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SFTR and EMIR Refit Developments

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SFTR Reporting Obligation Start Dates

Background[1]

Article 4 of the Securities Financing Transactions Regulation[2] ("SFTR") requires that in-scope counterparties to securities financing transactions ("SFTs"; being (i) repurchase transactions, (ii) securities or commodities lending and securities or commodities borrowing, (iii) buy/sell-back transactions and (iv) margin lending transactions) must report the details of any SFTs concluded, modified or terminated to a registered or recognised trade repository on a next working day basis. The reporting obligation was to be phased in, as from the date of publication of the relevant regulatory technical standards relating to the reporting SFTR reporting obligation, becoming applicable to in-scope counterparties depending on which phase-in category they fall into.

On 22 March 2019, the various Commission Delegated Regulations[3] and Commission Implementing Regulation[4] relating to the SFTR reporting obligation were published in the Official Journal and will enter into force on 11 April 2019. The SFTR reporting obligation applies to: (i) "financial counterparties" (this includes those entities captured in the first two phase-in periods, see below) and "non-financial counterparties" (those entities captured in the last phase-in period, see below) established in the EU; and (ii) third country equivalents, if the SFT is concluded in the course of operations of a branch of that entity in the EU.

Phase-in Reporting Start Dates

As a consequence, the reporting obligation will apply to the following counterparties from the following dates:

11 April 2020 (the phase-in date, being the start date following a 12 month phase-in period)

1. Investment firms authorised in accordance with MiFID;
2. Credit institutions authorised in accordance with Directive 2013/36/EU or Regulation (EU) No 1204/2013; and
3. Third country equivalents to entities listed in (i) and (ii) above.

11 October 2020 (the phase-in date, being the start date following a 18 month phase-in period)

1. Insurance or reinsurance undertakings;
2. UCITS authorised in accordance with the UCITS Directive;
3. Alternative investment funds ("AIFs") managed by an alternative investment fund manager ("AIFM") authorised or registered in accordance with the AIFMD[5];
4. Institutions for occupational retirement provisions; and
5. Third country equivalents to entities listed in (i), (ii), (iii) and (iv) above.

11 January 2021 (the phase-in date, being the start date following a 21 month phase-in period)

1. Undertakings established in the EU other than (broadly) those listed above; and
2. Third country equivalents to entities listed in (i) above.

How to Comply

As with the derivatives reporting regime, an in-scope counterparty may delegate the reporting of the details of its SFTs, but it will remain liable for compliance with its obligations. It is noteworthy that: (i) where a UCITS managed by a management company is the SFT counterparty, the management company is responsible for fulfilling the reporting obligation on behalf of the UCITS; and (ii) where an AIF is the SFT counterparty, its AIFM is responsible for fulfilling the reporting obligation on behalf of the AIF.

In-scope SFTs are those: (1) concluded before the relevant phase-in date but which remain outstanding on that date if (a) the remaining maturity of that SFT on that date exceeds 180 days or (b) that SFT has an open maturity and remains outstanding 180 days after that date (in which case presumably the SFT would be reported at the end of that 180 day period); and (2) concluded on or after the relevant phase-in date.

Exemption

Where a 'financial counterparty' enters into a SFT with a 'non-financial counterparty', then the financial counterparty will be responsible for reporting for both counterparties if the non-financial counterparty does not exceed, as of its balance sheet dates, at least two of the following three criteria: (1) balance sheet total of EUR 20,000,000; (2) net turnover of EUR 40,000,000; and (3) average number of employees during the financial year of 250.

Although this exemption is drafted to apply only to the conclusion of a SFT, we would assume that it applies equally to modification or termination of a SFT.

Brexit

In the event of a no-deal Brexit on 12 April 2019, the reporting obligation legislation will not have become effective by exit day. However, the current draft of the Financial Services (Implementation of Legislation) Bill lists the legislation relating to the SFTR reporting obligation and, as such, would provide HM Treasury with the ability to implement and make changes to it (for up to two years post Brexit).

EMIR 2.1: ESMA Guidance on the Implementation of the new EMIR REFIT Regime for the Clearing Obligation

Background

The proposed Regulation[6] ("EMIR 2.1") amending the European Markets Infrastructure Regulation[7] ("EMIR") is now in its final stages of negotiation and it is expected that it may be published in the Official Journal during May and may enter into force during either May or June (i.e., 20 days after its publication in the Official Journal).

The majority of the provisions of EMIR 2.1 are expected to take effect immediately upon its entering into force (the "Effective Date") with no phase-in period; meaning that counterparties may need to be ready to comply with certain obligations as early as the end of May.

With that in mind, and following a statement from the European Securities and Markets Authority ("ESMA") on 28 March 2019 on the implementation of the new EMIR Refit regime for the clearing obligation (the "ESMA Statement")[8], we wanted to briefly highlight two key issues arising out of the latest draft of EMIR 2.1 (which we do not expect to materially change between now and the publication date) which the buy side may wish to begin considering now[9]:

- Potential re-classification of their EMIR regulatory status, possible new resultant EMIR obligations and counterparty notification obligations; and
- Re-calculation of clearing threshold calculations using a new methodology and potential notification obligations to relevant regulatory authorities, each on the Effective Date.

1. Re-Classification of EMIR Status

The definition of "financial counterparty" ("FC") will be amended to include, inter alia, all AIFs established in the EU. The key consequence of this is that a non-EU AIF with a non-EU AIFM will now be a 'hypothetical' FC[10] rather than a 'hypothetical' non-financial counterparty[11] ("NFC") as is (in our view) currently the case. All EU AIFs will now be FCs.

What Action Should be Taken?

- It is necessary to consider whether an entity's EMIR classification status has changed. 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 counterparty classification will also need to be updated where necessary.
- Additionally, 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.

2. New Clearing Threshold Methodology and Notifications

FCs

In recognition that not all FCs are systemically important, FCs are to be sub-divided into two sub-categories in the same way that NFCs currently are: namely, (i) an FC exceeding any clearing threshold (a "Large FC"); and (ii) an FC that does not exceed any clearing threshold (a "Small FC")[12]. Only Large FCs will be subject to the mandatory clearing obligation for OTC derivative contracts. Therefore FCs will have a new calculation to undertake as well as, potentially, a notification obligation to ESMA and the relevant national competent authority ("NCA"). Small FCs will still be required to comply with the EMIR risk mitigation requirements (including exchange of collateral) in respect of all of their OTC derivative contracts.

NFCs

An NFC will be required to clear those OTC derivative contracts subject to the mandatory clearing obligations only in the asset classes in which the NFC breaches the clearing threshold; it is no longer a 'breach one, breach all' provision. (In which case, the Calculation described and defined below should be performed for each separate asset class.) The recitals to EMIR 2.1 state that once a clearing threshold is breached (or deemed to be breached) for one asset class, the exchange of collateral risk mitigation requirements will apply to all classes of OTC derivative transactions.

Exceeding Clearing Threshold Calculations: New Methodology

In order to determine whether a clearing threshold has been breached, an FC or NFC may calculate (on a group basis – although AIFMs managing more than one AIF can calculate positions at the AIF level provided certain criteria are met), every 12 months, its aggregate month-end average position for the previous 12 months (the "Calculation"). Whilst NFCs can continue to exclude OTC derivative contracts which are objectively measurable as reducing risk, FCs must include all OTC derivative contracts in their Calculation.

If an FC or an NFC does not perform the Calculation, it will be deemed to have exceeded the clearing thresholds for all asset classes and will be subject to the mandatory clearing obligation for all asset classes.

What Action Should be Taken?

- In accordance with the ESMA Statement, all counterparties that chose to make the Calculation must determine the results of that Calculation on the Effective Date. Therefore, as the ESMA Statement indicates, it is necessary to begin collecting all the necessary data and information for the Calculation in the meantime, so as to be ready to perform the Calculation once EMIR 2.1 enters into force. By way of example, if the Effective Date occurs during June 2019, the relevant month-ends for the purpose of the Calculation will be June 2018 to May 2019.
- On the Effective Date, it will be necessary for actual FCs and NFCs to notify ESMA and the relevant NCA where it (i) is exceeding the clearing threshold(s) or (ii) chose not to perform the Calculation. There is still some uncertainty as to whether: (1) a Small FC (that has performed the Calculation) or (2) an NFC that (a) is currently below all clearing thresholds under the current version of EMIR, (b) has chosen to perform the Calculation and (c) does not exceed a clearing threshold pursuant to the Calculation, is required to make a notification notifying ESMA and the NCA that it has not exceeded a clearing threshold. We hope that this will be clarified in advance of the Effective Date, but this should not entail a significant further burden in any event.
- An NFC that had previously notified ESMA and the relevant NCA that it had exceeded a clearing threshold (under the previous 30 day rolling average position calculation) and which is now below one or more clearing threshold(s) pursuant to the Calculation will also need to notify and demonstrate the same to the NCA. (In the absence of any guidance on what would constitute sufficient demonstration, we would assume a simple notification would suffice rather than details of the Calculation.)
- As outlined in "Re-Classification of EMIR Status" above, trading counterparties will need to be informed whether an FC is a Large FC or a Small FC, and NFCs will need to confirm whether their status in terms of exceeding or not exceeding a clearing threshold status has changed. Indeed, counterparty classification status for NFCs may become complicated, it being possible that an NFC may exceed the clearing threshold for some asset classes but not for others.

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[1] See also our July 2017 edition of Briefs for the Buy side (available at: https://abderivs.com/client-news/july-2017-the-securities-financing-transactions-regulation-sftr-revisited/).

[2] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R2365&from=EN).

[3] Being: (i) Commission Delegated Regulation (EU) 2019/356 of 13 December 2018 specifying the details of securities financing transactions to be reported to trade repositories (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0356&from=EN); and (ii) Commission Delegated Regulation (EU) 2019/358 of 13 December 2018 regarding the standards on the collection, verification, aggregation, comparison and publication of data on securities financing transactions to be reported

to trade repositories (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0358&from=EN).

[4] Being Commission Implementing Regulation (EU) 2019/353 of 13 December 2018 regarding the format and frequency of reports on the details of securities financing transactions to be reported to trade repositories (available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0363&from=EN).

[5] It is uncertain whether a non-EU AIF managed by an authorised AIFM would be in-scope for reporting. Indications from the FCA and ESMA are that it would not be.

[6] The latest version is available at: https://data.consilium.europa.eu/doc/document/ST-6913-2019-ADD-1/en/pdf, being the draft confirmed by the Committee of Permanent Representatives in the EU and published on 6 March 2019. EMIR 2.1 is also known as EMIR Refit.

[7] Available at: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ%3AL%3A2012%3A201%3A0001%3A0059%3AEN%3APDF

[8] 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

[9] Please note that we will be releasing an in depth edition of Briefs for the Buy side focusing on the key aspects of EMIR 2.1 once the text is finalised.

[10] 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.

[11] i.e., an entity established in a third country that would be an NFC if it were established in the EU. Sometimes called ‘third country’ NFCs, for the purposes of this Briefs for the Buy side we use the term ‘hypothetical’ NFC.

[12] Currently, the clearing thresholds are: (i) EUR 1 billion gross notional value for (x) OTC credit derivative contracts and (y) OYC 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.