CLIENT ALERT

EMIR Refit: Implications for EU and Non-EU Asset Managers and Funds Trading in Derivatives

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Introduction and background

The EU implemented the European Market Infrastructure Regulation[1] ("**EMIR**") in 2012. The main objective of EMIR is to reduce systemic risk by increasing the transparency of the OTC derivatives market, by mitigating counterparty credit risk and by reducing operational risk associated with OTC derivatives. Core requirements include:

- central clearing of standardised OTC derivative contracts;
- margin requirements for non-cleared OTC derivatives;
- operational risk mitigation requirements for non-cleared OTC derivative contracts; and
- reporting obligations for derivative contracts.

Following a review of EMIR as part of the EU's Regulatory Fitness and Performance programme, the EU has agreed amendments to EMIR ("**EMIR Refit**") to reduce some of the burdens on non-financial counterparties ("**NFCs**") and small financial counterparties.

This briefing focuses on the key changes relevant to asset managers and funds, whether based in or outside the EU. It does not review the changes relevant to central counterparties or trade repositories.

[1] EU 648/2012.

Proposed changes

EMIR Refit[2] makes a number of changes to EMIR. Those most relevant to the buy-side and reviewed in this briefing relate to:

- the wider definition of a financial counterparty ("**FC**");
- imposing the reporting obligation on the manager rather than the fund; and
- exempting small financial counterparties from the clearing obligation.

Amendment to the definition of financial counterparty

The definition of an FC under EMIR includes EU authorised banks, investment firms, UCITs, insurance companies and alternative investment funds ("**AIFs**") managed by EU authorised alternative investment fund managers ("**AIFMs**").

An FC does not currently include either EU AIFs or Non-EU AIFs managed by a Non-EU authorised AIFM. Such funds are most commonly treated as an NFC or third country equivalent.

EMIR Refit amends the definition of FCs to include all EU AIFs whether or not their AIFM is based in the EU.[3]

This change has implications for Non-EU funds, as EMIR has the concept of a third country entity ("**TCE**") which is any entity not established in the EU. Indirect requirements apply to TCEs, and the exact nature of these depend on whether the TCE would be an FC or an NFC if it were established in the EU. As the definition of an FC has been expanded, a Non-EU AIF with a Non-EU AIFM will now be classified under EMIR Refit as a TCE FC rather than as a TCE NFC.

Implications of change in classification for an EU AIF with a Non-EU AIFM from NFC to FC

Reporting obligation

Currently, as an NFC, an EU AIF managed by a Non-EU AIFM is subject to the reporting obligation. Under EMIR Refit the manager of the AIF, rather than the AIF itself, will become solely responsible for and legally liable for reporting each OTC derivative trade. The manager will have 12 months to put the required procedures and arrangements in place to implement this change.

2 Regulation 2017/0090 was adopted by the EU council on 14 May 2019.
3 AIFs established for the purpose of an employee share purchase plan or a securitisation special purpose entity are excluded.

Requirement to exchange margin

EU AIFs which become FCs will be subject to the requirements to exchange variation margin and potentially initial margin.[4]

This contrasts with their position as an NFC where the margin requirements apply only to an NFC which exceeds the clearing obligation (“**NFC+**”).

Clearing obligation

An EU AIF which becomes an FC will become subject to the EU clearing obligation unless they do not exceed the clearing threshold (see below).

Risk mitigation requirements

An FC must put in place procedures to measure, monitor and mitigate operational and counterparty risk including timely confirmations, reconciliation and dispute management processes. An EU AIF may need to revisit its procedures accordingly.

Implications for Non-EU AIFs and their managers

Non-EU funds – of whatever type, e.g. hedge funds, PE funds, and mutual funds – will be indirectly affected by EMIR when they trade with EU banks and other EU FCs. EU FCs will treat such funds as TCE FCs and as such the EU FC will be required to apply margin requirements to OTC derivative trades and, if the fund’s trading activities exceed the clearing threshold (see below), the trades may become subject to the clearing obligation. This is likely to lead to amendments to any ISDA documentation including margin arrangements with such EU counterparts.

The new concept of a small financial counterparty (“**FC-**”)

Under EMIR the clearing obligation applies to all FCs and NFC+s. In its review of EMIR the EU has recognised that for small FCs the burden of becoming subject to the clearing obligation imposes a disproportionate cost. EMIR Refit exempts small FCs from the clearing obligation. EMIR Refit sets the same clearing thresholds as currently apply to NFCs (in determining whether they are an NFC+ or NFC-) to FCs. The clearing thresholds are EUR 1 billion in gross notional value for each of credit and equity OTC derivatives and EUR 3 billion in gross notional value for each of OTC interest rate derivatives, OTC FX derivatives, OTC commodity derivatives and other OTC derivatives.

4 Initial margin is required where a fund’s average aggregate notional amount (AANA) of OTC derivatives outstanding for the months March, April and May exceeds EUR 8 billion.

For an FC, e.g. a fund, to determine whether it is above the clearing threshold ("**FC+**") it must calculate its aggregate month-end position for the previous 12 months, in each asset class. Unlike the case for NFCs, hedging transactions should be included in the calculation. This calculation will first need to be carried out when EMIR Refit enters into force and annually thereafter. For those funds currently classified as NFC- or TCE NFC and converting to an FC or TCE FC, it is likely they will continue to remain below the clearing threshold and be an FC- or TCE FC-. Equally for those FCs including AIFs managed by EU AIFMs they may benefit from being an FC- if the level of their trading activity remains below the clearing threshold as the clearing obligation will not apply as it would have done under EMIR.

If the fund exceeds the clearing threshold for any one of the asset classes it will be treated as an FC+ or TCE FC+ (dependent upon location). Such funds will be subject to the clearing obligation, so any OTC trades which are subject to the EU clearing obligation must be cleared at an authorised central counterparty or EU trading venue. Practically there are only a limited number of OTC derivative contracts subject to the EU clearing obligation, being certain interest rate derivatives in G4 currencies and some credit default swaps.[5] Those funds which will be FC+ or TCE FC+ will have four months from EMIR Refit coming into force to put in place any necessary clearing arrangements.

What asset managers and funds should do

EMIR Refit will come into effect 20 days after its publication in the EU's official Journal, which is expected to be in June 2019.

Funds with existing ISDA master agreements in place with EU banks are likely to have made representations as to their status as an NFC+ or NFC-. Such funds will need to notify their EU counterparts as to their new classification under EMIR Refit as an FC+ or FC-, or third country equivalent, to avoid a breach of such representations. For funds which have not to date agreed to margin arrangements, they should expect their EU counterparties to require amendments to existing documentation to agree to margin provisions. Any fund that is an FC+ or TCE+ may need to put in place clearing arrangements.

In addition FCs which could include Managers of funds which are FCs must notify ESMA[6] of whether the FC is an FC+ or FC- or if they have not performed the clearing threshold calculation, in which case they will automatically be an FC+.

Asset managers newly subject to the reporting obligation may need to put in place relevant arrangements.

[5] https://www.esma.europa.eu/sites/default/files/library/public_register_for_the_clearing_obligation_under_emir.pdf

[6] European Securities and Markets Authority.

If you have any questions regarding this client alert, please contact the following attorney or the Willkie attorney with whom you regularly work.

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