EMIR REFIT: GOOD NEWS FOR SMALLER DERIVATIVES COUNTERPARTIES

The EMIR REFIT Regulation (Regulation (EU) 2019/834)[1] came into force (with some limited exceptions) on 17 June 2019. EMIR REFIT makes a broad range of amendments to existing requirements under the European Market Infrastructure Regulation (**EMIR**)[2], including in relation to counterparty categorisation, clearing, margin and reporting requirements. EMIR REFIT aims to simplify and apply more proportionately some of EMIR's obligations, particularly for non-financial counterparties and smaller financial counterparties. This briefing looks at what has changed and the implications for those affected.

Background

EMIR came into force on 16 August 2012. It introduced a range of measures designed to improve financial stability, by bringing more transparency to the OTC derivatives market and reducing the operational and counterparty credit risks associated with OTC derivatives. EMIR requires central clearing (with a central counterparty (**CCP**) of eligible OTC derivative contracts and requires bilateral exchange of margin and operational risk mitigation measures for those OTC derivatives that are not clearing-eligible. It also specifies obligations for counterparties to report derivative contracts to a trade repository (**TR**) and imposes requirements on CCPs and TRs. The obligations are triggered and calibrated according to the categorisation of a counterparty as a financial or non-financial counterparty (an **FC** or **NFC**), and by the volume of trading activity the counterparty undertakes.

Key changes introduced by EMIR REFIT

The EMIR REFIT Regulation results from the European Commission's review of EMIR under its regulatory fitness and performance programme (**REFIT**). It makes a number of targeted amendments to EMIR. In particular it:

- amends the definition of "Financial Counterparty", broadening its scope to include central securities depositories and EEA[3] domiciled alternative investment funds (**EEA AIFs**) regardless of whether or not they are managed by an EEA domiciled or non-EEA domiciled alternative investment fund manager (**EEA AIFM** or **non-EEA AIFM**, respectively);
- introduces a new Financial Counterparty clearing threshold and a new category of "small financial counterparty";
- amends the triggers for the clearing obligation;
- introduces new obligation for clearing members and clients to provide clearing services on a fair, reasonable, non-discriminatory and transparent basis (**FRANDT**);
- requires member states to bring their national insolvency laws into line with the EMIR's requirements;
- removes the frontloading requirement for clearing and the backloading requirement for reporting;
- empowers the European Commission to temporarily suspend the clearing obligation under certain circumstances; and
- makes various other changes to streamline reporting requirements to improve the quality of data reported.

Financial Counterparty Definition

EMIR REFIT expands the FC definition to include central securities depositaries. The definition of an AIF in Article 2(8), EMIR has been amended, such that it captures:

"…an alternative investment fund (**AIF**), as defined in point (a) of Article 4(1) of Directive 2011/61/EU, which is either established in the Union or managed by an alternative investment fund manager (**AIFM**) authorised or registered in accordance with that Directive, unless that AIF is set up exclusively for the purpose of serving one or more employee share purchase plans, or unless

[1] Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories, available here.

[2] The text of EMIR is available in its consolidated form here.

[3] The EMIR REFIT Regulation has EEA relevance (the EU28 Member States plus Norway, Iceland and Lichtenstein.

that AIF is a securitisation special purpose entity as referred to in point (g) of Article 2(3) of Directive 2011/61/EU, and, where relevant, its AIFM established in the Union"

The effect of the revised definition is to bring all EU AIFs within the definition of an FC whether or not they are managed by an EU AIFM. If their AIFM is established in the EU, the EU AIFM will also be an FC. This change will bring a much higher number of AIFs into the scope of EMIR's obligations and has a number of implications for fund managers.

Clearing Threshold Calculations

EMIR REFIT simplifies the methodology for the calculation of positions to compare against the clearing thresholds below (which are unchanged from EMIR):

- for equity derivatives or credit derivatives, gross notional value of €1bn;
- for interest rate and foreign exchange derivatives, gross notional value of €3bn; and
- for commodity derivatives and all other classes of derivative combined, gross notional value of €3bn.

Where EMIR required that the calculation be carried out on a 30-day rolling basis, EMIR REFIT instead requires the calculation to be done annually, based on the aggregate month-end average position in OTC derivatives contracts for the previous 12 months. EMIR's "frontloading" requirement (which required clearing of OTC derivative contracts entered into after a CCP has been authorised under EMIR and before the date of application of the clearing obligation) has also been removed.

Small financial counterparties (FC-)

The new FC- category introduced by EMIR REFIT applies where an entity's OTC derivatives trading activity falls below all clearing thresholds.

If an AIF falls within the FC- category it will not be subject to the clearing obligation, but will still need to comply with the margin and risk mitigation provisions EMIR imposes on FCs. Where a non-EEA AIF with a non-EEA AIFM falls within the FC- category (thereby being categorised as a third-country entity FC-), its EEA counterparties will not be subject to the clearing obligation with respect to transactions entered into with the fund, but they will still need to comply with EMIR's margin and risk mitigation provisions.

The FC-will be required to carry out the relevant calculation every 12 months, which will establish whether it has remained below the clearing thresholds[4]. It must make a notification to ESMA and to its relevant competent authority if it has exceeded the clearing thresholds (which will change its categorisation to FC+), and must establish clearing arrangements within four months of the notification.

Temporary suspension of the clearing obligation

EMIR REFIT inserts a new provision (Article 6a, EMIR) allowing the European Commission – at the request of ESMA and subject to consultation with national competent authorities and the European Systemic Risk Board – to temporarily suspend the clearing obligation under certain circumstances. The European Commission can suspend the obligation, either in respect of a specific derivatives class or for a specific counterparty type, for an initial period of up to three months, extensible by increments of up to three months, up to a maximum of 12 months. The corresponding obligation under the Markets in Financial Instruments Regulation (**MiFIR**) which requires clearing-eligible derivatives to be traded on a trading venue can also be suspended, at ESMA's request, in relation to derivatives for which the clearing obligation has been suspended.

[4] The clearing thresholds are (gross notional value) €1 billion for OTC credit derivative contracts; €1 billion for OTC equity derivative contracts; €3 billion for OTC interest rate derivative contracts; €3 billion for OTC foreign exchange derivative contracts; and €EUR 3 billion for OTC commodity derivative contracts and all other classes of OTC derivatives combined.

Fair reasonable, non-discriminatory and transparent (FRANDT) clearing services

EMIR REFIT inserts a new provision (Article 4(3a), EMIR) with the aim of making clearing services more accessible and affordable. The new Article 4(3a) requires clearing members and clients of clearing members that are providing direct or indirect clearing services to provide those services under fair, reasonable, non-discriminatory and transparent commercial terms (FRANDT). Clearing members (or their clients where applicable) must take all reasonable measures to identify, prevent, manage and monitor conflicts of interest that may adversely affect the provision of their services under FRANDT terms. The requirement, which enters into force in mid-2021, also applies where trading and clearing services are provided by different legal entities belonging to the same group.

The EMIR REFIT amendments include provision for the European Commission to adopt, in due course, delegated acts specifying the conditions under which commercial terms will be considered to meet the FRANDT requirement.

Alignment of Member States' insolvency laws

EMIR REFIT requires member states to align their insolvency laws so that national insolvency laws will not prevent a CCP from acting in accordance with its obligations regarding:

- the transfer (i.e. porting) or liquidation of assets and positions held by a defaulting clearing member; and
- client collateral segregation.

Reporting Obligations

EMIR REFIT makes a number of changes to EMIR's reporting obligations, which will potentially reduce operational burdens for NFCs:

- The requirement to report historic transactions (the "backloading" requirement) has been removed;
- There is a new intragroup exemption from reporting, where at least one counterparty is a NFC or is a third-country counterparty that would otherwise be categorised as an NFC;
- An FC will be responsible (and legally liable) for reporting on behalf of both itself and a NFC that is not subject to the clearing obligation (i.e. a NFC-); and
- The management company of a UCITS, and the manager of an AIF, is responsible and legally liable for reporting of contracts entered into by the fund.

Application of EMIR REFIT

The following amendments took effect on 17 June 2019 when EMIR REFIT came into force:

- The extended FC definition and the introduction of the FC- category;
- The timing for the clearing threshold calculation for NFCs (newly aligned with the timing for FCs);
- The clearing obligation for FC+ firms (the four month period runs from 17 June 2019 and mandatory clearing takes effect from 18 October 2019);
- Removal of the backloading obligation for reporting and the exemption for certain intragroup transactions;
- Powers of ESMA to request, and the European Commission to adopt, a suspension of the clearing obligation provided certain conditions are met

The following provisions come into force at later dates:

- A new obligation on CCPs to provide their clearing members with a margin simulation tool applies from 18 December 2019;
- A new requirement on Member States to align their insolvency laws applies from 18 December 2019;
- The provisions relating to the responsibility of FCs to report transactions apply from 18 June 2020; and
- The FRANDT requirements apply from 18 June 2021.

Comment

Many AIFs that were previously categorised as Category 3 counterparties (i.e. NFCs or smaller FCs) are likely to fall within the FC- category. Under the provisions of EMIR, Category 3 counterparties were due to become subject to the clearing obligation for G4 interest rate can credit derivatives on 21 June 2019. These entities would also have become subject to the linked MiFIR trading obligation on the same date. The advent of EMIR REFIT means that Category 3 counterparties that fall into the FC- category will no longer be subject to the clearing obligation, and those categorised as FC+ will now have until 17 October 2019 to put in place the necessary clearing arrangements.

Asset managers in particular should reassess the categorisation of any AIFs that they manage under the new EMIR REFIT Regulation. This will allow them to be prepared well in advance of the EMIR REFIT Regulation coming into force, at which point they will be required to immediately notify ESMA of their FC or small FC status.

If you have any questions, please do not hesitate to contact your usual AG contact or one of the lawyers listed below:

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