EMIR Refit: Are you fit for the future?

The European Market Infrastructure Regulation[1] (**EMIR**) came into force on 16 August 2012 and was the European response to the G20 commitment to implement measures to increase transparency and reduce both counterparty credit risk and operational risk in the derivatives market. Because it is in the form of a regulation, EMIR is directly applicable in all EU member states and does not require any further national implementation. Over the past six and a half years, the provisions of EMIR have been coming into effect on a rolling basis; "Level 2" delegated regulations adopted by the European Commission (**EC**) have provided much of the substantive detail required. Although EMIR is not yet fully effective, the majority of the Level 2 legislation has now been passed into law and provides timeframes for the rest of the phasing in.

EMIR generally applies to all standardised over-the-counter (**OTC**) derivatives[2], including interest rate, credit, equity, commodity and certain foreign exchange transactions. In order to achieve its objectives, it imposes certain obligations upon central counterparties, trade repositories and the counterparties to OTC derivatives contracts, which are categorised as financial counterparties (**FCs**) or non-financial counterparties (**NFCs**). In this article, we will particularly focus on some new changes to EMIR that impact the categorisation of FCs and NFCs and their clearing and margining obligations.

EMIR Refit legislative journey

As with most European legislation, a review mechanism was built into EMIR[3]. Accordingly, three years after EMIR came into force, the EC launched a study to consider how the regulation was performing compared to its objectives, taking into account cost and burden to market participants. The EC published a report on 23 November 2016 and a legislative proposal, which took the form of a new regulation to modify EMIR, on 4 May 2017 (**EMIR Refit**)[4]. Many of the proposed changes were hotly debated and so it took nearly a further two years, until early February of this year, for the three main EU legislative bodies to reach political agreement. The result was the publication of a revised compromise text of the proposed regulation on 1 March 2019. Since then the European Parliament and the European Council formally adopted EMIR Refit and the agreed legislation was published in the Official Journal on 28 May 2019 and entry into force will be on 17 June 2019.

What does EMIR Refit do?

EMIR Refit effects a broad range of changes, which include:

- Expanding the definition of FC to include additional market participants;
- Creating a new sub-categorisation of "small FCs";
- Introducing a new EC power to suspend the clearing obligation in respect of an asset class or counterparty type in certain circumstances;
- Modifying rules for NFCs in relation to (a) monitoring of notional amounts and (b) the type of trades that need to be cleared once clearing thresholds are exceeded;
- Removing the front-loading obligation, i.e. the requirement to clear contracts entered into before the clearing obligation takes effect;
- Establishing rules for clearing members to provide their clearing services on fair, reasonable and non-discriminatory terms (**FRAND**);
- Revising responsibility for reporting (e.g. FCs will need to report for NFC-s), narrowing the reporting requirements (e.g. certain intragroup exemptions now apply to reporting as well as clearing and margining) and removing the "backloading" obligation for historical trades to be reported;
- Extending the exemption for pension funds by two years (until 18 June 2021), with the possibility to extend twice more for a year each time;

1 Regulation (EU) No. 648/2012 of the European Parliament and of the European Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

2 For the purposes of clearing and margining under EMIR, an "OTC derivative" is a derivative contract that is not executed on a regulated market, with each term taking the meaning as defined in the Markets in Financial Instruments Directive.

3 Article 85(1) of EMIR requires the EC to review and prepare a general report on EMIR and to submit the report to the European Parliament and the European Council, together with any appropriate proposals.

4 "EMIR Refit" derives from the EC's 2016 Regulatory Fitness and Performance programme (**REFIT**).

- Bridging the gap for pension funds between 16 August 2018, when their original exemption lapsed, and entry into force of EMIR Refit, in order to confirm that no breach will be considered to have occurred;
- Clarifying rules on exchange of margin in relation to physically settled FX swaps and forwards; and
- Increasing the upper limits for the fines that can be imposed in relation to an EMIR infringement.

When do the obligations under EMIR Refit apply?

The key obligations discussed above generally apply from the date EMIR Refit enters into force. Two exceptions to this are the requirement for FCs to report on behalf of NFC-s, which applies one year later, and the FRAND requirements, which apply two years later[5].

Expansion of the definition of Financial Counterparty

Under the original EMIR rules, an FC was, in summary, established and regulated in the EU and one of the following:

a) an investment firm (MiFID[6] definition);

b) a credit institution;

c) an insurance, assurance or reinsurance undertaking;

d) undertakings for collective investments in transferable securities (**UCITS**) fund;

e) a pension scheme; or

f) an alternative investment fund (**AIF**) (which would capture both an EU AIF and a non-EU AIF) that was managed by an alternative investment fund manager (**AIFM**), which is authorised or registered in accordance with the EU Alternative Investment Fund Managers Directive.

EMIR Refit expands the definition to include the following entities:

g) investment firms falling within the MiFID II[7] definition (which was expanded from that for MiFID);

h) all EU AIFs (this expands category (f) above such that it is no longer relevant where the AIFMs are based) and, where relevant, AIFMs established in the EU[8]; and

i) central securities depositories (i.e. entities that offer infrastructure for the settlement of securities transactions, for example, Euroclear and Clearstream).

An NFC is defined by reference to what is not covered, i.e. any entity established in the EU that is not an FC.

New sub-categorisation of Financial Counterparties

Under the EMIR rules, NFCs are further broken down into two sub-categories, i.e. "NFC+" and "NFC-", and different rules apply to each. An NFC is considered an "**NFC+**" if the aggregate notional amount of outstanding derivatives entered into by it, together with those of all other NFCs within its group on a worldwide basis, exceeds one of the specified clearing thresholds. If no threshold is met, the NFC will be an "**NFC-**" and the obligations applicable to it are lighter.

5 There is a further exception in relation to a new requirement for central counterparties to provide a simulation tool in relation to the calculation of margin.

6 For these purposes, MiFID means Directive 2004/39/EC.

7 For these purposes, MiFID II means Directive 2014/65/EU.

8 This is also relevant to non-EU AIFs because the change will impact the equivalent categorisation of non-EU AIFs that are not directly caught by EMIR.

The current clearing thresholds are as follows[9]:

Transaction type	Clearing threshold (in gross notional value)
Credit derivatives	EUR 1 billion
Equity derivatives	EUR 1 billion
Interest rate derivatives	EUR 3 billion
Foreign exchange derivatives	EUR 3 billion
Commodity and any other OTC derivative not described above	EUR 3 billion

EMIR Refit introduces a similar sub-categorisation for FCs that is based on the same clearing thresholds[10]. The rationale behind this is that certain FCs have a volume of activity in the OTC derivatives markets that is too low to pose an important systemic risk for the financial system and for central clearing to be economically viable. Given the operational burden clearing imposes, these "small" FCs should be exempted from the clearing obligation.

Changes to the way clearing thresholds are calculated and applied for Financial Counterparties

Under the new rules, on an annual basis, an FC will need to calculate its aggregate month-end average position of all OTC derivatives contracts that are entered into by it or other entities within its group for the previous 12 months. If the result of its calculation does not exceed an applicable clearing threshold, the entity is considered a small FC and will not be required to clear trades. As a result of the new rules, some FCs that currently clear their trades may be able to demonstrate that they fall below relevant thresholds and no longer need to clear (although they remain subject to the requirement to exchange collateral to mitigate any systemic risk). FCs that exceed an applicable threshold remain subject to the obligation to clear derivative trades and this continues to apply across all relevant asset classes. They are also required to notify the European Securities and Markets Authority and their relevant competent authorities of their status. Where a small FC subsequently exceeds an applicable clearing threshold, for these purposes,

9 Article 11 of Commission Delegated Regulation No 149/2013

10 Although the rules for FCs and NFCs are similar, it should be noted that there are some differences, for example, FCs will not be able to disregard hedging transactions in their calculations.

an "**FC+**", the clearing obligation kicks in within four months of such FC becoming classed as an FC+[11] and applies to all asset classes capable of being cleared. They must also provide the notifications mentioned above. In summary, the change means that OTC derivatives contracts need to be cleared when entered into between any two entities where each is required to clear that particular asset class of derivatives (e.g. two FC+s, an FC+ and an NFC+ or between two NFC+s). In addition, such entities would be required to clear if they enter into an OTC derivatives contract with any third country counterparty that would be categorised as an FC+ or NFC+ if it were established in the EU.

It is also worth noting that the effective date of the obligation to clear depends on the nature of the counterparty. The relevant regulatory technical standards (**RTS**) defined four categories of entities with staggered phase-in dates as below. The first two phases and some of phase four have already rolled out fully.

The original applicable phase-in dates for Category 3 firms were postponed until 21 June 2019[12]. This was done in response to the difficulties being faced by smaller FCs with a limited volume of activity in establishing the necessary clearing arrangements to meet their compliance deadline, and in consideration of the limited impact in terms of systemic risk that these counterparties represent. There was a concern that EMIR Refit would enter into force after 21 June 2019 and and Category 3 firms would need to put the necessary clearing arrangements in place, possibly just for a very short period of time (which would have been costly and burdensome). This issue has fallen away because EMIR Refit will enter into force on 17 June 2019 so just before the exemption Category 3 firms has lapsed.

Category	Entities covered	RTS with respect to interest rate swaps in G4 currencies	RTS with respect to interest rate swaps in non-G4 currencies	RTS with respect to credit default swaps
1	Clearing members of authorised or registered CCPs	21 June 2016	9 February 2017	9 February 2017
2	Entities, not falling in Category 1 that belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for January, February and March 2016 is above EUR 8 billion, and which are either (i) FCs or (ii) AIFs that are NFCs	21 December 2016	9 July 2017	9 August 2017
3	Entities, not falling in Category 1 or 2, that are either (i) FCs or (ii) AIFs that are NFCs	21 June 2019	21 June 2019	21 June 2019
4	NFC+s, not falling in Category 1, Category 2 or Category 3	21 December 2018	9 July 2019	9 May 2019

11 An entity could become an FC following EMIR Refit coming into effect because it falls within the expanded definition of FC.

12 Commission Delegated Regulation No 2017/751

Changes to the way clearing thresholds are calculated and applied for NFCs

The clearing obligation applicable to NFCs has been narrowed. NFCs will now only be required to clear trades that fall within a class of OTC derivatives for which they have exceeded the clearing threshold. In other words, if an NFC exceeds the threshold for interest rate swaps, it will only need to clear that asset class, whereas previously it had to clear all relevant trades. NFCs will still remain subject to the requirement to exchange collateral for all OTC derivatives trades where any one of the clearing thresholds is exceeded.

As mentioned above, NFCs are divided into two categories based on the aggregate notional amount of their trades, calculated in accordance with the method prescribed by EMIR. NFCs that do not take action to calculate their positions against the clearing thresholds will automatically be subject to the clearing obligation for all relevant classes of OTC derivatives regardless of whether they are actually an NFC+ or not. It remains open, at any time, to an NFC adopting this approach, however, to demonstrate that its positions no longer exceed the clearing threshold for a class of OTC derivatives, in which case it will no longer need to comply with the clearing obligation for that class.

Currently, NFCs are required to calculate their average outstanding notional amount by class over a rolling period of 30 working days, which requires constant monitoring of their positions. EMIR Refit changes this methodology in such a way that NFCs will be able to monitor the notional amounts on an annual basis. Introduction of this longer timeframe aims to ease the operational burden on NFCs.

Main impact of these changes

The primary goal of the drafters of EMIR Refit was to simplify requirements and reduce any disproportionate costs and burdens. Although this may be achieved in the longer term, the changes will require counterparties, in the short term, to consider if they need to implement new or revised procedures and systems for calculations of clearing thresholds, clearing, margining and reporting. In other words, there may be an up-front cost to assess and implement a change to the new regime. In addition, because most requirements under EMIR Refit enter into force immediately, with no grandfathering, there is likely to be a heavier operational burden than expected because of the tight time pressure. In particular:

- both FCs and NFCs will need to reconsider their categorisation and inform their respective counterparties once EMIR Refit has entered into force;
- large banks may need to proactively contact their counterparties to ensure those counterparties are being correctly categorised;
- entities that are near the clearing thresholds may wish to consider if some or all of their trades no longer need to be cleared; and
- FCs, as well as NFCs, will be expected to calculate their aggregate month-end average position for the previous 12 months and so will need to be in a position to collate all the necessary data every 12 months.

For further information on any of the changes to EMIR mentioned or discussed in this article, feel free to be in contact with us.

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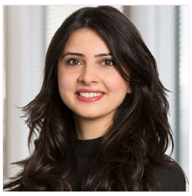

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