstrate that the thresholds are not exceeded.

SUSPENSION OF CLEARING OBLIGATION

The Commission (at ESMA's request) will have the power to temporarily suspend a clearing obligation (and the related trading obligation under MiFIR) for an initial period of up to 3 months, and to extend the suspension for further periods of up to 3 months, for a maximum aggregate period of 12 months. If the clearing obligation is suspended, the MiFIR trading obligation may also be suspended.

SCOPE FOR MORE CHANGES ON CLEARING

When EMIR Refit will come into force, the Commission will be required to issue reports to the European Council and the UK Parliament on various topics, among which, whether trades resulting from post trade risk reduction services, including portfolio compression, should be exempted from clearing.

CCPS AND CLEARING MEMBERS

CCPs are highly regulated institutions under EMIR, which focuses on OTC derivatives contracts. The EMIR Refit contains a number of changes for CCPs, i.e. financial institutions that specialize in managing counterparty credit risk between parties to a transaction, and provide clearing and settlement services for trades in foreign exchange, securities, options and derivative contracts.

Clearing members on the other hand are financial institutions that are members of at least one CCP, are authorised or recognised under EMIR to clear one or more classes of derivatives subject to the Regulatory Technical Standards ("**RTS**") that complete EMIR at a technical level, provided that their clearing membership allows them to clear one or more of those classes of derivatives, as classified under EMIR.

Unlike in the US, where the agency relationship model is used, EMIR has opted for the principal to principal model, in order to regulate the CCPs clearing member and counterparty relationship. This in turn generates a number of risks for clearing members, that are heavily regulated by EMIR itself.

Client Margin

Article 39 of EMIR is amended by inserting a new provision requiring that EU Member States' national insolvency laws shall not prevent a CCP from distributing client margin of a defaulting clearing member to its underlying clients.

Information from CCPs

CCPs will be required to provide information to clearing members on their initial margin models, and to provide them with a simulation model enabling them to calculate the additional initial margin that the CCP may require to clear a new transaction. This should not represent a significant change to existing practices.

FRANDT principle

There will be a requirement for clearing members, and clients providing indirect clearing, to offer their clearing services on fair, reasonable, non-discriminatory and transparent ("**FRANDT**") commercial terms. They must also take all reasonable steps to manage conflicts of interests, especially between trading and clearing units, that may adversely affect the provision of clearing services on FRANDT terms.

The conditions under which commercial terms are considered FRANDT are to be specified in more detail in delegated acts by the Commission. EMIR Refit does however make clear that the FRANDT principle shall not impose an obligation to clear nor prevent clearing members, or their clients, from controlling risks associated with the clearing services offered.

ESMA will be required to report to the Commission on, among other things, the impact of the EMIR Refit regulation on levels of clearing and the continued appropriateness of the clearing thresholds, and on whether the FRANDT requirement has been effective in facilitating access to clearing.

RISK MITIGATION FOR UNCLEARED DERIVATIVES

Simpler types of derivatives constituting FX forwards and swaps are included in the scope of the variation margin ("**VM**") regulation implemented from the end of 2016 onwards under the Margin RTS.

However, they are not generally subject to margining in all jurisdictions, and they are in fact excluded in the U.S., Australia and Japan.

In order for firms in the EU not to be put at a disadvantage compared to firms in other jurisdictions, in December 2017 draft standards were published to modify the Margin RTS, so that physically-settled FX forwards entered into by anyone but two investment firms or credit institutions, would be exempt from VM obligations.

However, the Commission has not yet adopted them. The industry currently relies on regulatory forbearance from regulators in the meantime.

EMIR Refit will include a recital acknowledging that the need for international convergence means that margining of both FX forwards and FX swaps should be limited to transactions between the most systemic counterparties (i.e. credit institutions and investment firms). The recital also acknowledges the need for international convergence with respect to other classes of derivatives.

Validation by regulators

There will be a new requirement (to be set out in detail in the RTS) for initial and on-going validation by regulators of counterparties' procedures for complying with the Margin RTS.

REPORTING OF DERIVATIVES TRANSACTIONS

The changes in this area are probably the most significant and controversial aspect of the EMIR Refit.

Backloading

The "backloading" requirement (that is, to report transactions that were no longer outstanding when the reporting obligation under EMIR came into effect), that came into effect on 12 February 2019 will be removed. In order to mitigate its impact, ESMA granted regulatory forbearance on 31 January 2019 to the effect that NCAs do not need to prioritise backloading in their supervision and enforcement of EMIR. The removal of this obligation, and the associated regulatory forbearance, is a particularly welcome step.

Intra-group transactions

The reporting obligation is to be disapplied for intra-group transactions involving an NFC, but only if both parties are part of the same group (and subject to consolidation and centralised risk management), and do not have a parent undertaking that is an FC. It will also be necessary for counterparties that want to rely on this exemption to notify their appropriate NCA. In practice, it does not seem that this exemption is likely to be of much assistance to NFCs.

Reporting by FCs on behalf of NFCs-

For OTC transactions between an FC and an NFC-, the FC will be required to report on behalf of both counterparties (rather than the FC reporting a single data set as proposed by the European Parliament), and with the FC having legal liability for the reports.

The NFC- is required to provide the reporting FC with details about the NFC- that are relevant for reporting purposes and that the FC cannot reasonably be expected to possess, a mandatory delegation that has been strongly opposed by the derivatives industry.

An NFC- will also be relieved from the reporting responsibility if it transacts with a third country entity that would be an FC if established in the EU, but only if that entity reports the transaction under its home reporting regime, and that regime has been determined as "equivalent" under article 13 of EMIR. An NFC- may elect that it will make its own reports rather than relying on its FC counterparty to report on its behalf, and it can do this via prior notification to the relevant FC.

Reporting by funds and IORPs

The EMIR Refit also specifies that the management company of an Undertaking for Collective Investment Vehicles ("**UCITS**") or Alternative Investment Fund ("**AIF**") is legally responsible for making the reports on behalf of the investment vehicle. The same applies to management companies of institutions for occupational retirement provisions ("**IORPs**"), where the IORP does not have legal personality.

Follow up on reporting obligations

There is provision for follow-up reports to be produced by the Commission with regard to avoidance of duplication, and greater alignment, between reports on exchange-traded derivatives made under EMIR and MiFIR. ESMA is also required to report to the Commission on the changes made by EMIR Refit to the reporting regime, including delegated reporting by FCs, and its impact on the reporting burden for NFCs-.

Definition of financial counterparty

There are some fairly technical changes, with central securities depositories being included, and also all EU AIFs (whether or not its AIFM requires registration under the Alternative Investment Fund Managers Directive to manage that AIF). However, there will be a carve-out from the definition of FC for UCITS or AIFs related to an employee share purchase plan, and for any securitisation special-purpose entities that constitute an AIF.

TRADE REPOSITORIES

While this note does not cover the various technical changes as regards regulation of trade repositories ("**TRs**"), a new article 76a of EMIR is being introduced, to allow the Commission to approve arrangements for EU authorities to have direct access to information held by TRs in a third country, and to allow relevant authorities in that third country to have access to information held by EU TRs.

This could potentially be relevant in future years to arrangements between the UK and the EU after Brexit.

OTHER CHANGES

A number of changes in the Commission's original legislative proposal have not been accepted, and various changes that the industry lobbied for have not been made (or have been included only as matters that will be the subject of reports in due course, that could potentially lead to further changes to EMIR in the future).

An example of an industry proposal that has not been included was for all central banks globally to be exempted from EMIR (rather than only central banks that have been the subject of an implementing decision by the Commission).

TIMELINE OF IMPLEMENTATION IN THE UK

In case of a no deal Brexit, that is the case where the UK leaves the EU without an implementation period, and if it happens before the final approval of the EMIR Refit, the new regulation won't be in force and apply, so will not be "onshored" under the European Union Withdrawal Act 2018 ("**Withdrawal Act**"). Instead, the Financial Services (Implementation of Legislation) Bill gives the UK Treasury power, during the 2 years following the day the UK leaves the EU to implement the EMIR Refit in the UK.

If an implementation period enters into force as a consequence of the approval of the Withdrawal Act, EMIR will continue to apply in the UK during that period, and the EMIR Refit amendments that become applicable during that period will be binding on UK entities.

Currently, the UK has been granted an extension to the original two years negotiation time, running until 31 October 2019, unless it is cut shorter by the approval of the Withdrawal Act by the UK Parliament. In this case, it is very likely that the EMIR Refit will be in place and directly applicable to the UK.

NEXT STEPS

Given the above timeline and array of possibilities, while the EMIR Refit does contain some phase-in periods, the timings are very tight. Most notably, the changes to the definition of FC will apply immediately upon the entry into force of the EMIR Refit.

AIFs, their managers and counterparties affected by the new FC definition will need to implement enhanced conduct requirements and amend their ISDA documentation, taking into account whether they will become an FC+ or FC-. Non-EU funds may be asked to make changes by their EU bank counterparties. Therefore, the next steps for firms is to commence there updates as soon as possible as these changes may require a lot of time and effort.

For more information, and any guidance or advice on updating your ISDA documentation in light of the impact of the EMIR Refit, Cleveland & Co, External In-House Counsel™, your specialist outsourced legal team, are here to help.

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CONTACT

EMMA CLEVELAND

Founder and Managing Director

ecleveland@cleveland-co.com
www.cleveland-co.com