

EMIR Refit – Redefining a “Financial Counterparty” and why this Matters to Fund Managers

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Legislative reform to the European Market Infrastructure Regulation (**EMIR**) has now been finalised and the changes are expected to take effect in or around June 2019.ⁱ The EMIR Refit, as the reform is known, amends the scope of the existing clearing, reporting and margin requirements. While the EMIR Refit is intended to simplify EMIR and more carefully calibrate its rules in relation to smaller counterparties, some of the changes are likely to increase the compliance burden for fund managers.

The following highlights the key items which are immediately relevant to fund managers:ⁱⁱ

Changed definition of the term “Financial Counterparty”:

An entity categorised as a “financial counterparty” (**FC**) under EMIR is required, among other things, to clear over-the-counter (OTC) derivatives and exchange bilateral margin with counterparties for uncleared transactions. Similar requirements also apply to non-financial counterparties (**NFCs**) whose open OTC derivatives positions exceed specified thresholds (such counterparties, **NFC+**)ⁱⁱⁱ. Currently, all alternative investment funds (AIFs) (EU and non-EU) managed by authorised or registered EU-alternative investment fund managers (AIFMs) are FCs,^{iv} whereas EU AIFs managed by non-EU AIFMs are not. Under the Refit, the definition of an FC will change as follows:^v

“...an alternative investment fund as defined in [the AIFMD] which is either established in the Union or managed by an alternative investment fund manager [...] authorised or registered in accordance with [the AIFMD], except if that AIF is set up exclusively for the purpose of serving one or more employee share purchase plans, or if the AIF is a [securitisation special purpose entity] as referred to in [the EU Securitisation Regulation], and, where relevant, its AIFM established in the Union.”

This means that, under the revised definition, all EU AIFs (and their EU AIFMs) will be FCs. The key consequence to the new definition is that the EMIR margin requirements will now apply to an AIF that was previously categorised as an NFC-.^{vi} All FCs are subject to the requirement to post variation margin (**VM**)^{vii} to their counterparties in respect of their OTC derivative transactions, regardless of the size of their open OTC

Contact Information

If you have any questions concerning this alert, please contact:

Ezra Zahabi

Partner
Ezra.zahabi@akingump.com
London
+44 20.7661.5367

JP Bruynes

Partner
jpbruynes@akingump.com
New York
+1 212.872.7457

James Campbell

Associate
james.campbell@akingump.com
London
+44 20.7012.9852

derivatives positions.^{viii} In order to comply with the margin rules, the AIF must have in place the requisite trading documentation, including credit support annexes (CSAs).

Where an AIF that was previously categorised as an NFC- continues to fall below the relevant clearing thresholds, it would be categorised as a small financial counterparty for the purposes of the clearing obligation. It would therefore only be subject to the clearing obligation under EMIR if it exceeded the clearing thresholds (see below the discussion regarding the exemption for Small Financial Counterparties).

Exemption from the Clearing Obligation for Small Financial Counterparties:

The EMIR Refit creates a new category of FC for those FCs whose open OTC derivatives positions do not exceed the clearing thresholds, i.e. small FCs (alternatively called **FC-** entities, with entities exceeding the clearing thresholds being **FC+**). The FC- classification is intended to address concerns that smaller market participants are often unable to access clearing arrangements without incurring significant and, relative to the size of their derivatives activity, disproportionate cost. FC- entities will however still be required to comply with EMIR requirements relating to margin exchange and risk mitigation.

An FC or NFC that either exceeds the clearing threshold under EMIR, or which elects not to conduct the calculation, will be required to immediately notify the relevant EU competent authority and the European Securities and Markets Authority (**ESMA**) of the same after the EMIR Refit takes effect. Relevant clearing arrangements must be established within four months of notification. While an AIF is permitted to elect not to perform the calculation, ESMA has indicated that this would result in the entity becoming subject to the clearing obligation in respect of all categories of OTC derivative transactions.^{ix}

Amendments to Reporting Rules:

EU and non-EU AIFMs will now “*be solely responsible and legally liable*” for reporting the OTC derivative contract of an EU AIF. The reporting obligation is thus transferred from the legal counterparty to the trade, as currently under EMIR, so that it now belongs to the AIFM (and will be transferred from the Undertaking for Collective Investments in Transferable Securities (UCITS) to the UCITS ManCo). It may therefore be necessary for AIFMs to revisit reporting delegation agreements to the extent that these do not adequately address the change in responsibility for reporting.

Further, intra-group transactions where at least one of the counterparties in the group is an NFC will be exempt from the requirement to report intra-group trades. This is the case regardless of the location of establishment of the NFC.

Non-EU AIFs:

Non-EU AIFs managed by non-EU AIFMs will continue to be classified as third country entities (and not FCs *per se*). This means that the requirements under EMIR will apply to them only indirectly when dealing with EU counterparties subject to EMIR. However, non-EU AIFs trading with EU FCs and NFC+ entities are generally required to make representations as to their EMIR counterparty classification on the basis of their status under EMIR, were they established in the EU. As their status will change as a result of the EMIR Refit, non-EU AIFs managed by non-EU AIFMs should update the representations. As a result of the change in counterparty categorisation, the considerations relating to the margin requirements and the clearing obligation with

respect to EU AIFs as FCs will also be relevant to non-EU AIFs managed by non-EU AIFMs.

Next Steps:

The changes described above will, to the extent relevant, require steps to be undertaken by non-EU asset managers in respect of their AIFs. Among other measures, it may be necessary to:

- Assess the impact on AIFs of the change to the counterparty classification.
- Consider whether any counterparty representations require updating.
- Establish arrangements for clearing OTC derivative transactions on an ESMA authorised or non-EU recognised central counterparty (CCP).
- Consider whether adherence to CSAs is required for the exchange of collateral for uncleared OTC derivative transactions.
- Consider the appropriateness of existing infrastructure and arrangements for reporting.

i. Agreement between the European Commission, European Parliament and the Council of the EU was reached on the text of the EMIR Refit on 5 February 2019 (http://europa.eu/rapid/press-release_IP-19-848_en.htm). The final compromise text is available here: <https://data.consilium.europa.eu/doc/document/ST-6913-2019-ADD-1/en/pdf>. The version published in the Official Journal of the European Union (OJEU) may differ from the compromise text in minor respects. Brexit is not expected to impact the scope of these changes once they take effect in the U.K. Most changes introduced by the EMIR Refit will take effect 20 days following the publication of the text in the OJEU, in which changes are expected to be published in May 2019.

ii. The EMIR Refit contains a number of other changes which are outside of the scope of this Client Alert relating to: (i) extension of the clearing obligation for pension schemes for two years; (ii) ESMA's new power to suspend the derivatives clearing and trading obligations where required to address systemic risk concerns; (iii) removal of the "frontloading" and "backloading" requirements under EMIR; and (iv) CCP infrastructure and risk management.

iii. The clearing thresholds are €1 billion in gross notional value for OTC credit derivatives and OTC equity derivatives; and €3 billion in gross notional value for OTC interest rate derivatives, OTC FX derivatives, OTC commodity derivatives and other OTC derivatives. The calculation methodology is further specified in EMIR and in guidance issued pursuant to EMIR. An AIF will be classified as FC- if its aggregate month-end gross notional value of OTC derivative transactions for the previous 12 months, calculated at the fund level, falls below the above clearing thresholds for each asset class. These are the same clearing thresholds which currently apply to NFCs under EMIR to determine whether a counterparty is an NFC+ or NFC-.

iv. Per article 2(8) of EMIR.

v. Per the amended definition of FC, under Article 1(1)(e) of the EMIR Refit, amending Article 2, point (8) of EMIR which currently states that "*financial counterparty* means [...] a UCITS and, where relevant, its management company, authorised in accordance with [the UCITS Directive] [...] and an alternative investment fund managed by AIFMs authorised or registered in accordance with [the AIFMD]."

vi. In addition, the reporting requirements under EMIR will apply. FCs will also be required to report on behalf of their NFC counterparties.

vii. In addition to VM, initial margin will also be required to be exchanged to the extent that the AIF's average aggregate notional amount of OTC derivative transactions that are outstanding for the months of March, April and May of the preceding year exceed €3 billion.

viii. This means that there is no exemption under EMIR Refit comparable to the exemption from the clearing obligation available to FC- entities for margin. See above: "Exemption from the Clearing Obligation for Small FCs."

ix. ESMA Guidance "On the New Emir Refit Regime for the Clearing Obligation" of 28 March 2019 (<https://www.esma.europa.eu/press-news/esma-news/esma-provides-guidance-new-emir-refit-regime-clearing-obligation>).

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