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Briefing

Update on the EMIR Refit Process

May 2019

The final text of the amendments to EMIR[1] (the "**EMIR 2.1 Amendments**" and EMIR as thereby amended, "**EMIR 2.1**") was published in the European Union's Official Journal on Tuesday, 28 May 2019, and will enter into effect twenty days after publication on 17 June 2019. In addition, ESMA updated its EMIR Q&A to reflect the EMIR 2.1 Amendments on 28 May 2019 (the "**Updated Q&A**").

Significantly, many of the EMIR 2.1 Amendments do not provide for any delay in their implementation and much of EMIR 2.1 will apply as soon as the EMIR 2.1 Amendments enter into force. It is, therefore, essential for in scope entities (including those brought in scope by the amendments) to take now the measures necessary to ensure that they can comply with EMIR 2.1 from the day the EMIR 2.1 Amendments enter into force.

Overview

The European Commission's original proposed amendments to EMIR were published in May 2017, with a view to simplifying certain of the requirements, and removing certain disproportionate costs, of EMIR. See our previous briefings here and here.

Since the original Commission EMIR 2.1 proposal was published, certain counterparties have become subject to certain EMIR requirements which will cease to apply to those counterparties under EMIR 2.1. ESMA had issued "regulatory forbearance" statements in respect of these requirements, in which it stated that it expected competent authorities generally to apply their risk-based supervisory powers in their day-to-day enforcement of EMIR in a proportionate manner and not to prioritise their supervisory actions towards entities that were not expected to be subject to specified EMIR requirements, once EMIR 2.1 entered into force (see our previous briefings here, here and here).

[1] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

Definition of Financial Counterparty

The EMIR 2.1 Amendments expand the definition of a "financial counterparty" ("**FC**") to encompass certain additional categories of counterparties perceived to pose important systemic risk to the financial system, so that:

- every AIF established in the EU, or managed by an AIFM authorised or registered in the EU under AIFMD[2], will be an FC and any AIFM established in the EU of such an AIF will also be an FC. Currently, only AIFs managed by AIFMs authorised or registered under AIFMD are FCs; and
- central securities depositaries are now encompassed as FCs.

While the existing definition of "financial counterparty" under EMIR includes UCITS and, where relevant, UCITS management companies, EMIR 2.1 introduces a new carve-out for both UCITS and AIFs which are set up exclusively for the purpose of serving one or more employee share purchase plans. It also provides for a carve out for an AIF that is a securitisation special purpose entity.

The Clearing Requirement

EMIR 2.1 establishes a new regime for determining when FCs and non-financial counterparties ("**Non-FCs**") are subject to the clearing requirement, depending on whether or not their positions exceed the clearing thresholds[3].

While the EMIR 2.1 Amendments are largely aimed at removing some of the burden of the clearing requirement, certain entities may fall into scope of the clearing requirement for the first time on EMIR 2.1's entry into force.

EMIR 2.1 also:

- requires clearing services to be provided on fair, reasonable, non-discriminatory and transparent commercial terms ("**FRANDT**")[4], from 18 June 2021.
- requires clearing members and their clients that provide clearing services to take all reasonable steps, from 18 June 2021, to identify, prevent, manage and monitor conflicts of interest, particularly between the trading unit and clearing unit, that may adversely impact on FRANDT;

[2] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers. As used in this briefing, the terms "AIF" and "AIFM" have the meanings given to them in AIFMD.

[3] These thresholds are, in gross notional value, €1 billion for credit and equity derivatives contracts; and €3 billion for interest rate, FX, commodity and other OTC derivative contracts (Article 11 of Commission Delegated Regulation (EU) No 149/2013).

[4] The Commission is to specify, in delegated acts, the conditions under which such terms are considered FRANDT.

- provides for the ability to temporarily suspend the clearing requirement in certain circumstances where the criteria on the basis of which specific classes of OTC derivatives have been made subject to the clearing requirement are no longer met. EMIR 2.1 also provides for the suspension of the trading obligation set out in MiFIR[5], where there has been a request to suspend the clearing requirement and there is a material change in the criteria for the trading obligation to take effect.

The table below sets out the changes to scope of the clearing requirement under EMIR 2.1.

SCOPE OF CLEARING REQUIREMENT	
EMIR	**EMIR 2.1**
An FC must clear all OTC derivatives of a class that has been declared subject to the clearing requirement. Category 3 FCs will become subject to the clearing requirement on 21 June 2019, however ESMA had issued a regulatory forbearance statement in this respect. See our briefing here.	An FC will only be subject to the clearing requirement if it fails to calculate its positions (at group level[6]) or where the result of the calculation exceeds any of the clearing thresholds previously applicable only to NFCs (an FC whose group positions do not exceed any threshold being a "**Small FC**"). Unlike the position for NFCs, no carve-out for hedging transactions applies to an FC when calculating whether its group positions exceed a threshold.
An NFC becomes subject to the clearing requirement when the rolling average of its notional positions in OTC derivatives and those of other NFCs in its group exceed, over 30 working days, any of the clearing thresholds set by the Commission for a relevant class of derivatives. An NFC need not include hedging contracts when calculating whether or not it has exceeded the clearing thresholds.	An NFC taking positions in OTC derivative contracts may calculate, every 12 months, its aggregate month-end average position for the previous 12 months. An NFC need not include hedging contracts when calculating whether or not it has exceeded the clearing thresholds.

[5] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

[6] Note that UCITS and AIFs calculate at fund level but that any UCITS management company or AIFM managing more than one UCITS or AIF, respectively, must be able to demonstrate to the relevant competent authority that calculation at fund level does not lead to a systemic underestimation of the positions of any of the funds or of its positions and a circumvention of the clearing obligation.

Once an NFC's positions in OTC derivatives exceed any of the clearing thresholds, it must clear all OTC derivatives of each class that has been declared subject to the clearing requirement ("**NFC+**"). ESMA had issued a regulatory forbearance statement regarding the requirement to clear certain interest rate products, which came into effect on 21 December 2018. See our briefing here.	Once an NFC exceeds the clearing threshold for a certain asset class, it will become subject to the clearing requirement in respect of that asset class but not in respect of the other asset classes that have been declared subject to the clearing requirement if it has not exceeded the clearing threshold for those asset classes. An NFC that does not calculate its positions in OTC derivatives contracts is subject to the clearing threshold in respect of all asset classes that have been declared subject to the clearing requirement.
OTC derivative contracts that are objectively measurable as reducing investment risks directly relating to the financial solvency of pension scheme arrangements ("**PSAs**") were exempt from the clearing requirement until 16 August 2018. ESMA had issued a regulatory forbearance statement in this respect. See our briefing here.	The exemption for PSAs from the clearing requirement is extended by a further two years. The two year period can be extended up to twice, in each case by one year. EMIR 2.1 retroactively applies the exemption to OTC derivative contracts entered into by PSAs between 17 August 2018 and 17 June 2019.
EMIR applies the Clearing Requirement to certain OTC derivative contracts entered into or novated before the date the Clearing Requirement takes effect, known as "front-loading".	EMIR 2.1 removes the front-loading requirement.

As outlined above, an FC or NFC taking positions in OTC derivatives has the option under EMIR 2.1 to calculate every 12 months whether it is subject to the clearing requirement on the basis of its aggregate month-end average position (at group level) for the previous 12 months.

An FC or NFC that chooses not to conduct that calculation, or the calculation for which confirms that it exceeds a clearing threshold, must immediately notify ESMA and its national competent authority ("**NCA**") of that fact and has four months from making that notification to establish the required clearing arrangements. It will become subject to the clearing requirement for all OTC derivative contracts subject to the clearing requirement (which in the case of an NFC whose calculations confirm that it exceeds one or more, but not all, clearing thresholds, comprises only those in the categories the threshold for which was exceeded) that are entered into, or novated, from expiry of that four month period.

In a Statement issued on 28 March 2019 (the "**Statement**"), ESMA reminded FCs and NFCs that they must be able to carry out the relevant calculations and/or comply with their notification requirements from the day EMIR 2.1 enters into force. This means that they must collect all the necessary data and information for the calculation in advance and be prepared to make any required notification on that day. This requirement is re-emphasised in the Updated Q&A.

This poses significant challenges for FCs and NFCs not already subject to the clearing requirement, particularly as the calculation methodologies under EMIR and EMIR 2.1 differ (so that the approach taken to determining that an FC was a Category 3 FC, or an NFC was not an NFC+, cannot be applied for this purpose).

It is also unclear why FCs and NFC+s that are subject to the clearing requirement prior to entry into force of EMIR 2.1 should be required to notify ESMA and its NCA of the fact that it has not performed the calculation on the date that EMIR 2.1 enters into force, as suggested in the Statement and confirmed in the Updated Q&A. EMIR 2.1 clearly envisages that such an entity remains subject to the clearing requirement until it demonstrates to its NCA that it is below the clearing threshold, determined in accordance with EMIR 2.1[7].

Risk Mitigation

Article 11(15) of EMIR 2.1 introduces an amendment requiring the European Supervisory Authorities (the "**ESAs**") to develop draft regulatory technical standards ("**RTS**") on risk management procedures relating to the exchange of collateral, specify supervisory procedures to ensure initial and ongoing validation of these procedures and providing that the European Commission may then adopt these RTS. Recital (20) of EMIR 2.1 notes that such validation is required given the complexity of "risk management procedures .... which involve the use of internal models" and that competent authorities should validate "those risk management procedures or any significant changes to those procedures, before they are applied". This suggests that the prior validation might be limited to procedures relating to internal models although that suggestion is not reflected in Article 11(15).

Plainly, the impact of this amendment would be significantly reduced if supervisory validation was limited to internal models, provided that any applicable internal model governance would not apply with respect to the ISDA Standard Initial Margin Model (ISDA SIMM). ISDA has established a governance and testing regime to validate and back-test ISDA SIMM assumptions, which is shared with global regulators on an annual basis, with data on ISDA SIMM shared with regulators every three months. Given this, the imposition of additional governance requirements with respect to ISDA SIMM on individual in scope counterparties would be a disproportionate burden

[7] See Article 4a(2a) and 10(3) of EMIR 2.

and cost for those counterparties. It is anticipated that it will be some months before the draft RTS are available.

As the process and time frame for validation may have a significant impact on speed to market, the ESAs' draft RTS – particularly with regard to categories of in scope counterparties whose procedures would not otherwise be in scope for review by the relevant competent authority - are awaited with interest.

Recital (21) of EMIR 2.1 acknowledges that it is necessary to restrict the mandatory exchange of variation margin on physically settled FX forwards and physically settled FX swaps to transactions between the "most systemic counterparties", citing the need for international convergence and for NFCs and Small FCs to reduce the risks associated with their currency risk exposures. Counterparties are currently relying on regulatory forbearance regarding the application of EMIR's variation margin requirement to physically settled FX forwards, as amendments proposed in December 2017 to the Margin RTS[8] to take them out of scope of that requirement have not entered into force (see our previous briefing here). This recital paves the way for a formalised disapplication of the variation margin requirement to physically settled FX forwards under EMIR 2.1, and the expansion of that disapplication to physically settled FX swaps (which are not generally subject to margining under other jurisdictions' margining requirements) as well as, potentially, to other classes of derivatives[9].

EMIR Reporting

EMIR 2.1 clarifies who is responsible for reporting in specific circumstances and eliminates the reporting requirement for certain intragroup and historic transactions. The provisions setting out responsibility for reporting will apply from 18 June 2020.

EMIR	
EMIR	**EMIR 2.1**
Counterparties and Central Counterparties ("**CCPs**") must report to a trade repository the details of any derivative contract they have concluded and of any modification or termination of that contract.	An FC is responsible for reporting any OTC transaction between an FC and an NFC that is not subject to the clearing requirement ("**NFC-**") on behalf of both counterparties. The NFC- must provide the FC with details relating to the OTC derivatives contract concluded between them which the FC cannot be reasonably expected to possess. Any NFC- that has already invested in a reporting system may elect, by notice to its FC counterparty, to report its OTC derivatives to a trade repository itself.

[8] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016.

[9] Recital (16a) also states that "International convergence should also be ensured with regard to risk-management procedures for other classes of derivatives.".

	An NFC- that concludes an OTC derivative contract with an entity established in a third country that would be an FC if established in the EU is not required to report the transaction to a trade repository where the third country entity has reported such information pursuant to the regime applicable to it and that regime has been deemed equivalent to that set out in EMIR. This is unlikely to be of significant relevance as no such regimes have yet been deemed equivalent. Intragroup transactions within the meaning of Article 3 of EMIR, will no longer have to be reported where at least one of the two counterparties is an NFC (or would qualify as an NFC if established in the EU), both counterparties are subject to consolidation on a full basis and centralised risk management and the parent undertaking is not an FC. Counterparties must notify their intention to apply this exemption to their national competent authorities and the exemption will apply unless the notified competent authorities, within three months of the date of notification, do not agree that the conditions are fulfilled. In the case of a UCITS or AIF, the UCITS Management Company and AIFM, respectively, shall be responsible and legally liable for reporting on behalf of that UCITS or AIF, as applicable and for the correctness of the details reported.
The reporting requirement applies to derivative contracts which were entered into before 12 February 2014 and were not outstanding on that date (historic transactions). The reporting requirement applies to such historic transactions since 12 February 2019. ESMA had issued a regulatory forbearance statement regarding such transactions. See our briefing here.	Counterparties are no longer required to report their derivative contracts which were entered into before 12 February 2014 and were not outstanding on that date.

CCPs

With effect from 17 December 2019, CCPs must provide their clearing members with tools to stimulate their initial margin requirements and with a detailed overview of the initial margin models they use. The results generated by a CCP's simulation tool will not be binding on the CCP.

EMIR 2.1 expressly provides, with effect from 17 December 2019, that Member States' national insolvency laws shall not prevent a CCP from complying with certain EMIR requirements (which requirements remain unchanged in EMIR 2.1) relating to the management of a defaulting clearing member's clients' assets and positions.

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