MORRISON | FOERSTER

Client Alert

18 May 2017

Proposed EMIR II – Key Points for Derivatives Markets Participants

On 4th May 2017, the European Commission announced its proposals to amend the current European Market Infrastructure Regulation (Reg. No. 648/2012) ("EMIR"). The proposals stem from its public consultation and Call for Evidence carried out in 2015 and 2016 (the "EMIR Review").

The proposed changes will now be considered by the European Parliament and the Council of the EU but, if enacted in the current proposed form, will affect not only European counterparties, but also many non-EU counterparties.

Although not related to the EMIR Review, the Commission also chose 4th May 2017 to publish a Communication addressed to the European Parliament, the Council of the EU and the European Central Bank.

The Communication sets out the Commission's intention to introduce, in June 2017, legislative proposals aimed at ensuring "financial stability and the safety and soundness of central clearing counterparties ("CCPs") that are of systemic relevance for financial markets across the EU". Essentially, these proposals will provide for "enhanced supervision" at EU level of non-EU CCPs and/or location requirements for those CCPs. Many commentators regard this as an attempted "land-grab" by the EU of the business of clearing euro-denominated derivatives, and the Commission notes that 75% of euro-denominated interest rate derivatives are currently cleared in the UK (which has notified its intention to leave the EU).

Although this Communication has generated far more interest in the mainstream media than the EMIR Review, in the rest of this alert we focus on the key points of the Commission's proposals for the EMIR Review.

Classification of Counterparties

Whilst most of the proposed changes in the draft amending legislation can be regarded as streamlining or reducing the regulatory burden on derivatives counterparties, the European Commission has also taken the opportunity to propose a reclassification of certain counterparties. Specifically, it has proposed to broaden the definition of "financial counterparty" in order to include central securities depositaries and most securitisation special purpose entities ("SSPEs"), i.e., those that issue on a tranched credit risk basis.

Currently, under EMIR, SSPEs are likely to be classified as non-financial counterparties. Reclassifying them as financial counterparties will cause serious problems for banks and other financial institutions structuring securitisation transactions. This is because the designation "financial counterparty" will automatically mean that, unless it can utilise the proposed new clearing threshold provisions for financial counterparties - see "Clearing" below, the SSPE will become subject to the mandatory clearing obligation (in relation to any trades of a class designated by ESMA as being clearable) in addition to becoming subject to the obligation to post and collect margin in respect of their non-cleared trades. This seems an entirely inappropriate obligation to impose on an

SSPE because, firstly, an SSPE does not typically hold assets that can qualify to meet margin obligations and, secondly, an SSPE will typically pledge or otherwise secure all of its assets for the benefit of its creditors, including swap counterparties, thus already mitigating the counterparty risk on the SSPE, without the need for margin.

Whilst other parts of the proposals are explained by the European Commission in reasonable detail, there is no explanation or justification provided for the inclusion of these additional counterparties as financial counterparties.

Another proposed change to the definition "financial counterparty" will be equally concerning for non-EU alternative investment funds ("AIFs") and non-EU managers of AIFs ("AIFMs"). This change relates to the type of AIF that is considered to fall within the definition of financial counterparty. Currently, a non-EU AIF is only classified as a financial counterparty where it is managed by an AIFM that is authorised or registered under the AIFM directive (Directive 2011/61/EU). The effect of the draft proposals is that any AIF (whether established in the EU or outside the EU) will constitute a financial counterparty, even if its manager is not authorised or registered under the AIFMD and even if it has never been marketed in the EU. Again, there is no explanation by the European Commission for this proposed change.

For non-EU managers of AIFs, this provision would subject all their AIFs to the mandatory clearing obligation and compulsory margining of OTC trades, even where they have never managed an EU fund or marketed any of their funds in the EU. It is entirely unclear how EU authorities could enforce such provisions, in practice, against fund managers who have never managed or marketed funds in the EU and may have no EU presence, although such change of designation would potentially result in any EU counterparties facing such an AIF having to clear, or collect margin for, their trades.

Reporting

Currently, under EMIR, all EU counterparties to OTC derivatives are required to report those transactions to a trade repository, whether or not they are subject to a mandatory clearing obligation. Unlike some other jurisdictions, the obligation to report is placed on both parties to the transaction (if they are both EU counterparties). In practice, this has placed a significant burden on small non-financial counterparties who may in practice enter into very few derivative transactions and are much less likely to have the necessary systems and resources to report trades to trade repositories compared to most financial counterparties.

In order to reduce this burden, the Commission is proposing that OTC transactions that take place between a financial counterparty and a non-financial counterparty, and that are not subject to the clearing obligation, will now be reported to a trade repository by the financial counterparty on behalf of both parties. In addition, it proposes that intra-group OTC transactions will no longer require reporting to a trade repository, where at least one of the counterparties is a non-financial counterparty.

As from January 2018, all derivatives traded on a regulated market will be required to be cleared through a CCP, pursuant to the Markets in Financial Instruments Regulation (Regulation (EU) No. 600/2014). The Commission is proposing that such exchange-traded derivative transactions will be reported only by the CCP, on behalf of the counterparties.

The scope of reportable trades is also proposed to change so that reporting will only apply to derivative contracts that were outstanding, or entered into, on or after 12 February 2014 (the date upon which the reporting obligation became effective). The effect of this change is to remove the requirement to report historic trades entered into or outstanding before the reporting obligation took effect – so-called back-loaded reporting.

In addition, the reporting obligation is to be removed for all intra-group transactions where at least one of the counterparties is a non-financial counterparty.

Whilst all the above provisions can be seen as reducing or lightening the reporting obligations, the proposals provide that counterparties and CCPs are responsible for ensuring the accurate reporting of the derivative contracts, without duplication.

This effectively imposes an additional burden on counterparties to co-operate to ensure harmonised reporting of transactions, even where each party is reporting to a different trade repository. In relation to the proposals to ensure the quality of reported data, the provisions also specify that trade repositories must have adequate procedures for the reconciliation of data between different trade repositories to ensure the quality of the reported data and for the orderly transfer of data to other trade repositories where this is requested or required. Trade repositories will also be required to grant any counterparty access to all data reported on behalf of such counterparty, in order to allow its accuracy to be verified.

Clearing

The new proposals introduce an element of proportionality in the application of clearing rules. Specifically, they provide that financial counterparties will not now automatically become subject to a clearing obligation in relation to a clearable trade, but will only be required to clear where the notional amounts of their trades exceed certain thresholds. These thresholds will be the same as those that are used to determine when a non-financial counterparty should be subject to a clearing obligation.

However, in contrast to the way that the clearing thresholds work for non-financial counterparties, in calculating the derivatives positions of the financial counterparty, the counterparty is not permitted to exclude commercial hedging transactions from these calculations. In addition, if a clearing threshold is exceeded by the financial counterparty for any asset class, then it would become subject to the clearing obligation in respect of all of its OTC derivative contracts, even if it exceeded the threshold for only one asset class. In contrast, the proposals provide that a non-financial counterparty exceeding the clearing threshold for a particular asset class will become subject to the clearing obligation for derivative contracts in that asset class only.

Both financial counterparties and non-financial counterparties will need to calculate their OTC positions annually, to measure the aggregate month-end average position for the months of March, April and May. Currently, non-financial counterparties can become subject to the clearing obligation if their rolling-average position exceeds the threshold over 30 working days.

The draft legislation also provides for ESMA to have the power to request that the European Commission should suspend the clearing obligation for a specific class of OTC derivative, or for a specific type of counterparty, if:

- the class of OTC derivative is no longer suitable for central clearing; or
- a CCP is likely to cease clearing that specific class of derivative and no other CCP is able to clear that class without interruption; or
- suspending the clearing obligation is necessary to avoid or address a serious threat to financial stability in the EU, and where suspension is proportionate for that purpose.

Access to Clearing

In order to promote client access to clearing services, the proposals specify that clearing members, and clients providing clearing services, must provide clearing services under "fair, reasonable and non-discriminatory commercial terms". The Commission is authorised to adopt a delegated act as to the meaning of such phrase.

In addition, in order for clients to understand the rules and procedures of a CCP more clearly, a CCP will be obliged to provide its clearing members with a simulation tool that enables them to determine the amount of additional initial margin that would be requested by a CCP upon clearing a new transaction. A CCP will also be required to provide information to clearing members on the design of its initial margin model and the key assumptions and limitations of that model.

In order to increase certainty as to the treatment of assets held by a CCP in the event of its insolvency or that of a clearing member, the proposals provide for an express confirmation that where a CCP maintains records enabling it to distinguish between assets of different clearing members, and between clearing member assets and its own assets, then those segregated assets will not form part of the insolvency estate of the CCP or of defaulting clearing members.

Margin

The Commission's proposals specify that the existing regulatory technical standards provided by EBA, ESMA and ETOPA, in relation to the collection and provision of margin for non-cleared trades, should be expanded to specify also the levels and type of collateral and segregation arrangements to ensure initial and ongoing validation of parties' risk management procedures. In particular, this would mean that prior regulatory approval of initial margin models and other risk management procedures could be required in future.

Pension Funds

To date, pension funds have enjoyed an exemption from the clearing obligation for their OTC contracts that are objectively measurable as reducing investment risks directly relating to their financial solvency. This is due to the perceived difficulties for pension funds in acquiring and posting assets that would be eligible for margin required by CCPs.

The proposals provide for the current exemption to be extended by three years from the date of entry into force of the amending regulation.

Within two years after the entry into force of the legislative proposals, the European Commission, aided by ESMA, EBA and EIOPA, must determine whether CCPs, clearing members and pension funds have developed viable technical solutions to facilitate the participation of pension schemes in central clearing. Where the Commission concludes that no viable technical solution has been developed, it can extend the three-year exemption period by a further two years.

However, if it does not reach such a conclusion, pension funds will become subject to the clearing obligation as from the end of the three-year period.

Timing

The majority of the legislative proposals are to become applicable 20 days after publication in the Official Journal of the EU (the "in-force" date), possibly before the end of 2018. However, the provisions regarding clearing thresholds for financial counterparties are proposed to become applicable six months after the in-force date, and those regarding the expanded margin RTS are to become applicable 18 months after the in-force date.

Final Observations

All in all, the proposals would reduce some of the existing burdens of the EMIR regime for non-financial counterparties and small financial counterparties, although two-sided reporting of trades to repositories will still be required.

However, the proposals (if implemented in their current form) would represent bad news for the arrangers of securitisations, whose securitisation vehicles would generally become subject to EU clearing and margin obligations. For the same reason, they would also represent bad news for the managers of non-EU AIFs – certainly those entering into derivatives transactions with EU financial counterparties or large non-financial counterparties.

The proposals will now be considered by the European Parliament and the Council of the EU, and the provisions relating to designation as financial counterparties, in particular, can expect to receive some close scrutiny.

Authors

Peter Green
London
+44 (20) 79204013
pgreen@mofo.com

Jeremy Jennings-Mares
London
+44 (20) 79204072
jjenningsmares@mofo.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, and Fortune 100, technology, and life sciences companies. We've been included on *The American Lawyer*'s A-List for 13 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com. For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.