July 2019

CORPORATE DEBT UPDATE

INTRODUCTION

Welcome to the Summer 2019 edition of the Addleshaw Goddard Corporate Debt Update.

During the last quarter, the general economic outlook combined with continued political uncertainty and distraction, not least that caused by Brexit, has led to subdued activity levels and resultant demand for credit. Capital remains available, but cautious investment plans and credit appetite towards certain sectors (for example, construction, retail and care homes) has given rise to uncertain transaction volumes. Competition and liquidity for stronger credits and proposals, and the continued expansion of the range of funders and evolution of products, does mean that solutions are available provided terms can be agreed.

In this edition, we look at the upcoming replacement of LIBOR and the fast approaching transition date. As 2021 approaches we summarise the current position regarding the replacement of LIBOR as a benchmark funding rate and highlight how it is crucial at this stage that consideration is given to the treatment of legacy products, including some thoughts on the issues that lenders and borrowers may want to take into account.

Following on from the article that considered the growth of 'green' financing, which appeared in one of our previous editions of this publication, we take a look at the evolving scope and growth of sustainable financing, how it differs from green financing, what the benefits of being involved in this type of financing might be for lenders and borrowers; and what the future of sustainable financing might look like.

Finally, EMIR REFIT entered into force on 17 June 2019. It seeks to amend and simplify EMIR to "address transparency issues, compliance costs and insufficient access to clearing for certain counterparties". It provides some good news for the new category of "small financial counterparty" introduced by the legislation and also seeks to simplify and streamline reporting requirements. Our article summarises the changes brought about by EMIR REFIT.

We do hope these articles are of interest – do not hesitate to contact any of the team if you would like to discuss or if there are topics which you would like us to address in future editions.

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LIBOR TRANSITION

Background

Our Q4 2018 Corporate Borrower Update introduced information on the upcoming replacement of the London inter-bank offered rate (**LIBOR**), setting out its proposed replacement (**SONIA**, being Sterling Overnight Index Average, a risk free rate (**RFR**)) and some of the perceived issues and challenges with the use of SONIA.

Given the fundamental differences between LIBOR and SONIA, and the fact that LIBOR is expected to be phased out by the end of 2021, this transition is one of the biggest changes to the loan market in recent years and one that requires engagement and planning by those that currently rely on LIBOR.

In the UK, a group (the Working Group on Sterling Risk-Free Reference Rates) is looking to agree a way forward for the implementation of SONIA across all product areas. That group was initially made up of the Bank of England and the Financial Conduct Authority, but now incorporates representatives from over 100 investment managers, non-financial corporates and other sterling issuers, infrastructure firms and trade associations, alongside banks and dealers.

Some markets have moved decisively towards the new rate (for example, the derivatives market where the amount of new issuances using SONIA is roughly equivalent to that for LIBOR and fixed rate notes where most new issuances use SONIA) whereas others (for example, the loan market) still heavily rely on LIBOR. In his speech on 15 July 2019[1], Andrew Bailey, Chief Executive of the FCA, highlights the need for lenders to begin engaging with borrowers about lending based on RFRs. He urges that transition is not just about new business but about converting outstanding, or legacy, LIBOR contracts, however, he acknowledges that this will be harder in some markets than in others. The loan market is now the key focus and where there is a "major transition programme to be undertaken".

Although NatWest announced on 1 July 2019 that it had provided its first loan using SONIA to National Express, generally speaking, LIBOR is still being retained in most sterling-denominated loans due to the questions that remain with regard to calculation, administration and operation of SONIA that have the potential to cause problems for lenders and borrowers. We have considered some of those issues in this briefing.

What is being done to address the concerns of using SONIA?

Pricing

One of the concerns across the market, which we highlighted in our previous LIBOR transition article, relates to pricing. As SONIA is a RFR, unlike LIBOR, it does not contain any term or credit premium to reflect the risk of longer dated funds and market volatility risk respectively. This means that, for legacy loans, there may be a pricing gap which could need to be dealt with on transition and, for new loans, term and credit risk will need to either be priced separately or included within the margin.

This is an important issue because, in a credit stress market, an RFR could remain stable or go down which means that, whilst a lender's costs of funds is increasing, the interest it receives under its loan is decreasing. Obviously this pricing gap needs to be addressed and, although there are various ongoing discussions, there is not yet a consensus as to how this issue will be dealt with.

How to calculate interest payable

The market needs to agree upon a standard method for the calculation of SONIA taking into account (for example):

(i) whether interest would be calculated using a simple averaging methodology, or compounded on a daily basis;

(ii) whether the margin should be included on a daily basis or added at the end of the relevant term; and

(iii) in order to allow for calculations to be made in time for interest to be paid on each interest payment date, whether the SONIA for the relevant term would be calculated a few days before the relevant interest payment date:

(A) using a look-back starting an equivalent period prior to the start of the term (a "lag" mechanism) or

[1] https://www.fca.org.uk/news/speeches/libor-preparing-end

(B) by repeating a daily rate for the last few days of a term (a "lock-out" mechanism).

A fall-back mechanism in the event of the unavailability of SONIA would also need to be adopted.

Whilst there appears to be a market preference for the 'lag' option, and the National Express facility, referred to in the introduction to this article, used this methodology to calculate the interest payable, all options present operational issues that will need careful consideration. Whichever calculation methodology is used, it is agreed by market participants that it would be preferable to have the relevant rates calculated by a third party. As of yet, this is not available.

Forward looking term rate

One of the perceived advantages of LIBOR, as a forward looking term rate, is that it provides cost certainty for borrowers. Critics of SONIA and other RFRs reference its lack of cost certainty (due to the fact that it is a backwards looking daily rate) as one of the disadvantages.

To address this issue, and for ease of transition, the market considers that the creation of a forward-looking Term SONIA Reference Rate (**TSRR**) would be beneficial. Three benchmark agencies in the UK are looking at this, however, the provision of a forward looking term rate relies on liquidity in the underlying derivatives market, which, for many of the RFRs, isn't possible at the moment. It is for SONIA but there needs to be data available from the derivatives markets to enable the relevant benchmark agencies to set the rate. At the moment the derivatives market is not established in a way which makes the delivery of this data possible and so, whilst there is a possibility of a TSRR being developed, the timeline of this is not certain. Indeed, the advice from the Bank of England is not to rely on the establishment of a TSRR (and certainly not to wait for this to transition) and so, it may be that it will be easier to proceed with the overnight rate, SONIA, in which case market participants would need to get themselves comfortable with the issues noted above.

Legacy Loans

Unfortunately, for the cash markets, there is no ISDA style protocol which will enable a wholesale change across the market. This means that individual facility agreements will need to be amended on a case by case basis. Consideration needs to be given to whether the existing documentation provides for replacement of screen rate and also to the required consent levels to amend the documents.

We understand that the Loan Market Association (**LMA**) has indicated that it is working on a form of amendment agreement, which will be designed to allow lenders and borrowers to agree the high level changes required to a facility (e.g. the alternative rate and the adjustment spread) and then delegate discretion to the Agent to implement the necessary changes. Whilst this will be helpful, given the number of LIBOR reliant loans in existence, there is still a significant amount of work to be done to ensure an effective transition within the proposed timescale.

New Loans

The sterling-denominated loan market in the UK has not really progressed this issue within the last 12 months and most new facility agreements still retain LIBOR as the basis for interest calculations, even where the term of the loan goes beyond the end of 2021.

We also understand that the LMA is currently preparing a draft facility agreement which uses a 'compounded in arrears' SONIA rate as the basis of calculating interest, however, the publication of this is a long way off. For the moment the best option appears to be including a form of the LMA-recommended replacement of screen rate language within any new facilities agreements, but this is in effect just pushing resolution of the problem further towards the 2021 deadline.

What next?

There are still a number of outstanding questions and, at the moment, there is a perception amongst the regulators that there has been a "wait and see" attitude until the financial services industry as a whole has more clarity on the final position as to whether SONIA or a TSRR will be adopted for loans. To that end, in September 2018, the FCA and Prudential Regulation Authority wrote to CEOs of major banks and insurers supervised in the UK asking for details of the preparations and actions they are taking to manage transition from LIBOR to alternative interest rate benchmarks including SONIA. The range of responses received was mixed, but it does seem that this has encouraged market participants to accelerate their plans to deal with the transition. 2021 is fast approaching and a successful transition will need an industry-led solution to what will be one of the most significant changes to impact on the loan market.

What can you do?

While it seems that currently there is little that can be done in terms of documenting new plans to reflect the position after the LIBOR transition (beyond ensuring that the LMA Replacement of Screen Rate language (or equivalent) is included when new facility agreements are entered into (and ideally when amending and/or restating existing facility agreements)) borrowers and lenders should both look to consider their existing loans and what (if anything) needs to be done with them.

To avoid disputes it would be sensible to address this early on. The fallback provisions in existing LMA loan agreements are not designed to work long term so it is much more beneficial to a borrower to address the replacement of LIBOR as soon as practicable rather than wait until LIBOR is no longer available. A borrower could consider repaying or prepaying any LIBOR linked loans if this is a possibility and if no agreement on an alternative can be reached.

Being aware of the issue, engaging with your lenders and considering the implications of LIBOR transition in any financial planning will assist with ensuring that you are as prepared as you can be for what the future of LIBOR/SONIA will hold.

If you have any questions around the impact of the LIBOR transition and if there is anything that we can do to assist with your management of LIBOR transition please do not hesitate to contact your usual AG contact or one of the lawyers listed below:

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THE EVOLVING SCOPE OF SUSTAINABLE FINANCING

In our Q4 2018 Corporate Borrower Update, we considered the growth of green financing in general, i.e. financing (whether that be bonds, equity or debt) that supports or encourages environmentally sustainable economic behaviour, and then provided more focused commentary on green loans. In this edition, following publication by the Loan Market Association (**LMA**) of its Sustainability Linked Loan Principles (**SLLP**), hot on the heels of its revised Green Loan Principles (**GLP**), we consider the general scope of sustainable financing, how it differentiates itself from green financing and the GLP, what is meant more specifically by sustainability linked loans and what these could mean for corporate lending.

What does sustainable financing currently encompass and how does it differ from green financing?

Until recently (and perhaps still) the terms 'sustainable financing' and 'green financing' have been used interchangeably to refer to financing that supports and promotes economic activity with environmentally sound objectives. However, as objectives, principles and guidelines, terminology and industry awareness has evolved to create a more sophisticated market of financial products in this area, the distinction between sustainable financing and simply green financing has become clearer.

At its core sustainable financing still has environmental objectives and concerns similar to those that drive, and are captured by, green financing but it casts the net even wider to take account of social and governance objectives too (together known as Environmental, Social and Governance (**ESG**) standards). In a practical corporate lending context, this may include not only taking account of, for example, a corporate borrower's contribution to CO2 emissions or water usage within its business but also the working conditions of its employees and its internal approach to corporate governance issues.

Publication of the SLLP by the LMA has arguably helped significantly in clarifying this distinction for industry participants. In our previous article on green financing we outlined how the key focus in a GLP compliant green loan is the 'use of proceeds', i.e. the requirement that the proceeds of the loan be invested into projects, activities or assets that have a specified environmental benefit (for example eco-efficient products, production technologies or processes). We also noted though how participants in the loan market are already devising commercial concepts and documentary mechanisms that mean that, although such loans do not technically meet GLP requirements, they nonetheless provide a financial incentive for the borrower to engage in environmentally responsible or 'green' behaviour.

The SLLP have both formalised this concept of incentivising borrowers to engage in environmentally friendly behaviours and widened the scope of that incentive to encompass and encourage more all-round ESG friendly behaviour. The formal form of incentive will usually be financial, i.e. sustainability performance objectives (e.g. relating to CO2 emissions, water usage, sourcing of sustainable raw materials or supplies, recycling, production of sustainable products and/or improvements in the borrower's overall ESG rating or achievement of a recognised ESG certification) and will be predetermined and incorporated into the loan documentation in the form of covenants that in turn are tied to a reducing margin ratchet. Note that incentive is the key word and failure to meet the sustainability linked covenants will not result in a breach or trigger an event of default - it is not intended to be used as a stick.

The informal incentive for all participants, is an improved positive public imagine and business development opportunities. Sustainability linked loans naturally open up the door to these evolving new loan products to a much wider group of corporate borrowers than the strict use of proceeds approach supported by the GLP might otherwise have done. However, it is worth highlighting that the requirements and objectives of the GLP and SLLP are not mutually exclusive. There is nothing stopping borrowers and lenders striving to incorporate both into their loans, although of course this will understandably only be possible in a narrow group of transactions.

With these new sustainably linked products come potential new roles in the financing cycle. For example, the need for a new internal officer role within businesses to devise (if this has not been done by an external expert) an ESG strategy to pin sustainable covenants against, and to then implement, monitor and report on that strategy. In some instances though, internal expertise alone may not be considered sufficient; this will depend, for example, on the lender/borrower relationship and the sophistication and resources of the borrower. In some cases, a lender may wish to agree the appointment of an external reviewer to report independently on how a borrower is meeting its sustainability linked covenants. The SLLP does not set requirements or obligations for such new roles in stone, but helpfully it does offer guidance on these points for parties to consider on a deal-by-deal basis.

What are the benefits to corporate lenders?

As with 'use of proceeds' green loans, the benefits to the lender of providing a sustainability linked loan are that (i) they are associated with a type of financing that is being widely promoted across the globe by the TFCFD, the European Commission, the UK Government and industry bodies to ensure a successful transition to a low-carbon economy; (ii) corporates that engage in sustainability, are environmentally and socially conscious are viewed as a better credit risk, as such engagement arguably enhances their competitive advantage, increases their operational cost effectiveness, and ultimately, improves their long-term financial performance; and, (iii) more specifically, encouraging sustainability can often result in an increase in the value of a lender's security (for example improving the energy efficiency of a real estate asset could increase its market value or improving a borrower's corporate governance or public image could have a significant impact on the value of its business).

How can corporate borrowers take advantage of this?

As is evident from the 'noise' in the market around both green and sustainable financing there is clearly an appetite for improved ESG performance from both lenders and borrowers. This coupled with lenders' internal corporate and social responsibility requirements means borrowers could use the opportunity to obtain beneficial pricing. Public expectation of brands acting in an environmentally conscious manner is growing, and positive sustainable behaviour is a useful selling point to both stakeholders and customers.

Thoughts on the future of sustainable financing

Statistics, referenced at a recent LMA seminar, show that Europe as a whole is a leading market in the field of sustainable financing with 80% of all sustainable financing deals deriving from Europe; and in the Accelerating Green Finance Paper (prepared by the Green Finance Taskforce, an organisation established by the City of London Corporation) London is described as a world leading hub for green finance. There still remains great scope for growth and development in this field and these reports indicate that London and the wider European market will be leading the field on that front.

So far, voluntary measures and self-monitoring have moved the sustainability linked finance market forward but naturally this has led to inconsistencies in approach, standards and products and the appetite for engaging with sustainable issues in financing continues to vary across sectors and institutions. To ensure that sustainability is integrated across our national and international economies, and that a universal change in attitudes, approaches and implementation evolves, there clearly needs to be a move towards regulation, codification and perhaps even legislation both nationally and cross-border.

We have already seen movement in this direction. For example:

- the Task Force on Climate-related Financial Disclosures (**TFCFD**) (established by the Financial Stability Board - an international body created by the G20) has published recommendations aimed at addressing climate-related risks in governance, disclosure, strategy, risk management, metrics and targets, that are intended to be adoptable by investors and lenders;

- the EU strategy on sustainable finance developed by the High Level Expert Group on Sustainable Finance has put forward recommendations which have already started to be considered and implemented by the technical expert group (**TEG**) on sustainable financing. For example, a proposal has already been suggested for regulations dealing with unified taxonomy in relation to environmentally sustainable economic activity, disclosure requirements in respect of ESG factors and defining minimum standards for the methodologies of the ‘EU climate transition’ and ‘EU Paris-aligned’ benchmarks to address the risk of green-washing; and

- the UK government, as well as UK regulators (for example, the Prudential Regulatory Authority (**PRA**) and the Financial Conduct Authority) are examining various measures to integrate sustainable issues into financial decision making and embed climate risk into the regulatory framework.

Such formal guidance, monitoring and regulation will help address issues of inconsistencies across the financial industry but to further drive appetite there needs to be a formal and universal incentive too, for both lenders and borrowers. Clearly this won't come about overnight, but we are seeing that positive steps are already being taken. For example there are now central bank discussions taking place regarding sustainable supporting factors being taken into account in determining bank capital requirements. This is a big step forward to where we were even 12 months ago when such an idea was not yet being entertained.

So, could sustainable financing eventually become standard rather than a separate product? This certainly seems like a possibility in the face of changing social attitudes and the progress we have seen so far. An assertion supported by the recent

(March 2019) Sustainable Finance Progress Report issued by the UN, in which it was reported that sustainable financing was becoming increasingly mainstream and less of a niche offering, as a diverse range of financial players were found to be integrating elements of sustainability into financial decision-making in both public and private financial markets (including, development banks, institutional investors, commercial banks, insurers and some of the largest private equity firms). However, the key risk that all these players need to be live to and ensure is avoided is so-called 'green/sustainable washing', i.e. spinning the nature of a product to make it appear greener or more sustainably linked than it actually is in the drive to be seen to be making green and sustainable standard practice in financing. Consequently, progress may be slowed by the need to carefully engineer, monitor and regulate this evolving market but that of course should not be perceived as a negative – getting a universal framework in place and promoting improved data sharing and transparency will be key.

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EMIR REFIT: GOOD NEWS FOR SMALLER DERIVATIVES COUNTERPARTIES

The EMIR REFIT Regulation (Regulation (EU) 2019/834)[2] 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**)[3], 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[4] 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

[2] 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.

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

[4] 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[5]. 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.

[5] 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.

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