

# EMIR REFIT: How it will affect you

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## The Short Read

On 28 May 2019, EMIR 2.1[1] (also known as EMIR REFIT) was published in the *Official Journal* and (subject to some phase-in provisions detailed below) will come into effect on 17 June 2019 (the “Effective Date”). EMIR 2.1 makes a number of material amendments to the provisions of The European Markets Infrastructure Regulation[2] (“EMIR”) which are intended to reduce the burdens on, and cost of compliance[3] to, less systemically important market participants.

The ramifications of EMIR 2.1 for the buy side will be most keenly felt in: (i) the potential reclassification of the status of certain alternative investment funds (“AIFs”) and other investment vehicles under EMIR from the Effective Date; (ii) changes to the clearing threshold calculation methodology and the potential notification requirements to the European Securities and Markets Authority (“ESMA”) and the relevant national competent authority (an “NCA”) on the Effective Date as a result of such changes; and (iii) certain proposed changes which offer opportunities to smaller counterparties to reduce their overall costs (both financial and in terms of resources employed).

(A “national competent authority” or “NCA” refers to the relevant authority designated by the Member State and is usually the national regulator. So, for example, in the case of the United Kingdom, the NCA is the Financial Conduct Authority (“FCA”).)

In summary, the key features of EMIR 2.1 are as follows:

- Amendments to the definition of ‘financial counterparty’ (“FC”) such that most AIFs established in the European Union (the “EU”) will be FCs, with the result that a non-EU AIF with a non-EU alternative investment fund manager (“AIFM”) will now be categorised as a ‘hypothetical’ FC[4].
- The recategorisation of an entity may have implications for its compliance with EMIR risk mitigation techniques and other obligations (see the Appendix for the application of these obligations to the different entity categorisations).
- An FC that does not exceed *any* clearing threshold applicable to any asset classes (a “Small FC”) will be exempt from the clearing obligation. It must be below the clearing threshold in respect of all asset classes to fall within the Small FC classification.
- A ‘non-financial counterparty’ (“NFC”) will only be required to clear those OTC derivative contracts subject to the mandatory clearing obligations that pertain to the asset class(es) in which it exceeds a clearing threshold.
- For both FCs and NFCs, the determination as to whether a clearing threshold has been exceeded must be carried out annually; and there is also the option, instead of performing the calculation, to elect to be an NFC that has exceeded the clearing threshold (“NFC+”) in relation to all asset classes[5] or an FC exceeding a clearing threshold (a “Large FC”).
- The methodology for calculating the clearing threshold has changed to the aggregate month-end average position for the previous 12 months (on a group wide basis), with the first calculation to be made as at the Effective Date.
- An NFC+ and a Large FC (whether so categorised following its clearing threshold calculation or because it did not undertake the calculation at all) must notify ESMA and the relevant NCA as at the Effective Date of its status.

- Being a Small FC or an NFC+ only in respect of some asset classes, though, will not exempt such an entity from complying with other EMIR risk mitigation techniques, including the exchange of collateral, in respect of all its non-cleared OTC derivative transactions.
- To improve access to clearing services for smaller market participants, clearing members must provide clearing services under fair, reasonable, non-discriminatory and transparent commercial terms.
- Frontloading of transactions for the purposes of the clearing obligation has been removed.
- The reporting obligation has been improved: (i) greatly by removing the 'backloading' obligation to report certain transactions; and (ii) slightly, by allowing an NFC that has not exceeded a clearing threshold (an "NFC-") to push the obligation onto an FC or, in limited circumstances, onto a 'hypothetical' FC.

Whilst some phase-in periods apply, these are limited in scope and nature. Importantly, the changes to the definition of "financial counterparty" and the amendments to the clearing obligation will be applicable from the Effective Date.

The above, together with other material changes made to EMIR by EMIR 2.1, are considered in depth in "The Full Read" section below, together with our analysis and commentary.

Note that this edition of Briefs for the Buy side does not consider the parallel legislative proposal to (*inter alia*): (i) establish a new supervisory authority for central counterparties ("CCPs") within ESMA; and (ii) amend EMIR as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third country CCPs (known as "EMIR 2.2")<sup>[6]</sup>. This contains the controversial 'location' policy whereby recognition of a non-EU CCP may be denied where it or its clearing services are of "such substantial systemic importance"; meaning that EU clearing members and others subject to the EU clearing requirement will only be allowed to clear certain products on a CCP established and authorised within the EU. EMIR 2.2 is expected to be published in the *Official Journal* during Q3 2019 and, if appropriate, will be the subject of a future edition of Briefs for the Buy side at the relevant time.

## The Full Read

### The EMIR Update: Background

In common with certain other EU legislation, EMIR contained a provision mandating that the European Commission (the "EC") review and prepare a general report on EMIR within a prescribed timeframe<sup>[7]</sup>. As a result, between May and August 2015, the EC carried out an extensive assessment of the EMIR rules (including a public consultation) and, following the Call of Evidence on the EU Regulatory framework for financial services, the EC adopted the EMIR general report in November 2016 (the "EMIR Report").

The EMIR Report did not recommend any sweeping changes or major overhaul of the EMIR regime, noting that a comprehensive review of EMIR at that time was not possible and that the core requirements had the broad support of market participants and relevant authorities. On reflection, the review was probably premature given that the majority of material EMIR provisions were not operative at that time. However, it was noted that EMIR could be amended in certain specific areas so as to: (i) eliminate disproportionate costs and burdens on certain (i.e. smaller and less systemically important) counterparties; and (ii) simplify rules. Consequently, the overall review of EMIR for these purposes was included in the 2016 EC's Regulatory Fitness and Performance programme ("REFIT") with the aim of ensuring that the objectives of EMIR – to promote transparency and standardisation in derivatives markets as well as reduce systemic risk through the application of its core requirements – are met in a more proportionate, effective and efficient manner; and to eliminate disproportionate costs and burdens but without prejudicing the overarching objective of preserving financial stability and reducing systemic risk.

In general, whilst improvements have been made by EMIR 2.1, it has also deferred consideration or resolution of a number of issues to a

later date and a number of helpful or useful provisions have been lost during the two year negotiation process.

This Briefs for the Buy side will consider the key terms of EMIR 2.1.

## 1. Entering into Force

EMIR 2.1 comes into effect on the Effective Date. However, certain aspects will apply from six months after that date, and others from 12 or 24 months afterwards (as detailed below).

### **AB Trading Advisors View and Comment**

The very short timeline for the entry into force of many of the substantial provisions of EMIR 2.1 may be problematic for market participants and will require immediate attention in some instances. We consider this further under each of the headings below.

## 2. Definition of Financial Counterparty

This definition has been expanded to include central securities depositories, investment firms authorised in accordance with MiFID II (rather than MiFID I) and all AIFs established in the EU (other than (i) UCITS and AIFs set up exclusively to serve employee share purchase plans and (ii) AIFs that are securitisation special purpose entities, which are excluded from the definition of an FC (each an “Excluded AIF”). The unwelcome extraterritorial reach present in the EC’s May 2017 proposal for EMIR 2.1 (the “May 2017 Proposal”), whereby any and all AIFs globally would have been directly within the expanded definition, has been removed. (Of course, AIFs (anywhere in the world) managed by an authorised or registered AIFM are still within this classification.)

In terms of extraterritorial counterparty classification, a non-EU AIF (other than an Excluded AIF) with a non-EU AIFM will now be a ‘hypothetical’ FC<sup>[8]</sup> rather than a ‘hypothetical’ NFC<sup>[9]</sup> as has (in our view) been the case. All EU AIFs (other than Excluded AIFs) will now be FCs.<sup>[10]</sup>

### **AB Trading Advisors View and Comment**

An actual or ‘hypothetical’ NFC that is reclassified as an actual or ‘hypothetical’ FC can expect to be required to comply (either directly or indirectly) with a greater scope of EMIR risk mitigation techniques than it is currently subject to (see *Sections 4 and 5* below). Any representations or confirmations given to trading counterparties (whether by way of side letter, embedded in documentation directly or otherwise) as to an entity’s EMIR classification should be updated to avoid any potential breaches.

Given that the change to the “financial counterparty” definition takes effect on the Effective Date with no delay, it would be prudent to consider now whether any updated classifications should be made and in what form. AB Trading Advisors can assist with the production of an updated EMIR status notification letter for this purpose.

To see, at a glance, how an entity’s requirements under the EMIR risk mitigation techniques and other relevant obligations may change due to a reclassification (arising for any reason, including due to the change in clearing threshold calculation methodology – see *Section 3* below), please refer to the Appendix.

## 3. Clearing Obligation Issues

### New FC Clearing Classification

In recognition that not all FCs are systemically important, FCs are to be divided into two sub-categories in the same way that NFCs

currently are: namely, (i) a Large FC and (ii) a Small FC. Only Large FCs will be subject to the mandatory clearing obligation. To recap, a Large FC is an FC which exceeds *any* clearing threshold and a Small FC is one that does not exceed *any* clearing threshold<sup>[11]</sup>. Only Large FCs will be subject to the mandatory clearing obligation for OTC derivative contracts. Therefore, FCs will have a new calculation to undertake and potentially a notification obligation to ESMA and the relevant NCA. A Small FC will still have to comply with the EMIR risk mitigation techniques, including the exchange of collateral, in respect of all its non-cleared OTC derivative contracts.

#### Clearing Threshold Calculation for FCs

In order to determine whether an FC is a Large FC or a Small FC, every 12 months the FC *may* calculate its aggregate month-end average position for the previous 12 months (the “FC Clearing Threshold Calculation”). The FC Clearing Threshold Calculation must be undertaken on a ‘group’ basis so the FC should include all OTC derivative contracts entered into by that FC and by other entities within its group (whether FCs or NFCs). For UCITS and AIFs the positions shall be calculated at the level of the fund or sub-fund. Where a UCITS management company manages more than one UCITS or an AIFM manages more than one AIF, they will need to be able to demonstrate to the relevant NCA that the calculation of positions at the UCITS / AIF level does not lead to: (i) a systematic underestimation of the positions of any of the funds they manage or the positions of the manager; and (ii) a circumvention of the clearing obligation.

There is no requirement for an FC to undertake the FC Clearing Threshold Calculation. If an FC chooses not to make the calculation then it shall be deemed to be a Large FC for all asset classes.

The initial FC Clearing Threshold Calculation, and any consequent notifications (see “*Notifications*”, below), will need to be undertaken on the Effective Date.

The FC Clearing Threshold will operate on a ‘breach one, breach all’ basis. If an FC exceeds a clearing threshold in relation to (e.g.) the interest rate asset class, then it will be deemed to be a Large FC for all asset classes and will be required to clear all OTC derivative contracts pertaining to any and all classes of OTC derivative which are subject to the clearing mandate, subject to a four month grace period in certain circumstances.

Unlike NFCs (in relation to which the hedging exemption is retained), FCs cannot exclude OTC derivative contracts which are objectively measurable as reducing risks directly relating to the commercial activity of the FC or of that group from the FC Clearing Threshold Calculation.

#### Clearing Threshold Calculation for NFCs

The clearing threshold calculation for NFCs will no longer be based on a spot and 30 working day rolling average position calculation. Instead, an NFC *may* calculate its aggregate month-end average position for the previous 12 months (the “NFC Clearing Threshold Calculation”). The NFC Clearing Threshold Calculation must be undertaken on a ‘group’ basis, in which case the NFC should include all OTC derivative contracts entered into by that NFC and by other non-financial entities within its group. The NFC can exclude OTC derivative contracts which are not objectively measurable as reducing risks directly relating to the commercial activity of the NFC or of that group.

There is no requirement for an NFC to undertake the NFC Clearing Threshold Calculation. If it does not, it will be deemed to be an NFC+ in relation to all asset classes for the purposes of the clearing obligation<sup>[12]</sup> and will be required to clear all OTC derivative contracts pertaining to any class of OTC derivatives which is subject to the clearing mandate, subject to a four month grace period in certain circumstances.

The initial NFC Clearing Threshold Calculation, and any consequent notifications (see “*Notifications*”, below), will need to be undertaken on

the Effective Date.

Currently, in respect of NFC+s, the clearing obligation operates on a 'breach one, breach all' basis. EMIR 2.1 changes this such that an NFC+ is obliged to clear only those OTC derivative contracts pertaining to the class of OTC derivative contract for which the clearing threshold was exceeded, subject to a four month grace period in certain circumstances. In which case, for example, an NFC might be an NFC+ in respect of credit derivatives and an NFC- in respect of all other asset classes.

#### Notifications<sup>[13]</sup>

Those FCs and NFCs: (i) exceeding one or more clearing thresholds; or (ii) that choose not to make the FC Clearing Threshold Calculation or the NFC Clearing Threshold Calculation (as applicable), must notify ESMA and the NCA on the Effective Date and, where relevant, indicate the period used for the calculation.

An NFC that had previously notified ESMA and the relevant NCA that it had exceeded a clearing threshold (under the previous 30 working day rolling average position calculation) and which is now below one or more clearing thresholds pursuant to the NFC Clearing Threshold Calculation will also need to notify the NCA and demonstrate the same. (In the absence of any guidance on what would constitute sufficient demonstration, we would assume a simple notification would suffice rather than providing details of the NFC Clearing Threshold Calculation.)

It will also be necessary for: (i) an FC to inform its counterparties whether it is a Large FC or a Small FC (or the hypothetical equivalent) and (ii) an NFC to inform its counterparties whether it is an NFC+ for one or more asset classes or an NFC- (or the hypothetical equivalent).

#### Clearing Thresholds

It is expressly envisaged that the clearing thresholds for FCs and NFCs shall be periodically reviewed, taking into account the interconnectedness of FCs (and thus perceived systemic risk). As such, it may be that the clearing thresholds for FCs and NFCs diverge in the future.

#### Front-Loading

This was the much criticised requirement to clear those OTC derivatives transactions with a minimum prescribed remaining maturity, which had been entered into after a CCP had been authorised to clear a class of OTC derivative, but before the date upon which the mandatory clearing obligation for that class of OTC derivative took effect. Acknowledging in the recitals to EMIR 2.1 that the requirement created "legal uncertainty and operational complications, while providing limited benefits", the requirement has been removed, with mandatory clearing now to apply only to OTC derivative contracts entered into or novated on or after the date on which the clearing obligation takes effect *provided that*, on that date, both counterparties meet the conditions to be subject to mandatory clearing.

#### **AB Trading Advisors View and Comment**

These clearing-related changes all take effect on the Effective Date, meaning that counterparties have very limited time to determine their actual or hypothetical NFC+ / NFC- / Large FC / Small FC status. All counterparties that choose to make the FC Clearing Threshold Calculation or the NFC Clearing Threshold Calculation (as applicable) must determine the results of such calculation *on the Effective Date*. Therefore, as the public statement from ESMA on 28 March 2019 on the implementation of the new EMIR Refit regime for the clearing obligation<sup>[14]</sup> states, it is necessary to begin to collect all the necessary data and information for the calculations so as to be ready to perform the calculations on the Effective Date. For the initial calculations, the relevant month-ends will be June 2018 to May 2019.

NFCs will no longer be required to perform the clearing threshold calculation on a spot basis for the purposes of notification to ESMA and the relevant NCA, and additionally on a 30 working day rolling average position calculation basis for the purposes of the clearing obligation. This is to be welcomed. The new annual nature of the calculation will also mitigate problems faced by those counterparties that hovered on or around a clearing threshold whereby their NFC+ / NFC- status could vary from month to month (or even from day to day).

That an NFC is no longer compelled to perform the NFC Clearing Threshold Calculation is a mixed blessing. Those NFCs that were confident that they would be an NFC+ will no longer need to expend resources to confirm what they already knew. However, many counterparties will have classified themselves as an NFC- without having performed the appropriate calculation, on the basis of being sure that they fall under the clearing thresholds. To take the same approach now (i.e. to *not* perform the NFC Clearing Threshold Calculation) will automatically result in an NFC being an NFC+ for all asset classes (with the resultant notification obligations, as described above, and enhanced risk mitigation requirements, as described below). It is therefore crucial that an NFC that believes it will be under a clearing threshold should perform the NFC Clearing Threshold Calculation in order to avoid being deemed an NFC+. The same is obviously true of an FC wishing to be classified as a Small FC: it must actually perform the FC Clearing Threshold Calculation.

The change to the 'breach one, breach all' approach for NFCs will result in a potentially complicated set of counterparty classifications: a counterparty may be an NFC- for some asset classes but an NFC+ for others. Indeed, it remains to be seen whether dealer counterparties will be able to accommodate a different classification per asset class or whether they will simply treat an NFC+ in one asset class as an NFC+ in relation to all asset classes. Many on the buy side may in any event 'opt-up' to NFC+ in all asset classes for convenience and simplicity, as well as to ensure operational conformity.

Given that the clearing obligation under EMIR and the trading obligation under MiFIR are interlinked, EMIR 2.1 requires the EC to prepare and submit a report to the European Parliament on the necessity and appropriateness of aligning the two obligations; in particular, the scope of entities that are subject to the clearing obligation.

#### 4. Risk Mitigation Techniques: Exchange of Collateral

Article 11(3) of EMIR requires that NFC+s and FCs shall have risk management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to certain OTC derivative contracts ("Collateral Risk Management Procedures"). Regulatory technical standards<sup>[15]</sup> are in place dealing with the mandatory collection of variation margin (since 1 February 2017 for the buy side) and also for initial margin (subject to an ongoing phase-in process, with the most relevant category, 'Phase 5', having a start date of 1 September 2020 for in-scope counterparties belonging to groups, each of which has an aggregate average gross notional amount of non-centrally cleared derivatives recorded on the last business day of March, April and May 2020 that is above Euro 8 billion).

A new provision in EMIR 2.1 requires the relevant NCA to validate the Collateral Risk Management Procedures on an initial and on-going basis, with regulatory technical standards required to be developed in this regard within 12 months of the Effective Date.

Once an NFC becomes an NFC+ for any asset class, it will be subject to the risk mitigation requirements regarding the segregation and exchange of collateral in respect of all classes of non-cleared OTC derivatives. Both Large FCs and Small FCs are also still subject to this obligation in respect of all their non-cleared OTC derivatives trades.

#### **AB Trading Advisors View and Comment**

Any NFC- (or 'hypothetical' NFC- facing an in-scope counterparty) that has not put in place EMIR compliant margining documentation but

that will now be classified as an (actual or hypothetical) FC or NFC+, can expect to be required to rectify this before the Effective Date either because it is now directly subject to the exchange of margin rules (as an 'actual' FC or NFC+) or to assist in-scope counterparties in their own EMIR compliance (where it is a 'hypothetical' FC or 'hypothetical' NFC+). In our experience, such entities with non-compliant documentation should comprise a very small sub-set, as most dealers have rolled out variation margin compliant documentation across their client bases generally.

The recitals to EMIR 2.1 state that the mandatory exchange of variation margin on physically settled foreign exchange (FX) forwards and physically settled FX swaps should apply only to transactions between the most systemic counterparties (although not specifically named, we assume these to be credit institutions and investment firms), in order to "limit the build-up of systemic risk and to avoid international regulatory divergence". In terms of scope, this suggests a possible future exemption for physically settled FX swaps, in addition to the current proposal<sup>[16]</sup> to exempt physically settled FX forwards where one party is not an 'institution'. However, there are no operative provisions in EMIR 2.1 addressing this, in which case the industry must continue to rely on the existing regulatory forbearance in this regard (which applies to physically settled FX forwards only).

The supervision of Collateral Risk Management Procedures by an NCA signals a new level of involvement by the NCAs and will mean that some counterparties will be subject to the oversight of a regulatory authority that previously had no such power. The detail of the regulatory technical standards will be crucial, and concerns here will focus on whether the timeframe for such validation will hinder or delay new investment vehicles / products being launched. The recitals to EMIR 2.1 suggest that the validation of such Collateral Risk Management Procedures may be limited to those involving the use of internal models.

## 5. Risk Mitigation Techniques: Other

Counterparties that undergo a change in their EMIR classification may find that new or more stringent risk mitigation techniques (including portfolio reconciliation, dispute resolution, portfolio compression, valuation and timely confirmations) may apply to them.

### **AB Trading Advisors View and Comment**

In order to be able to see, at a glance, how an entity's requirements under the EMIR risk mitigation techniques and other obligations may change as a result of reclassification, please refer to the Appendix.

## 6. Reporting

### Backloading

Noting in the recitals to EMIR 2.1 that the requirement to report historic contracts "has resulted in a high reporting failure rate and the poor quality of reported data, while the burden of reporting those contracts remains significant" and that there is "a high likelihood that those historic data will remain unused", the mandatory reporting of legacy trades ("backloading") is removed such that it is no longer necessary to report in relation to derivative transactions that were entered into after 16 August 2012 but terminated before 12 February 2014.

### Exchange-Traded Derivatives ("ETDs")

Despite it being proposed in the May 2017 Proposal that CCPs be responsible for reporting ETDs on behalf of both counterparties, this has not found support in EMIR 2.1. However, the EC is required to prepare a report assessing whether reporting of ETDs could be reduced or simplified for all counterparties without undue loss of information (see also Section 11 "Future Developments" below).

Mandatory reporting of ETD contracts in an intra-group context has been removed where certain criteria are met (see "Intra-Group

Transactions" below).

#### Limited One-Sided Reporting Involving an NFC-

The changes to the reporting regime noted in this sub-section will take effect 12 months after the Effective Date.

FCs will be solely responsible and legally liable for reporting on behalf of both counterparties the details of OTC derivative contracts concluded with an NFC-, as well as for ensuring the correctness of the details reported. However, an NFC- will be required to provide the FC with details of such OTC derivative contracts which the FC cannot be reasonably expected to possess; and the NFC- will be responsible for ensuring that such provided details are correct.

However, it is recognised that many NFC-s will already have the operational infrastructure to report to a trade repository and may decide to continue to do so. In that case, such an NFC- must inform the FC in advance of its decision to continue to report such trades and the NFC- will then be responsible and legally liable for reporting and for ensuring the correctness of the details reported.

However, where an NFC- concludes an OTC derivative transaction with a 'hypothetical' FC, then the NFC- will not be required to report and will not be legally liable for reporting or ensuring the correctness of the details of such OTC derivative contract if: (i) the local regime for reporting applicable to such 'hypothetical' FC has been declared 'equivalent'; and (ii) the 'hypothetical' FC has reported such information under its local reporting regime to a trade repository and that trade repository is subject to a legally binding and enforceable obligation to grant certain entities<sup>[17]</sup> direct and immediate access to the data. Limb (i) above means that this exception cannot yet be relied upon since there are currently no such equivalence decisions in this regard. It is hoped that such equivalence decisions will be forthcoming in the coming year, so as to make this a useable exemption for an NFC-.

Given the numerous scenarios when an NFC- is still required to report (and the limitations of the limited one-sided reporting described above), it is likely that an NFC- will continue to retain its existing OTC derivative contract reporting arrangements.

#### AIFs and UCITS

With effect from 12 months after the Effective Date, the responsibility and legal liability for reporting the details of OTC derivative contracts and the correctness of the reported details in the case of an AIF or a UCITS shall be the responsibility and legal liability of the AIFM or the UCITS management company (as the case may be).

#### Intra-Group Transactions

The reporting obligation will also be disapplied for intra-group derivative contracts (i.e. both ETD and OTC derivative contracts) where at least one counterparty is an NFC or a 'hypothetical' NFC, the parent undertaking is not an FC and certain criteria concerning consolidation and centralised risk evaluation, measurement and control procedures are met (and the relevant NCA is notified).

#### Access to Information at a Trade Repository

EMIR 2.1 includes an express provision requiring trade repositories to give to counterparties, upon request, access to information reported on their behalf. This applies to counterparties who: (i) are not required to report the details of their OTC derivative contracts; or (ii) have delegated their reporting obligation.

#### **AB Trading Advisors View and Comment**

Single sided reporting (or the lack thereof) continues to be a hot topic for the industry – with recent data from ESMA disclosing a complete matching rate at trade repositories of 40 per cent<sup>[18]</sup> under the current dual reporting regime. Given that the REFIT focussed on ways to



ease the burden on smaller counterparties, this limited relief is disappointing given the many circumstances in which an NFC- must report and must therefore retain its infrastructure and legal documentation.

Shifting the responsibility for reporting from the AIF or UCITS onto the AIFM or management company should have little practical effect (beyond allocation of liability and potential re-papering). EMIR reporting delegation agreements with counterparties should be checked to see if changes are necessary to ensure compliance.

An open question will be: what are the details that an FC cannot be reasonably expected to possess and therefore must be provided by the NFC-? It may be that yet more documentation will be required (perhaps in the simple format of a list of 'static' type questions to respond to) or that dealers will be able to rely on existing provisions within their existing EMIR delegated reporting agreements to require the information.

There is recognition in EMIR 2.1 that there are a number of regulatory reporting regimes<sup>[19]</sup> that market participants must comply with and that, when developing implementing technical standards in respect of the EMIR reporting obligation, the standards across these regimes should, wherever possible, be consistent.

## 7. Clearing Member Services

Clearing members which provide direct clearing services, and their clients which provide indirect clearing services, must do so under fair, reasonable, non-discriminatory and transparent ("FRANDT") commercial terms. In addition, they must take all reasonable measures to identify, prevent, manage and monitor conflicts of interest that may adversely affect the FRANDT provision of clearing services. However, EMIR 2.1 makes clear that FRANDT should not prevent clearing members (and their clients in where they offer indirect clearing services) from controlling risks associated with the clearing services, nor should it impose an absolute obligation to provide clearing services. There are, therefore, limits on how far FRANDT can go.

Regulatory technical standards will be developed to specify the conditions under which commercial terms will be considered to comply with the FRANDT criteria.

The FRANDT obligation will apply 24 months after the Effective Date.

### **AB Trading Advisors View and Comment**

Some buy side participants have faced challenges in establishing and maintaining a relationship with a clearing member for central clearing. The FRANDT provisions are designed to ensure that smaller market participants with limited clearing volumes may still have access to a clearing member, and the provisions are to be supported with this aim in mind. However, the devil is in the interpretation of what will constitute "fair, reasonable, non-discriminatory and transparent", so the ensuing regulatory technical standards will be scrutinised in this regard. CCPs and clearing members will be keen to ensure that they are not otherwise prevented from operating in a commercial and appropriately risk-controlled manner. The FRANDT provisions will also need to be read alongside (and with an eye on ensuring that there is no conflict with) the requirements of Article 25 of MiFID II RTS 6<sup>[20]</sup> relating to the due diligence assessment of prospective clearing clients to be made by a clearing firm.

## 8. Clearing Obligation: Suspension

EMIR 2.1 introduces the ability of the EC (following a request by ESMA, which itself may receive a request from an NCA – neither type of request will be made public) to suspend the clearing obligation for specific classes of OTC derivative or for a specific type of counterparty

where one of the following conditions is met: (i) the specific classes of OTC derivatives are no longer suitable for central clearing in accordance with the criteria in EMIR; (ii) a CCP is likely to cease clearing those specific classes and no other CCP is able to clear them without interruption; or (iii) it is necessary to address or avoid a serious threat to financial stability or to the orderly functioning of financial markets in the EU and that suspension is proportionate to those aims.

If (but only if) a determination is made by the EC to suspend the clearing obligation, then such determination will be published in the *Official Journal*, on the EC's website and in the relevant public register. Initially, the suspension period can subsist for no more than three months from the date of suspension; but if the qualifying conditions for suspension continue to exist after that initial suspension (and ESMA must issue an opinion to the EC on the matter), the EC may extend the suspension for one or more periods of up to three months each – up to a maximum suspension period of 12 months.

To avoid what would otherwise be an obvious disjoint with the trading obligation pursuant to MiFIR, the MiFIR trading obligation may also be suspended at the same time (and for the same duration) as the relevant clearing obligation.

### **AB Trading Advisors View and Comment**

There are a number of stages to the suspension process which may result in delays. Any delays would be undesirable if, as intended, a suspension is made in response to an urgent or exceptional need to suspend clearing. ESMA has up to 48 hours to determine whether an initial request from an NCA should be considered by the EC or not, and the EC must then determine whether or not to suspend the clearing obligation “without undue delay” following a request. Implementing acts are required to effect the suspension and for any further extension periods.

A suspension is envisaged only as a temporary measure. If a suspension is to be made permanent or is to exceed the maximum suspension period, then further legislation will be required.

## **9. Pension Funds**

Article 89 of EMIR stated that for an initial three year period the clearing obligation would not apply to most trades entered into by a pension scheme arrangement (“PSA”), seeing as an obligation to clear would likely require a PSA to divest a significant proportion of its assets for cash in order to meet ongoing margin requirements of CCPs, thus negatively impacting the PSA's primary purpose. The intention was to postpone the clearing requirement until an appropriate technical solution for the transfer of non-cash collateral as variation margin was developed by CCPs, to address the problem. This exemption has been renewed a number of times but there is currently no appropriate solution to the issue.

The current exemption expired on 16 August 2018 (being the expiry of the second extension to the exemption) and since then an in-scope PSA has needed to rely on ESMA's published ‘clearing and trading obligation for pension scheme arrangements’ communication<sup>[21]</sup> to get comfortable that a failure to clear (and, if applicable, failure to trade on a trading venue) will not be punished. The communication noted that ESMA expects NCAs to “not prioritise their supervisory actions towards entities that are expected to be exempted again in a relatively short period of time and to generally apply their risk-based supervisory powers in their day-to-day enforcement of applicable legislation in a proportionate manner” (given that neither ESMA nor any NCA has the formal power to extend the temporary exemption for a third time). This approach has been supported by NCAs, including the FCA and the Central Bank of Ireland.

EMIR 2.1 codifies that regulatory forbearance and also extends the exemption by a further two years, which exemption can be further extended twice, each time by one year, if the EC concludes that no viable technical solution has been developed and that the adverse

effects of centrally clearing derivative contracts on the retirement benefits of future pensioners remains unchanged. CCPs, clearing members and PSAs are required to apply their best efforts to contribute to the development of viable technical solutions that facilitate the clearing of OTC derivative contracts.

### **AB Trading Advisors View and Comment**

EMIR 2.1 requires that both the EC and ESMA must prepare reports assessing whether viable technical solutions have been found and, in particular, whether CCPs, clearing members and PSAs have “undertaken an appropriate effort” to reach viable technical solutions (see Section 11 “*Future Developments*” below). Additionally, the EC is required to establish an expert group to monitor their efforts, which shall meet at least every six months.

Of course, some PSAs will be Small FCs and will therefore be exempt from the clearing obligation.

## **10. Segregation and Portability at a CCP**

Currently, a CCP must keep separate records and accounts to enable it to distinguish in its accounts the assets and positions held for the account of one clearing member from those of another and from its own assets. Additionally, a CCP must offer: (i) omnibus client segregation (“OCS”)[22]; and (ii) individual client segregation (“ICS”)[23]. In circumstances where a clearing member is defaulting, the CCP is required to[24]: (i) attempt to effect the porting of positions and assets to another clearing member; (ii) if that cannot be achieved within a predefined period, the CCP may take the necessary steps to actively manage its risk in relation to those positions, including liquidating the assets and positions; and (iii) return balances directly to the client or to the clearing member (together, the “Default Procedure Steps”).

Given uncertainties over: (i) whether assets and positions held in OCS accounts and ICS accounts are insolvency remote; and (ii) when positions can be transferred and liquidation proceeds paid directly to a client, EMIR 2.1 has introduced a provision requiring that the national insolvency laws of Member States must not prevent a CCP from acting in accordance with these Default Procedure Steps. This requirement is subject to a six month phase-in period.

### **AB Trading Advisors View and Comment**

The recitals to EMIR 2.1 state that indirect clearing clients should also continue to benefit from equivalent protection provided for as set out above, although there is no substantive provision in EMIR 2.1 to that effect.

## **11. Future Developments**

EMIR 2.1 sets out a number of reports and reviews that must be conducted to assess the operation and fitness for purpose of the EMIR regime. Some of these assessments could be viewed as simply kicking the can down the road rather than taking the opportunity under the REFIT procedure to address issues now in a more substantial manner. The most relevant are:

- Within five years, the EC must assess the application of EMIR and prepare a general report.
- Within four years, ESMA will report to the EC on: (i) the clearing obligation, including the appropriateness of the clearing thresholds; (ii) the quality and accessibility of the data reported to trade repositories; (iii) the changes to the reporting framework, including the use of the limited one-sided delegated reporting arrangements and the burden on NFC-s; and (iv) the accessibility of clearing services and the effectiveness of the FRANDT requirement in facilitating access.
- As referred to in Section 9 “*Pension Funds*” above, within: (1) 12 months (and then every 12 months until the final extension of the

exemption), the EC will prepare a report assessing whether viable technical solutions have been developed for the transfer by PSAs of cash and non-cash collateral as variation margin and the need for any facilitating measures; and (2) six months (and then every 12 months until the final extension of the exemption), ESMA will report to the EC assessing, *inter alia*: (i) whether CCPs, clearing members and PSAs have undertaken an appropriate effort and have developed viable technical solutions facilitating the participation of such arrangements in central clearing by posting cash and non-cash variation margin; (ii) the consequences of PSAs fulfilling the clearing requirement on their investment strategies; and (iii) whether any final measures are necessary to facilitate a clearing solution for PSAs.

- Within 18 months, the EC must prepare a report assessing whether reporting of ETDs could be reduced or simplified for all counterparties, without undue loss of information and whether duplicative transaction reporting for ETDs arises under MiFR.

## Appendix

| Risk Mitigation Techniques for OTC derivative contracts not cleared by a CCP       | EMIR Classification                                      |  |                                     |                 |                   |                   |
|--|--|--|-------------------------------------|-----------------|-------------------|-------------------|
|  | FC   | NFC+   | NFC-                                | Hypothetical FC | Hypothetical NFC+ | Hypothetical NFC- |
| Appropriate procedures and arrangements[25]  | ✓  | ✓  | ✓                                   | X               | X                 | X                 |
| Timely Confirmation[26]  | T+1  | T+1  | T+2                                 | Δ               | Δ                 | Δ                 |
| Monthly reporting to the relevant NCA for outstanding unconfirmed transactions[27] | ✓  | X  | X                                   | X               | X                 | X                 |
| Portfolio Reconciliation[28]   | ≥500 = daily<br>≥51 and ≤499 = weekly<br>≤50 = quarterly | ≥500 = daily<br>≥51 and ≤499 = weekly<br>≤50 = quarterly | >100 = quarterly<br>≤100 = annually | Δ               | Δ                 | Δ                 |
| Portfolio Compression[29]  | ✓  | ✓  | ✓                                   | Δ               | Δ                 | Δ                 |

|  |    |    |   |  |  |   |
|--|----|----|---|--|--|---|
| Marking to Market[30]  | ✓  | ✓  | X | X  | X  | X |
| Holding of appropriate capital[31]   | ✓  | X  | X | X  | X  | X |
| Dispute Resolution[32]   | ✓  | ✓  | ✓ | Δ  | Δ  | Δ |
| Reporting certain disputes to the NCA[33]  | ✓  | X  | X | X  | X  | X |
| Appropriately segregated exchange of collateral and risk management procedures[34]   | ✓+ | ✓+ | X | Δ (but not the written risk management procedures) | Δ (but not the written risk management procedures) | X |
| Independent legal review of: (i) the enforceability of netting and collateral agreements and (ii) the segregation arrangement of initial margin (if subject to the initial margin rules) | ✓  | ✓  | X | X  | X  | X |

+ Note that from mid-2020, NCAs will have powers to ensure initial and on-going validation of collateral and segregation arrangements risk management procedures (see “Section 4: Risk Mitigation Techniques: Exchange of Collateral”, above).

Although not a risk mitigation technique, the following is also relevant in the context of new obligations following a reclassification:

|                             | FC | NFC+ | NFC- | Hypothetical FC | Hypothetical NFC+ | Hypothetical NFC- |
|-----------------------------|----|------|------|-----------------|-------------------|-------------------|
| Enhanced Data Reporting[35] | ✓  | ✓    | X    | X               | X                 | X                 |

**Legend:**

✓ : Direct Application.

X: Does Not Apply.

Δ: Indirect Application: a ‘hypothetical’ (or third country) entity will need to comply to enable its FC or NFC counterparty to meet its own obligations.

[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 at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0834&from=EN>

[2] Available at: <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>

[3] During opening remarks at an earlier plenary session of the European Parliament, Vladis Dombrovskis noted that: "... the estimated cost reductions are up to 6.9 billion Euro in fixed or one-off costs, and up to 2.6 billion Euro in annual operational costs". Speech available at: [https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/european-parliament-plenary-debate-revision-european-market-infrastructure-regulation-emir-refit\\_en](https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/european-parliament-plenary-debate-revision-european-market-infrastructure-regulation-emir-refit_en)

[4] i.e. an entity established in a third country that would be an FC if it were established in the EU. Sometimes called 'third country' FCs, for the purposes of this Briefs for the Buy side we use the term 'hypothetical' FC.

[5] Currently, the clearing thresholds are: (i) EUR 1 billion gross notional value for (x) OTC credit derivative contracts and (y) OTC equity derivative contracts; and (ii) EUR 3 billion gross notional value for (x) OTC interest rate derivative contracts, (y) OTC foreign exchange derivative contracts and (z) OTC commodity derivative contracts and other OTC derivative contracts not mentioned.

[6] Final draft available at: [http://www.europarl.europa.eu/doceo/document/A-8-2018-0190-AM-002-002\\_EN.pdf](http://www.europarl.europa.eu/doceo/document/A-8-2018-0190-AM-002-002_EN.pdf)

[7] See Article 85(1) of (original) EMIR.

[8] See *fn. 4* above.

[9] i.e. an entity established in a third country that would be an NFC if it were established in the EU.

[10] See also the April 2019 edition of Briefs for the Buy side, available at: <https://abderivs.com/client-news/april-2019-sftr-and-emir-refit-developments/>

[11] The current clearing thresholds are set out in *fn.5* above but it may be that in future different thresholds are set for FCs (see "*Clearing Thresholds*" below).

[12] See *fn. 5* above.

[13] See also the April 2019 edition of Briefs for the Buy side (*Op cit. fn. 10* above).

[14] Available at: [https://www.esma.europa.eu/sites/default/files/library/esma70-151-2181\\_public\\_statement\\_on\\_refit\\_implementation\\_of\\_co\\_regime\\_for\\_fcs\\_and\\_nfcs.pdf](https://www.esma.europa.eu/sites/default/files/library/esma70-151-2181_public_statement_on_refit_implementation_of_co_regime_for_fcs_and_nfcs.pdf)

[15] Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN>

[16] Available at: <https://www.eba.europa.eu/documents/10180/2065831/Joint+Draft+RTS+on+margin+requirements+for+non-centrally+cleared+OTC+derivatives+%28JC-2017-79%29.pdf>. See also the December 2017 and February 2018 editions of Briefs for the Buy side, available at: <https://abderivs.com/client-news/>

[17] Those listed in Article 81(3) of EMIR, as amended by EMIR 2.1.

[18] As reported by Risk.net, available at: <https://www.risk.net/regulation/6575661/data-reveals-emir-swaps-report-matching-rates-at-40>

[19] For example, those under The Securities Financing Transactions Regulation and MiFIR.

[20] Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0589&from=EN>

[21] Originally published on 3 July 2018 and updated on 8 August 2018. 8 August 2018 version available at: <https://www.esma.europa.eu>

[22] i.e. separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the accounts of its clients.

[23] i.e. separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients.

[24] The exact requirements differ depending on whether assets and positions are held in an account under an OCS arrangement or an ICS arrangement.

[25] Article 11(1) of EMIR. In order to show this, this is taken to mean appropriate *written* procedures and arrangements to measure, monitor and mitigate operational risk and counterparty credit risk.

[26] Article 11(1)(a) of EMIR and Article 12(1), (2) and (3) of Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 (the "Risk Mitigation RTS").

[27] Article 11(1)(a) of EMIR and Article 12(4) of the Risk Mitigation RTS. FCs must have the necessary procedure to report on a monthly basis to the relevant NCA the number of unconfirmed OTC derivative transactions that have been outstanding for more than five business days.

[28] Article 11(1)(b) of EMIR and Article 13 of the Risk Mitigation RTS. Frequency depends on the number of outstanding contracts with a counterparty as set out in the table.

[29] Article 11(1)(b) of EMIR and Article 14 of the Risk Mitigation RTS. FCs and NFCs with 500 or more OTC derivative contracts outstanding which are not centrally cleared shall have procedures in place to regularly, and at least twice a year, analyse the possibility to conduct a portfolio compression exercise. FCs and NFCs must be able to provide a reasonable and valid explanation to the relevant NCA for concluding that such exercise is not appropriate.

[30] Article 11(2) of EMIR and Articles 16 and 17 of the Risk Mitigation RTS. FCs and NFC+ must mark-to-market on a daily basis the value of outstanding contracts. Where market conditions prevent marking-to-market, reliable and prudent marking-to-model shall be used. Such mark-to-model must meet specific criteria and also must be approved by the board of directors at least annually and may be delegated to a committee.

[31] Article 11(4) of EMIR. FCs must hold an appropriate and proportionate amount of capital to manage the risk not covered by appropriate exchange of collateral.

[32] Article 11(1)(b) of EMIR and Article 15(1) of the Risk Mitigation RTS.

[33] Article 11(1)(b) of EMIR and Article 15(2) of the Risk Mitigation RTS. FCs must report to the relevant NCA any disputes between counterparties relating to an OTC derivative contract, its valuation or the exchange of collateral for an amount or value greater than Euro 15 million and outstanding for at least 15 business days.

[34] Article 11(3) of EMIR and Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 (the "Collateral RTS"). Mandatory collection of initial margin is phased-in until 1 September 2020. Certain exemptions / exceptions provided for under the Collateral RTS need to be reported to senior management to be relied upon.

[35] Article 3 of Commission Delegated Regulation (EU) No 148/2013 of 19 December 2012, as amended by Commission Delegated Regulation (EU) 2017/104 of 19 October 2016. FCs and NFC+s must report collateral, mark to market or mark to model valuations.