+44 (0)20 3405 0201

contact@abderivs.com

EMIR REFIT: obligations for June 2020

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The Short Read

On 17 June 2020, the legislation known as EMIR REFIT (also known as EMIR 2.1[1]) will have been in force for one year[2]. EMIR REFIT made a number of material changes to the provisions of EMIR[3], with the intention of reducing the burdens on, and cost of compliance to, less systemically important market participants. Whilst the majority of EMIR REFIT's provisions were effective from the date it entered into force, certain provisions were subject to a one year phase in period. With that one year period expiring in June 2020, now is an appropriate time for market participants to consider those soon-to-be phased in obligations, as well as annual obligations imposed by EMIR REFIT.

This *Briefs for the Buy side* considers the following two impending requirements:

- Changes to the EMIR reporting requirements will be applicable from 18 June 2020. These changes include which party will be legally liable and responsible for making reports to a registered or recognised trade repository. In summary:
- with respect to a 'financial counterparty' ("FC") that is (i) an alternative investment fund[4] (an "AIF") managed by an alternative investment fund manager authorised or registered under AIFMD (an "AIFM") or (ii) a UCITS, responsibility and liability for the reporting of OTC derivative contracts under EMIR shifts from the AIF or the UCITS to the AIFM or the UCITS management company (as the case may be); and
- in the case of an FC trading with a 'non-financial counterparty' ("NFC") that has not exceeded any clearing thresholds[5], the FC will be solely responsible and liable under EMIR for the reporting of OTC derivative contracts between the parties.
- The annual determination as to whether a clearing threshold has been exceeded is to be performed on 17 June 2020.

The Full Read

1. **Clearing Threshold Calculation**

EMIR REFIT introduced two new sub-categories of FC, namely: (i) a Large FC and (ii) a Small FC. A Large FC is an FC which exceeds *any* clearing threshold and a Small FC is one that does not exceed *any* clearing threshold[6]. Only Large FCs will be subject to the mandatory clearing obligation for OTC derivative contracts. Small FCs will still need to comply with the EMIR risk mitigation techniques, including the exchange of collateral, in respect of their 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, at 12 month intervals the FC *may* calculate its aggregate month-end average position for the previous 12 months (a "Clearing Threshold Calculation"). The Clearing Threshold Calculation for FCs is undertaken on a 'group' basis, in which case the FC should include *all* OTC derivative contracts entered into both by the FC and by other entities within its group (whether FCs or NFCs, and whether cleared or uncleared). For UCITS and AIFs, calculations are made at the level of the fund or sub-fund (if legally segregated). In cases where a UCITS management company manages more than one UCITS, or an AIFM manages more than one AIF, the UCITS management company or the AIFM (as the case may be) will need to be able to demonstrate to the relevant National Competent Authority ("NCA")[7] 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.

The Clearing Threshold Calculation for FCs works on a 'breach one, breach all' basis. If an FC exceeds a clearing threshold in relation to (for example) the interest rate asset class, it will be deemed to be a Large FC and will therefore be required to clear all OTC derivative contracts pertaining to any and all asset classes which are subject to the clearing mandate, subject to a four month grace period after notification of its status (see "*Notifications to Authorities*", below).

Unlike NFCs, FCs are not allowed to exclude OTC derivative contracts which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the FC (or of its group) from the Clearing Threshold Calculation. (This is known as the 'hedging exemption'.)

Clearing Threshold Calculation for NFCs

In order to determine whether an NFC has exceeded a clearing threshold (in which case it will be an "NFC+") or has not exceeded a clearing threshold (in which case it will be an "NFC-"), at 12 month intervals the NFC *may* calculate its aggregate month-end average position for the previous 12 months (a "Clearing Threshold Calculation"). The Clearing Threshold Calculation for NFCs must be undertaken on a 'group' basis, in which case the NFC should include in the calculation all OTC derivative contracts entered into by that NFC and by other NFCs within its group. An NFC should exclude OTC derivative contracts which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the NFC or its group (i.e., the hedging exemption).

An NFC+ is obliged to clear only those OTC derivative contracts pertaining to the asset class for which the clearing threshold was exceeded, subject to a four month grace period after notification of its status (see "*Notifications to Authorities*", below). 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 for the purposes of the clearing obligation.

(However, an NFC which is classified as an NFC+ because it did not undertake the Clearing Threshold Calculation will be subject to the clearing obligation pertaining to all asset classes.)

When must the calculation be carried out?

The first point to note is that it is not mandatory to undertake a Clearing Threshold Calculation at all. If an FC chooses not to make a Clearing Threshold Calculation, it will be automatically categorised as a Large FC (and hence required to clear all OTC derivative contracts pertaining to any and all asset classes which are subject to the clearing mandate). If an NFC chooses not to make a Clearing Threshold Calculation, it will be automatically categorised as an NFC+ in relation to all asset classes (and hence also required to clear all OTC derivative contracts pertaining to any and all asset classes which are subject to the clearing mandate).

If a decision is taken to undertake a Clearing Threshold Calculation, EMIR REFIT specifies that this must be done on 17 June 2019 and annually thereafter – in which case, the next scheduled annual date on which to make the Clearing Threshold Calculation would be 17 June 2020 (the "Calculation Date").

Entities either (i) coming into existence after 17 June 2019 or (ii) which have taken positions in OTC derivative contracts only after 17 June 2019, and which therefore do not have a full 12 month period to aggregate, would (if they choose to make the Clearing Threshold Calculation) need to make the Clearing Threshold Calculation 12 months after the commencement of taking positions in OTC derivative contracts (a "Later Calculation Date").

Notifications to the Authorities

The required notifications to the European Securities and Markets Authority ("ESMA") and the relevant NCA will depend both on the results of the Clearing Threshold Calculation and whether a previous notification has been made.

Where a prior notification has been made

Where an FC has previously notified ESMA and the relevant NCA that a clearing threshold has been exceeded (or was deemed exceeded as a result of the FC not undertaking the Clearing Threshold Calculation), if the results of the new Clearing Threshold Calculation do not indicate a change in classification as of the Calculation Date (or if a new Clearing Threshold Calculation is not undertaken), then there is no need to notify ESMA and the relevant NCA.

Where an NFC has previously notified ESMA and the relevant NCA that a clearing threshold has been exceeded (or was deemed exceeded as a result of the NFC not undertaking the Clearing Threshold Calculation), if the results of the new Clearing Threshold Calculation do not indicate a change in classification as of the Calculation Date (or if a new Clearing Threshold Calculation is not undertaken), then there is no need to notify ESMA and the relevant NCA. However, ESMA and the relevant NCA should be notified if a clearing threshold in an additional asset class is exceeded or if a clearing threshold in a previously notified asset class is no longer exceeded.

Where a prior notification has not been made

Those FCs and NFCs: (i) exceeding one or more clearing thresholds for the first time; or (ii) that choose not to undertake a Clearing Threshold Calculation, must notify ESMA and the relevant NCA on the Calculation Date (or Later Calculation Date, if applicable) and, where relevant, indicate the period used for the calculation.

Trading counterparty representations

If an entity's status has changed (i.e., is it an FC or NFC, and is it above or below the clearing thresholds), it will be necessary to update any representations or other documentation provided to trading counterparties as to counterparty classification for EMIR purposes (whether provided in ISDA EMIR Classification Letters or other representation letters, the ISDA Master Agreement itself or via ISDA Amend).

Does the calculation always need to be performed annually?

If an entity is a Large FC or an NFC+ (either because it exceeded a clearing threshold or is deemed as such, because it did not undertake a Clearing Threshold Calculation), and is therefore subject to the clearing obligation, it may at any time demonstrate to the relevant NCA that its aggregate month-end average position for the previous 12 months does not exceed the clearing threshold (i.e., there is no requirement to wait until the anniversary of the Calculation Date or the Later Calculation Date to make the determination).

The date of the notification to ESMA and the relevant NCA would then become the annual date on which the calculation should be conducted in the future.

AB Trading Advisors' View and Comment

- For those entities making a calculation as of 17 June 2020, the relevant month-ends will be for the months running from June 2019 to May 2020.
- Market participants should note that, even if they believe that their actual or hypothetical[8] classification has not changed from last year, a Clearing Threshold Calculation must still be undertaken, otherwise the applicable entity will automatically be classified as an actual or hypothetical Large FC or NFC+ for all asset classes.
- We recommend retaining evidence of the calculations and determinations relating to a Clearing Threshold Calculation and the resultant classification of the entity as an actual or hypothetical Large FC, Small FC, NFC+ or NFC-. This may be necessary both for internal audit purposes and to be provided to the relevant NCA, if so required. In addition, the entity will also need to be able to demonstrate to the NCA (if requested to do so) that the calculation of the aggregate month-end average position for the previous 12 months does not lead to a systematic underestimation of its position.
- An entity should seek to take advantage of the ability to change from a Large FC or NFC+ (in one or more asset classes) to a Small FC or NFC- during the annual calculation period if it can demonstrate that the clearing threshold has not been exceeded. EMIR does not require the more stringent Large FC and NFC+ classifications to continue for a minimum 12 month period if the size of the entity's OTC derivatives portfolio does not warrant it. If an entity notifies ESMA and the relevant NCA of its classification on 17 June 2020 and, as a result, becomes subject to the clearing obligation, that obligation would begin four months following such notification (i.e., in this case, 18 October 2020). If, during that four month period, the entity demonstrates to the relevant NCA that it is below the clearing threshold and notifies ESMA and the relevant NCA accordingly, it will no longer be subject to the clearing obligation and will not be required to commence clearing at the end of the four month period.

2. **Reporting**

EMIR mandates the reporting of the details of derivative contracts (both OTC and exchange-traded) to a registered or recognised trade repository on a T+1 basis. The reporting is in respect of the entering into, modification or termination of the contract. Only 'actual' FCs and NFCs are in scope of this requirement ('hypothetical' FCs and NFCs are not required to report).

EMIR REFIT made several changes to the regulatory reporting regime. Two of the most significant changes coming into effect on 18 June 2020 are covered below.

- ***Mandatory Reporting involving an NFC-***

In respect of OTC derivative contracts concluded with an NFC- (in respect of all asset classes[9]), an FC will be solely responsible and legally liable for reporting the relevant details on behalf of both counterparties, as well as for ensuring the correctness of the details reported ("Mandatory Reporting"). 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, with the NFC- being responsible for ensuring that such provided details are correct. The details to be provided by an NFC- (and to be updated whenever relevant, so that they remain correct) relate to the reportable details characterising the NFC- itself and the details of the execution and clearing arrangements entered into by the NFC-[10]. In cases where the NFC- has not provided relevant details, the FC will be expected to submit the report without undue delay as soon as it receives the relevant details. The Mandatory Reporting provisions apply not only to new OTC derivative contracts concluded on or after 18 June 2020, but also to the modification and termination of OTC derivative contracts entered into before 18 June 2020 (whereby the modification or termination occurs on or after 18 June 2020). However, ESMA has stated that the FC and NFC- will be permitted to contractually agree that the responsibility and liability of the FC may be limited to new OTC derivative contracts concluded as from 18 June 2020[11].

Importantly, the NFC- will continue to be responsible and liable for reporting the details of derivative contracts other than OTC derivative contracts. (This will mean exchange-traded derivatives – but not necessarily *all* exchange-traded derivatives – see comments in the paragraph below.) In which case, parties will need to adopt two different approaches to reporting to cater for (i) Mandatory Reporting of OTC derivative contracts on the one hand and (ii) 'optional' delegation of reporting of other derivative contracts on the other.

It is important to note that an OTC derivative contract is one which is not executed on a 'regulated market' or on a third country market determined to be equivalent to a 'regulated market' under EMIR. Therefore, an exchange-traded derivative which is not traded on a 'regulated market' or on such a third country market will, in fact, be an 'OTC derivative' for the purposes of EMIR[12].

It has been 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, an NFC- deciding to continue to report must inform its FC counterparty in advance of its decision, whereupon the NFC- will then be responsible and legally liable for reporting and for ensuring the correctness of the details reported (and Mandatory Reporting will not apply).

In circumstances where an NFC- concludes an OTC derivative transaction with a 'hypothetical' FC, 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[13] direct and immediate access to the data. As there are currently no equivalence decisions as referred to in limb (i) above, this exception cannot yet be relied upon and therefore an NFC- facing a 'hypothetical' FC will continue to be responsible and legally liable for reporting all derivative contracts under the EMIR reporting regime.

- ***AIFs and UCITS***

In the case of an AIF or a UCITS, the responsibility and legal liability for reporting the details of OTC derivative contracts (but not other derivative contracts) and the correctness of the reported details shall be the responsibility and legal liability of the AIFM or the UCITS management company (as applicable). Therefore, any delegated reporting agreements in place will need to adequately distinguish between those derivative contracts for which the AIFM or UCITS management company is responsible for reporting (and therefore is the delegate) and those derivative contracts for which the AIF or UCITS is responsible for reporting.

The new Master Regulatory Reporting Agreement

In order to address the changes described above, ISDA (jointly with four other trade bodies[14]) has published the Master Regulatory Reporting Agreement[15] ("MRRA"). The MRRA is intended to address the new EMIR regulatory reporting requirements referred to above (as well as allowing parties to continue to 'optionally' elect to delegate reporting where Mandatory Reporting does not apply). The MRRA also covers market participants' regulatory reporting obligations in respect of securities financing transactions under the Securities Financing Transactions Regulation (known as 'SFTR'). Finally, it has been 'Brexit-proofed' in the sense that it will continue to operate in relation to both the European Union ("EU") and the United Kingdom ("UK") derivatives and securities financing transactions reporting regimes following the withdrawal of the UK from the EU.

AB Trading Advisors' View and Comment

- It will be necessary to update or supplement existing EMIR delegated reporting agreements to reflect the new reporting responsibilities, specifically the divergence between reporting responsibility for OTC derivative contracts and other derivative contracts. In addition, it will be necessary to add the AIFM or UCITS management company as a party to the EMIR delegated reporting agreement to reflect its obligations in a principal capacity. To the extent that dealers have not already communicated their intentions in this regard, they should be contacted to ensure that the appropriate contractual provisions are in place on time.

- Additionally, AIFMs and UCITS management companies may need to revisit terms in their portfolio / investment management agreements, to the extent that any terms relating to EMIR reporting no longer reflect the new reporting landscape.

- Market participants should also be aware that ESMA is currently consulting on updating the technical standards relating to EMIR regulatory reporting, with a view to revised technical standards being submitted to the European Commission for endorsement in Q4 2020[16]. Therefore, counterparties will need to review their regulatory reporting arrangements in due course to ensure compliance with the new standards.

The above material is provided in brief, summary form. It is provided for information purposes only and should not be taken to constitute legal advice. Professional legal advice should be obtained before taking or refraining from any action in relation to the contents of this email.

[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] For a comprehensive note on the EMIR REFIT, please see our May 2019 *Briefs for the Buy side*; available at: https://abderivs.com/client-news/may-2019-emir-refit-how-it-will-affect-you/

[3] Available at: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ%3AL%3A2012%3A201%3A0001%3A0059%3AEN%3APDF; and references in this *Briefs for the Buy side* to EMIR mean EMIR as amended by the EMIR REFIT.

[4] As defined in Directive 2011/61/EU of the European parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers ("AIFMD").

[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] The current clearing thresholds are set out in *fn.5* above.

[7] An 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.

[8] i.e. an entity established in a third country that would be an FC or NFC if it were established in the European Union. Sometimes called 'third country' FCs or NFCs, for the purposes of this *Briefs for the Buy side* we use the terms 'hypothetical' FC and 'hypothetical' NFC.

[9] It is generally accepted that if an NFC is an NFC+ in at least one asset class then the Mandatory Reporting provisions do not apply to any of that NFC's trades with the FC. See the ISDA document entitled "EMIR Refit: Financial counterparties legal liability for reporting on behalf of both itself and non-financial counterparties. Operational considerations"; available at: https://www.isda.org/2020/03/13/emir-refit-fcs-reporting-on-behalf-of-both-itself-and-nfc-clients-operational-considerations/

[10] See TR Answer 54 of the ESMA Questions and Answers on the Implementation of EMIR (version 28 May 2020); available at: https://www.esma.europa.eu/press-news/esma-news/esma-publishes-updates-emir-qas).

[11] See paragraph 16 in Section 4.1.1 of the ESMA Consultation Paper "Technical standards on reporting, data quality, data access and registration of Trade Repositories under EMIR REFIT" published on 26 March 2020; available at: https://www.esma.europa.eu/sites/default/files/library/esma74-362-47_cp_on_the_ts_on_reporting_data_quality_data_access_and_registration_of_trs_under_emir_refit.pdf

[12] This terminological complexity makes compliance with both this aspect of the reporting changes and also the changes under the following sub-section "*AIFs and UCITS*" challenging both from a documentation and a contract identification perspective.

[13] Those listed in Article 81(3) of EMIR.

[14] Association of Financial Markets in Europe (AFME), Futures Industry Association (FIA), International Capital Markets Association (ICMA) and International Securities Lending Association (ISLA).

[15] Available at: https://www.isda.org/2019/12/19/mrra/

[16] See the ESMA Consultation Paper noted at *fn. 12* above.