July 2017

EMIR 1.5

Just as the dust had settled on implementation of the EMIR[1] margin requirements[2], the European Commission recently published a proposal for a new regulation with the aim of simplifying some of the rules laid down in EMIR and making them more proportionate. But the news is not entirely positive for everyone.

EXECUTIVE SUMMARY

The proposed regulation is not a wholesale reform of EMIR (an "EMIR 2") but rather seeks to address some of the areas where the European Commission, acting in response to consultations, perceives EMIR to impose disproportionate costs, administrative burdens or complexity, in particular on non-financial counterparties and small financial counterparties.

Certain changes are likely to be welcomed, such as an end to the requirement to backload trade reporting and the frontloading requirement for clearing of derivatives transactions. Pension schemes are likely to be pleased that their temporary exemption from the obligation to clear certain classes of derivatives transactions is to be extended.

However, some may not regard the changes so positively. Under the proposed regulation, some parties would be re-categorised from non-financial counterparties to financial counterparties and become subject to the EMIR clearing and margining requirements. This will affect certain alternative investment funds (such as private equity, real estate and infrastructure funds) currently categorised as non-financial counterparties and some securitisation SPVs.

Though the proposed regulation itself has a wide scope, this note summarises some of the key changes to EMIR set out in the proposals, and considers the potential implications businesses may face.

The regulation will be subject to the normal EU legislative procedures, and could be changed by the European Parliament and European Council. It is not expected to take effect until late 2018 at the earliest, so no *immediate* action is required. You may, however, wish to start discussing the potential impact of the proposed changes with your counterparties, advisors and industry bodies of which you are a member.

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[1] The European Market Infrastructure Regulation on OTC derivative transactions, central counterparties and trade repositories (Regulation EU 648/2012)
[2] See the Regulatory Technical Standards and the Annexes published on 4th October 2016

BROADENING OF THE DEFINITION OF FINANCIAL COUNTERPARTY

CURRENT POSITION	PROPOSAL
• The definition of financial counterparty (**FC**) in Article 2(8) of EMIR includes alternative investment funds (**AIFs**) if they are managed by an alternative investment fund manager (**AIFM**) authorised or registered under the Alternative Investment Fund Managers Directive (**AIFMD**)[3]. In practice, this currently means only AIFs managed by AIFMs established in the European Economic Area (**EEA**).	• The definition of FCs in Article 2(8) of EMIR would be broadened to include **all** AIFs registered under national law. In particular, this would apply to non-EEA AIFs managed by non-EEA AIFMs trading with EEA counterparties. The definition would also be broadened to include securitisation special purpose vehicles (**SSPEs**).

IMPLICATIONS

AIFs

- Under the current regime, an AIF which is not managed by an AIFM authorised or registered under AIFMD is classified as a non-financial counterparty (**NFC**) so, provided it remains below the clearing thresholds (as an "**NFC-**" rather than an "**NFC+**"), it is not required to exchange collateral as margin or mandatorily to clear any over-the-counter (**OTC**) derivatives transactions. The clearing thresholds[4] are summarised below for reference:

ASSET CLASS	THRESHOLD
OTC credit derivatives transactions	EUR 1 billion
OTC equity derivatives transactions	EUR 1 billion
OTC interest rate derivatives transactions	EUR 3 billion
OTC foreign exchange derivatives transactions	EUR 3 billion
Other OTC derivatives transactions combined	EUR 3 billion

- The effect of the proposed re-categorisation is that many AIFs which are currently NFCs under EMIR will become subject to more onerous (and potentially costly) requirements under EMIR. Specifically, AIFs will potentially be required to clear some classes of OTC derivatives transactions (subject to other changes described below concerning "small financial counterparties") and to exchange collateral as margin in respect of other transactions. We have previously produced notes on the clearing and margining requirements under EMIR.
- AIFs affected by this re-categorisation will need to prepare for the increase in compliance obligations associated with being FCs, and consider whether they will be able to make the transition by the time the proposed regulation comes into force.
- The European Securities and Markets Authority (**ESMA**) has previously issued guidance in the form of Q&As which provide that a special purpose vehicle used by a private equity AIF whose purpose is to "*purchase, hold or administrate undertakings*" is able to enter into OTC derivatives transactions for the "*activity of the AIF*", and retain its classification as an NFC- (and is therefore out of scope for the clearing and margining requirements of EMIR[5]). These Q&As have not been updated in light of the proposed regulation, so AIFs may wish to consider whether this guidance could apply to, or be used for the benefit of, their OTC derivatives trading arrangements.

SSPEs

- SSPEs are entities established to facilitate a securitisation, such as by issuing securities and/or holding assets on a segregated basis from the underlying originator.
- SSPEs are often categorised as NFC- because they (i) fall outside the definition of FCs and (ii) they do not cross the clearing thresholds listed above.[6]
- The effect of the proposal would bring SSPEs into scope for the clearing and margining requirements for certain classes of OTC derivatives transactions.
- While they commonly act as counterparty to OTC derivatives transactions, SSPEs are not usually structured so as to support onerous ongoing obligations (like clearing and margining). These additional requirements would present operational and logistical challenges, increasing the cost and administrative burden faced by securitisation firms. Accordingly, it is likely that there will be resistance to SSPEs being made subject to the clearing and margining requirements under EMIR.

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[3] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011
[4] More detail on the calculation of clearing thresholds is set out below
[5] See General Answer 3(iv) of ESMA's EMIR Q&As
[6] See General Answer 3(iii) of ESMA's EMIR Q&As which confirms that SSPEs should be considered as NFCs for the purpose of EMIR

CALCULATION OF CLEARING THRESHOLDS

CURRENT POSITION	PROPOSAL
• Currently an NFC will become subject to the clearing and margining requirements under EMIR if the aggregate gross notional value of its outstanding, non risk-reducing OTC derivatives transactions entered into by that NFC and all other NFCs within its group, calculated on a *rolling average basis over a 30 working days period*, exceeds one of the clearing thresholds summarised on the previous page.	• Under the terms of the proposed regulation, an NFC would become subject to the clearing and margining requirements under EMIR if the aggregate gross notional value of all outstanding, non risk-reducing OTC derivatives transactions entered into by that NFC and all other NFCs within its group *at the month-end for the months March, April and May*, exceeded one of the clearing thresholds summarised on the previous page.

IMPLICATIONS

- This will significantly ease the monitoring burden on NFCs close to one of the clearing thresholds, as they need only focus on month-end figures for the months of March, April and May annually, rather than conducting an ongoing 30-day look-back review.
- Conversely, if an NFC goes above a clearing threshold when tested, it will not be able to show that it has dropped back below that threshold until (at the earliest) after the end of the next March, April and May.

NEW CATEGORY OF "SMALL FINANCIAL COUNTERPARTY"

CURRENT POSITION	PROPOSAL
• Currently, an NFC which exceeds one of the clearing thresholds summarised on the previous page will cease being an NFC- and will become an NFC+. • NFCs are permitted to exclude risk-reducing OTC derivatives when calculating the thresholds. • An NFC+ is subject to the clearing and margining requirements under EMIR. • There is no equivalent threshold requirement made in the categorisation of FCs.	• The proposed regulation introduces a new category of 'small financial counterparties' (**SFCs**) which will be exempt from the *clearing* requirement. • The table of clearing thresholds above will apply but FCs will need to include all OTC derivatives trading activity within their calculations, without any deduction for risk-reducing activity.

IMPLICATIONS

- This will eliminate the administrative burden of clearing for FCs that enter into a limited amount of OTC derivatives transactions and therefore pose minimal systemic risk to the financial system.
- We expect smaller FCs will welcome this change.
- Note, however, in any event that it is proposed that the *margining* requirements under EMIR will still apply to SFCs.

IMPACT OF EXCEEDING CLEARING THRESHOLD

CURRENT POSITION	PROPOSAL
• Currently, the effect of an NFC exceeding any one of the relevant thresholds (which only apply to NFCs), is that it will become an NFC+ for *all* asset classes even if no other threshold is exceeded.	• **FCs**: Introduces the same clearing thresholds for FCs as for NFCs (as summarised on the previous page). However, if the threshold for one class of OTC derivatives transactions is exceeded, this will trigger the clearing obligation for *all* asset classes of that FC's in-scope OTC derivatives transactions. • **NFCs**: In contrast, the position for NFCs is that the clearing obligation would apply on an asset class by asset class basis, meaning that the obligation to clear would be for in-scope OTC derivatives transactions of that particular asset class only.

IMPLICATIONS

- We expect this will be welcomed by NFC+s for reducing the operational, administrative and potential cost burden of otherwise being required to clear all classes of OTC derivatives transactions if they have exceeded the threshold for any one class.

EXTENSION OF TEMPORARY CLEARING EXEMPTION FOR PENSION SCHEME ARRANGEMENTS

CURRENT POSITION	PROPOSAL
• Under Article 89 of EMIR, pension scheme arrangements (**PSAs**) benefit from a temporary exemption from the clearing requirements under EMIR until August 2018.	• PSAs to be provided with an extension to the exemption from the clearing obligation by 3 years from the date on which the proposed regulation comes into effect. This is to provide the industry with more time to develop a viable technical solution to facilitate the participation of PSAs in the cleared market, specifically regarding the exchange of non-cash collateral as variation margin.

IMPLICATIONS

- We expect this will be welcomed by PSAs, many of which do not yet have in place the necessary arrangements to clear their in-scope OTC derivatives transactions.
- A practical issue facing PSAs is that the proposed regulation may not be in force before the expiry of the existing exemption, so there may be a period of uncertainty where PSAs are technically in scope for clearing. A solution to this temporary/technical break in the exemption period will need to be found, and we await further clarification on this point.

END TO THE FRONTLOADING REQUIREMENT

CURRENT POSITION	PROPOSAL
• Article 4(1)(b)(ii) of EMIR currently requires the largest FCs with the highest level of derivatives trading activity to clear certain OTC derivatives transactions entered into *before* the clearing obligation under EMIR comes into effect (where the relevant OTC derivatives transaction has a prescribed minimum remaining maturity).	• An end to this requirement.

IMPLICATIONS

- We expect this will be welcomed by affected FCs because the frontloading requirement has generated uncertainty and concerns about pricing.

UPDATE TO REPORTING REQUIREMENTS

CURRENT POSITION	PROPOSALS
• EMIR requires counterparties and central counterparty clearing houses (**CCPs**) to report details of concluded, modified or terminated OTC derivatives transactions to a trade repository. The obligation applies to both counterparties (i.e. two-sided reporting, rather than the single-sided reporting found under other regimes, such as Dodd-Frank). • Many smaller counterparties delegate reporting of their OTC derivatives transactions to their larger counterparties. However it is not possible for a smaller counterparty to absolve itself of the legal liability to report (or for the content of any report submitted on its behalf). The alternative is to establish direct membership of a trade repository, which has cost and administrative implications.	• The proposed regulation prescribes a reporting obligation dependent upon the type of counterparty. • For OTC derivatives transactions, responsibility and *legal liability* for reporting transactions between an NFC- and an FC will fall on the FC counterparty, who will be legally liable to report on behalf of both parties. • For exchange traded derivatives transactions, the CCP will be responsible and legally liable to report the details of the transaction. • An intragroup transaction where one of the parties is an NFC will be exempt from the requirement to report. • Managers of AIFs and UCITS will be legally liable to report trades on behalf of those AIFs and UCITs.

IMPLICATIONS

- We expect this will be welcomed by NFC-s as it will further reduce the burden of reporting. Although the proposal expects this to reduce "*EMIR-related compliance costs for the 'real economy'* ", FCs may be inclined to charge for assuming this burden, so there may be an unintended impact on the cost of trading for NFCs.

AN END TO BACKLOADING

CURRENT POSITION	PROPOSAL
• EMIR requires 'backloading' – the reporting of details of historic derivatives transactions.	• An end to this requirement.

IMPLICATIONS
• We expect this to be welcomed as it will reduce administrative burdens and also eliminate the risk of breach of the backloading requirement (for example where historic data simply is not available).

THE PROPOSED REGULATION: COST BENEFIT OR COST BURDEN?

A stated aim of the proposal is to make EMIR more proportionate. Some of the proposals, such as an end to the backloading and frontloading requirements and less onerous regulation for SFCs, will be well received.

On the other hand, some of the proposals may lead to significant additional costs for some counterparties. A clear example would be those AIFs and SSPEs which are brought into the scope of EMIR margining and potentially clearing obligations.

WHAT SHOULD COUNTERPARTIES BE DOING NOW?

The proposed regulation is subject to the usual EU legislative process, and is not currently expected to come into force until the end of 2018, so there is time to assess whether the proposed changes would affect your business.

You may wish to discuss the potential impact of the proposed changes with your counterparties, advisors and representative industry bodies.

HOW WE CAN HELP

If your business is likely to be affected by any of the changes in the proposed regulation, or you wish to discuss any of the issues raised in this note, please contact either of the partners below, or your usual Travers Smith contact.

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