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Proposal for EMIR Reform – targeted changes with important consequences for AIFs, AIFMs and UCITS Management Companies

Background to EMIR Reform

On 4 May 2017, the European Commission (the "**Commission**") published its proposal to amend the European Market Infrastructure Regulation ("**EMIR**"). As readers will be aware, EMIR is the centrepiece of the legislation introduced in the aftermath of the financial crisis and was introduced with ambition of making financial markets safer and more stable. In particular, EMIR seeks to reduce risks to the financial system arising from the entering into of derivatives transactions. EMIR aims to achieve its stated objectives by increasing the transparency of the over-the-counter (OTC) derivatives market and also to mitigate counterparty credit risk and reduce the operational risk associated with OTC derivatives.

Article 85(1) of EMIR requires the Commission to review and, if appropriate, submit proposals to amend EMIR. In 2015, the Commission carried out an extensive assessment of the current rules under EMIR which resulted in the preparation of a report by the Commission specifically in relation to the EMIR reform[1] (the "**EMIR Report**") which was adopted in November, 2016. The EMIR Report concluded that no fundamental change should be made to the nature of the core requirements of EMIR on the basis that the existing requirements were integral to ensuring transparency and mitigating systemic risk in the derivatives market and for which there is general support from authorities and market participants. Conversely, the EMIR Report recognised the possibility of amending EMIR in some specific areas so as to eliminate disproportionate costs and burdens on certain derivatives counterparties and to simplify rules without

[1] Report from the Commission to the European Parliament and the Council under Article 85(1) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

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compromising the essence and objectives of EMIR itself. The Commission on 4 May, 2017 published its proposals with respect to the package of reforms proposed for EMIR (the "**EMIR Reforms**").

The EMIR Reforms take the form of amending regulations and remain in draft form pending conclusion of the public consultation which concluded on 3 July, 2017 and as a result the proposals are likely to be further amended prior to finalisation. However, in their present form they have the possibility of having considerable impact on market participants, including AIFs, AIFMs and UCITS Management Companies. Therefore, it is important that those market participants be aware of the proposed changes.

For the purpose of this client briefing, we focus on the impact on AIFs, AIFMs and UCITS Management Companies and does not discuss the impact on Securitisation Special Purpose Entities ("**SSPEs**").

Counterparty Classification

EMIR prescribes different types of counterparties, namely: (i) financial counterparties ("**FCs**"); (ii) non-financial counterparties ("**NFCs**"); or (iii) third country entities ("**TCEs**"). EMIR also provides for certain limited exemptions for certain categories of counterparties. The NFC classification is further divided into two sub-classifications, namely: (i) non-financial counterparties which are above the clearing threshold ("**NFC+s**"); and (ii) non-financial counterparties are below the clearing threshold ("**NFC-s**").

At present, an FC (as classified under EMIR) is, in accordance with the requirements of EMIR, required to *inter alia*:

(i) undertake the mandatory clearing of certain OTC derivatives contracts through authorised or recognised central counterparties ("**CCPs**") (the "**EMIR Clearing Obligation**");

(ii) meet risk mitigation (including margin) requirements for OTC derivatives contracts not centrally cleared (the "**EMIR Risk Mitigation Requirements**");

(iii) undertake mandatory reporting of all derivatives contracts to a registered or recognised trade repository (the "**EMIR Reporting Obligation**").

Regulatory obligations under EMIR apply differently to FCs and NFCs. It is important to note that NFC+s are, for the most part, subject to the same obligations and requirements as FCs while NFC-s are not (i.e. no EMIR Clearing Obligation and the EMIR Risk Mitigation Requirements relating to daily valuation and margin).

AIF Classifications

Currently, alternative investment funds ("**AIFs**") are categorised as FCs provided that they have an alternative investment fund manager ("**AIFM**") which is authorised or registered in accordance with Directive 2011/61/EU ("**AIFMD**"). AIFs which do not fall within the meaning of an FC are classified as either (i) NFCs (if the AIF is located within the EU) or (ii) deemed equivalent of NFCs (if the AIF is located outside of the EU). Under the existing rules set out in EMIR, a non-EU entity that is "*deemed equivalent*" to an NFC or an FC has no requirement to undertake compliance with the obligations set out in EMIR directly. However, if such entities are entering into transactions covered by EMIR with EU based counterparties, this may result in certain obligations and requirements being imposed on the relevant EU counterparty.

Under the EMIR Reforms proposed by the Commission, AIFs will no longer be capable of being classified as NFCs and all AIFs (regardless of jurisdiction) will instead be categorised as FCs, whether or not they (or their AIFM) are located within the EU. As a result, that will mean that AIFs located outside of the EU will be classified as FCs which, on the face of it, would trigger a variety of obligations arising from EMIR being applicable directly to those AIFs, even if they have no direct connection to the EU. The rationale for this proposal appears to be that certain entities which are currently capable of being classified as NFC should be classified as FCs due to the nature of their operations and their activities. The application of the requirements of EMIR to AIFs which have no connection to the EU is not in keeping with the usual approach taken by the Commission with respect to entities which have no nexus to the EU and, as a consequence, it is questionable as to whether this proposal will make it into the final version of the EMIR Reforms.

A more likely outcome in respect of AIFs is that the EMIR Reforms are adjusted to provide that AIFs which have no legal or contractual nexus to the EU (i.e. are established outside the EU and have a non-EU AIFM) could be classified as equivalent to FCs.

As a result of such a change in classification, AIFs (of all varieties) would be required to comply with the EMIR Risk Mitigation Requirements (including the variation margining) and the EMIR Clearing Obligations.

What do these changes mean for AIFs from a practical perspective?

EMIR Risk Mitigation Requirements and Variation Margin

Under the EMIR Reforms, AIFs would become subject to margining obligations which would require them to value their swap positions on a daily basis and provide mark-to-market margin (i.e. post variation margin). As a result, AIFs and their AIFMs will be required to ensure that the relevant AIF has sufficient free cash or liquid assets available for the purposes of posting such variation margin. The re-classification of AIFs as FCs will require AIFs and AIFMs to be aware of their obligations with respect to variation margin which may not have otherwise applied previously and, accordingly, it will be important for them to implement systems to be able to deal with such issues.

In addition, under the EMIR Reforms AIFs would be brought within the scope of other risk-mitigation obligations such as monthly reports of OTC derivatives unconfirmed for five (5) business days (and those involving large disputes), tighter timeframes for exchange of confirmations and frequent portfolio reconciliations (such as daily valuation and reconciliation requirements). These obligations of themselves are quite onerous from a practical perspective and would need to be borne in mind by the AIFs and their AIFMs.

EMIR Clearing Obligation

These changes to the classification of counterparties may have important implications for counterparties. The Commission noted in the EMIR Reforms document that smaller FCs were encountering difficulties in accessing clearing services providers. It is of the view that the proposed changes under the EMIR Proposals may perhaps provide relief to certain counterparties currently impacted. Although that may be the case in theory, the reality is that the changes proposed under the EMIR Reforms will pose plenty of issues for counterparties whose classification under EMIR may change to FC. Currently, smaller FCs (Category 3) are those financial counterparties which have OTC derivatives below the EUR 8 billion threshold and AIFs that are non-financial counterparties whose aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives for January, February and March 2016 is below EUR 8 billion.

Under the EMIR Reforms, AIFs will be subject to the clearing obligation unless they qualify under a new clearing threshold applicable to small financial counterparties (small FCs)[2] or is otherwise brought out of scope by other factors (see footnote below[3]). Under the EMIR Reforms, the threshold for small FCs is the same as that applicable to NFCs and this is set at the following levels:

(i) EUR 1 billion for each credit derivatives and equity derivatives; or

(ii) EUR 3 billion for each interest rate derivatives, currency derivatives and commodity and other derivatives.

If an AIF exceeds the clearing threshold for any class of derivatives, it will be subject to the clearing obligation for all asset classes and must start clearing within four (4) months of triggering the clearing threshold. The calculation of the threshold has been changed so that the threshold is breached only when an AIF goes above the threshold for the months of March, April <u>and</u> May of a given year.

It is important to note that FCs and NFCs must calculate the clearing thresholds on a group basis and for FCs the group test is calculated by reference to all other entities within the group to which the FC belongs. (Currently the clearing threshold for an NFC is breached when the rolling average of its notional position in OTC derivatives and those of other NFCs in its group exceed the above threshold).

[2] Small FCs are exempted from clearing requirements because typically they account only for very small volumes of OTC derivatives and of systemic risk.

[3] For example:

- the transaction is entered into with an entity which is not subject to the EMIR clearing obligation;
- note that the obligation to clear applies for trades going forward so once off transactions would fall out-of-scope

Hedging Exemption

Under current rules, NFCs are permitted to exclude OTC derivative contracts which are "*objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity*" from the clearing threshold calculations. This is generally known as the 'hedging exemption' and as AIFs are currently classified as NFCs, this means that they are able, at present, to avail of the hedging exemption for the purposes of calculating their clearing thresholds.

Under the EMIR Reforms as proposed, AIFs (of all types) will no longer be able to avail of the "hedging" exemption on the basis that AIFs will be classified as FCs and as a result AIFs will potentially exceed the clearing thresholds more easily. This may be of significant importance bearing in mind that many AIFs use OTC derivatives predominantly for hedging purposes.

Role of AIFMs and UCITS Management Companies in respect of reporting

In the proposals outlined in the EMIR Reforms document, the Commission notes that the current reporting obligations imposed by EMIR could be streamlined to improve the quality of the data reported and as a result make supervision more effective. In this regard the EMIR Reforms propose the following:

(i) the CCP in transactions that are not OTC derivatives (i.e. exchange traded) will be responsible, and legally liable, for reporting on behalf of both counterparties;

(ii) for transactions between an FC and a NFC not subject to the clearing obligation, the FC is responsible, and legally liable, for reporting on behalf of both counterparties to the transaction;

(iii) the management company of a UCITS that is a counterparty to an OTC derivative contract is responsible, and legally liable, for reporting on behalf of the relevant UCITS; and

(iv) the management company of an AIF that is a counterparty to an OTC derivative contract is responsible, and legally liable, for the reporting on behalf of the relevant AIF.

As is the case at present, for AIFMs and UCITS Management Companies, the EMIR Reforms do not prohibit delegation and accordingly it is possible for the reporting obligation to be delegated where appropriate but it must be noted that the AIFM or the UCITS Management Company would remain responsible, and legally liable, for any such reporting.

Additional changes under the EMIR Reforms

Some of the additional changes proposed under the EMIR Reforms which will be of interest are discussed briefly below.

Front loading

In addition to the foregoing matters, it will be of interest to counterparties currently classified as Category 1 or 2 FCs that the Commission is proposing the removal of the so called "front loading" requirements in respect of the EMIR Clearing Obligations and it is anticipated that this removal of effective retrospective clearing will be well received by FCs.

Backloading

The EMIR Reforms also propose the removal of the 'backloading' obligations. This will result in market participants no longer having to provide reporting of historic transactions that were not outstanding on the starting date of the reporting obligation under EMIR (i.e. 12 February, 2014). The removal of this requirement is designed to reduce costs and reporting burdens on counterparties, especially given that much of the historical data would have limited benefit. Once again, market participants will welcome the removal of this obligation.

Pension Scheme Arrangements

At present Pension Scheme Arrangements ("**PSAs**") are exempt from the EMIR Clearing Requirements until 16 August, 2016. This exemption arises from the fact that there is currently no viable technical solution for the transfer by pension schemes of non-cash collateral to CCPs to meet variation margin requirements. Pension schemes do not generally hold large amounts of cash and therefore their ability to cover variation margin is very limited. Hence, the EMIR Reforms propose the extension of the exemption applicable to PSAs for a further three (3) years in order to develop further proposals regarding this particular issue.

Provision of clearing services on fair, reasonable and non-discriminatory commercial terms

The EMIR Reforms propose requiring clearing members and their clients who provide clearing services to ensure that they do so under fair, reasonable and non-discriminatory commercial terms. The Commission is empowered through delegated acts to specify what are fair, reasonable and non-discriminatory terms and, accordingly, entities providing clearing services will need to be aware of any such proposals so as to ensure that they can comply with them.

In addition to the foregoing the EMIR Reforms propose to clarify that assets covering the positions recorded in an account are not part of the insolvency estate of the CCP or clearing member that keeps separate records and accounts. The EMIR Reforms document suggests that these new provisions offer certainty to clients and indirect clients that in the case of default of a clearing member or a client providing clearing services, the client's assets are protected and can, thus, be moved to other clearing members or clients that provide indirect clearing services, thus providing a

further incentive for central clearing. It is still unclear as to how this provision will interact with local insolvency requirements/laws.

Suspension of clearing obligation

Under the EMIR Reforms as proposed, the Commission will be afforded the power, in certain circumstances, to temporarily suspend any EMIR Clearing Obligations on the basis of a request of ESMA, with the procedure for the implementation of any such suspension being set out. This new power and authority is subject to tightly framed conditions and is capable of being suspended for a limited time only.

Next Steps

The Commission consultation closed on 3 July 2017. It will be interesting to see what the outcome of the consultation process will be. The EMIR Reforms may be problematic for certain types of market participants including those which may be re-classified as FCs (in particular SSPEs) but AIFs and their AIFMs will also need to be aware of the potential changes which may come into effect, particularly in relation to instances where certain exemptions were previously available. Unfortunately, it is not possible to anticipate at this stage what the outcome of the EMIR Reform consultation will be but all market participants should be aware of the proposals and their implications.

If you require any further information in relation to the EMIR Reforms or EMIR generally, please feel free to contact us and we will be happy to assist.

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