CLIFFORD CHANCE

Briefing note

May 2017

European Commission releases EMIR review proposals

On 4 May 2017 the European Commission published a legislative proposal to amend the European Market Infrastructure Regulation (EMIR), reflecting the outcome of its review of how EMIR has worked since its adoption in 2012. Rather than fundamental reform, the proposals set out a limited number of changes aiming to address specific issues identified in the review, although many of these will have significant impact on market participants. The Commission also issued a communication indicating that it will propose legislation in June 2017 to enhance the supervision of central counterparties (CCPs). Framed in the context of the UK's exit from the EU, this will include proposals for enhanced EU supervision and/or location requirements for third country CCPs that play a systemic role in EU markets.

Timing

The Commission proposal will now make its way through the EU legislative process before being finalised and published in the Official Journal, likely towards the end of 2018. Most of the changes would take effect immediately the regulation enters into force (20 days after publication), without any transitional arrangements or conformance period.

However, some requirements would not take effect until six months later, such as the changes to the clearing threshold, the changes to insolvency protections and the new transparency obligations of CCPs. Other changes would take effect 18 months after the date of entry into force, including the new obligations on clearing firms, many of the changes to the regulation of trade repositories and the changes to the technical standards on margin. The European Securities and Markets Authority (ESMA) would be required to draft technical standards to give effect to some of the changes by the date nine months after the date of entry into force.

Scope: expanding the definition of "financial counterparty"

The Commission proposal would amend the EMIR definition of "financial counterparty" (FC) to include:

- All alternative investment funds (AIFs) as defined in the Alternative Investment Fund Managers Directive: This would extend the scope of the definition to include AIFs registered under national law that are

Key changes

- Expanding the definition of FC to include AIFs, SSPEs and CSDs
- A per-asset class clearing threshold for NFCs and a new clearing threshold for smaller FCs
- New duties for clearing firms offering clearing services to clients
- Insolvency protection for assets and positions with CCPs and clearing members
- Extension of the pension scheme exemption
- Removal of frontloading and powers to suspend the clearing obligation
- FCs to report on behalf of NFC-s
- Reducing barriers to regulatory access to EU trade repository data
- New powers to require approval of initial margin models

currently considered to be non-financial counterparties (NFCs). It would also mean that all third country AIFs would be considered to be third country entities that would be FCs if established in the EU, regardless of whether they are managed by an AIF manager authorised or registered in the EU.

- Securitisation special purpose entities (SSPEs): Currently, many SSPEs are not subject to the clearing and margining obligations under EMIR because their own positions do not exceed the clearing threshold and they are not part of a group whose non-financial entities have positions exceeding the clearing threshold. The proposed change will potentially bring all SSPEs into the scope of clearing and margining obligations, with only some relief from clearing (but not margining) for SSPEs that are able to take advantage of the new clearing threshold for FCs discussed below. There is no proposal to extend the existing relief from margining for covered bond issuers to cover SSPEs, even though SSPEs would face many of the same practical issues in margining their hedging transactions, as they do not have access to liquid collateral without additional liquidity facilities.
- Central securities depositories.

These changes would take effect as soon as the amending regulation enters into force and the Commission proposal does not include any conformance period or transitional provisions. Therefore, firms would need to carry out a reclassification exercise on their counterparties even before the legislation is officially published. It is also unclear how these changes affect existing contracts with entities that will become subject to margin and clearing obligations for the first time. In addition, entities that become subject to the clearing obligation for the first time may have to wait for six months before they can benefit from the new clearing threshold for FCs discussed below.

Next steps

Likely adoption by end 2018 - most provisions take effect immediately but some six or 18 months later

Proposed amending regulation may be subject to amendment during the legislative process

Commission to propose additional legislation in June 2017 on supervision of CCPs, including third country CCPs to take account of Brexit

Changes affecting the clearing obligation

Per-class clearing threshold for NFCs

The Commission proposes to narrow the scope of the clearing obligation for NFCs, so that NFCs would only be subject to the clearing obligation for those classes of OTC derivatives for which they exceed the clearing threshold (revised Article 10(1)). However, it appears that an NFC that exceeds the clearing threshold for any class of OTC derivatives may still be treated as an 'NFC+' for all other purposes, including the margining of uncleared transactions. Therefore, this change may only provide limited relief for those corporates with large positions in commodities derivatives that wish to be able to continue to conduct normal treasury operations without margining costs. In addition, firms will need to build systems that can classify counterparties as NFC+ for some purposes and not for others.

New clearing threshold for smaller FCs

The Commission also proposes to introduce a clearing threshold for FCs with a low volume of OTC derivatives activity (revised Article 4(1)(a) and new Article 4a(1)). This threshold will be set at the same level as the clearing threshold for NFCs. However, where an FC's positions in OTC derivatives exceed the clearing threshold for one class of OTC derivative, the FC would become subject to the clearing obligation for all classes of OTC derivatives (as is currently the case for NFCs). In addition, unlike the treatment of NFCs, the clearing threshold for FCs would be calculated on the basis of an FC's own positions without aggregation of the positions of other group members, an FCs' hedging transactions would count towards the clearing threshold and FCs would continue to be subject to margin and other risk mitigation obligations whether or not they exceed the threshold.

Clearing threshold calculation

Instead of carrying out clearing threshold calculations on a rolling basis, counterparties would instead need to calculate, annually, their aggregate month-end average positions for March, April and May (new Article 4a(1) for FCs and revised Article 10(1) for NFCs). This is broadly in line with the current process for calculating relevant thresholds for the margin obligations. However, the calculations are not identical and counterparties may need to build additional processes for this revised clearing threshold calculation (e.g., to calculate positions by asset class).

Removing barriers to clearing

The Commission proposes amendments to address concerns that counterparties with a limited volume of OTC derivatives activity may face difficulties in accessing central clearing. Clearing members which provide clearing services (and their clients which provide indirect clearing services) would be required to provide clearing services on "fair, reasonable and non-discriminatory commercial terms" (new Article 4(3a)). This goes further than the current requirement for clearing members to facilitate indirect clearing on reasonable commercial terms. The Commission would be empowered to adopt a delegated act to specify when commercial terms are to be considered fair, reasonable and non-discriminatory.

The proposal also provides that the assets and positions recorded in the separate accounts maintained by a CCP for its clearing members or a clearing member for its clients are not to be treated as part of the insolvency estate of the CCP or clearing member (new Article 39(11)). The Commission hopes that this will improve access to clearing by providing greater certainty that assets are protected in a default scenario, at least where assets are held with a CCP or clearing member. However, CCPs and market participants will need to analyse how this new rule interacts with national insolvency laws. In addition, the proposal does not specifically address the insolvency treatment of the 'leapfrog' payments made by CCPs to clients of insolvent clearing members or the positions held by clients of clearing members providing indirect clearing services.

In addition, the proposal aims to improve the transparency and predictability of CCPs' initial margin requirements. It would impose new duties on CCPs to provide their clearing members with a simulation tool allowing them to determine the amounts of initial margin that would be required by a new transaction and with details of its initial margin model (new Article 38(6) and (7)). The Commission would need to take these new requirements into account when evaluating the equivalence of third country regimes regulating CCPs recognised or seeking recognition under EMIR.

Extending the exemption for pension scheme arrangements

In the absence of a technical solution to allow pension scheme arrangements to participate in central clearing, the Commission proposes to extend the current exemption of pension scheme arrangements from the clearing obligation (revised Articles 85 and 89(1)). The extended exemption would apply until three years after entry into force of the amending regulation. The Commission would have the power to extend this exemption by a further two years. The Commission hopes that the extended exemption will allow CCPs and pension scheme arrangements to work together to bring pension scheme arrangements within the clearing obligation without negatively impacting pension returns.

However, the amending regulation might not take effect until after the current exemption expires on 18 August 2018. One potential solution to this timing issue might be to amend the RTS imposing the clearing obligation to create an extended phase-in period for pension scheme arrangements to bridge the gap until the amending regulation enters into force.

Removing the frontloading requirement

The proposal would repeal the existing 'frontloading' requirement under EMIR (current Article 4(1)(b)(ii)). Currently, contracts could become subject to the clearing obligation from the date when the CCP is authorised or recognised to clear a class of contracts even though ESMA has yet to consider whether to propose RTS mandating clearing of that class (although the RTS adopted to date have included provisions obviating this requirement).

Suspension of the clearing obligation

The proposal would also give the Commission powers to suspend the clearing obligation in specific circumstances, including where clearing may have an adverse effect on financial stability (new Article 6b). Suspension would be effective for a period of up to twelve months.

Changes affecting reporting of derivatives

Changes to reporting requirements

The Commission has proposed various changes to the EMIR reporting requirements. Some of these changes are likely to be helpful to market participants:

- CCPs would be responsible for reporting details of exchange-traded (non-OTC) derivatives transactions on behalf of both counterparties and for ensuring accuracy of the details reported (new Article 9(1a)), although this would not relieve counterparties from their obligation to report back-to-back transactions or transactions cleared on non-EU CCPs;

- firms would no longer need to report intragroup OTC derivatives transactions where one of the counterparties is an NFC (revised Article 9(1)), although the exemption would only apply where the transactions meet the conditions for an intragroup transaction under EMIR, including the condition requiring an equivalence determination for transactions with third country entities;
- firms would no longer have to report ('backload') transactions entered into before 12 February 2014 that were not still outstanding at that date (revised Article 9(1)), although backloading will continue for other contracts entered into before 12 February 2014.

However, FCs would become responsible for reporting details of OTC derivatives transactions with NFCs not subject to the clearing obligation (NFC-s) on behalf of both counterparties (new Article 9(1a)).

As with the similar requirements under the Securities Financing Transactions Regulation (SFTR), this would impose a direct regulatory obligation on the FC to report transactions on behalf of its counterparty, even if the FC has been unable to obtain all the required information from the counterparty.

Therefore, FCs will need to put in place new or revised agreements with all their NFC- counterparties, including any that currently report their own trades, to address this new regulatory obligation and accompanying risk. Managers of UCITS and AIFs would also become responsible for reporting trades on behalf of their funds.

These changes appear to apply when the amending regulation enters into force, with no transitional provisions. Therefore, counterparties might need to put in place the necessary agreements with clients and other systems changes before the legislation is officially published.

The proposal imposes new specific obligations on ESMA to draft implementing technical standards covering data standards, including entity, instrument and trade identifiers, and the methods and arrangements for reporting (revised Article 9(6)).

Registration and supervision of trade repositories

The proposal would impose new duties on trade repositories to ensure the effective reconciliation of data between trade repositories, to ensure the completeness and accuracy of reported data, to facilitate switching by transferring data to other trade repositories when requested by their clients and to give counterparties access to data reported on their behalf by a CCP or FC (new Articles 78(9) and Article 81(3a)).

The Commission has proposed increasing the upper limit of the basic amount of fines ESMA can impose on trade repositories, with the aim of increasing the deterrent effect of the sanctions system (revised Article 65(2)).

The proposal also introduces a simplified application process for the extension of registration for trade repositories that are already registered under SFTR (revised Article 56).

Access to trade repository data

The proposal would give regulators in non-EU countries with their own trade repositories direct access to data held by EU trade repositories where certain conditions are fulfilled (new Article 76a).

One of these conditions is that under the legal framework of the third country, trade repositories are subject to a legally binding and enforceable obligation to provide EU regulators with direct and immediate access to data.

This addresses the Financial Stability Board request for authorities to remove barriers to regulatory access to information. Currently, authorities in these third countries only have rights to direct access to data held by EU trade repositories where there is an international agreement in place between the EU and the relevant third country, although this would remain a condition for recognising a third country trade repository for the purposes of meeting the EU reporting requirements.

Changes affecting the margin rules

The Commission proposal would expand the scope of the RTS on risk management procedures for uncleared OTC derivatives to include supervisory procedures relating to the level and type of collateral and segregation arrangements, to ensure initial and ongoing validation of counterparties' risk-management procedures (revised Article 11(15)(a)).

This would allow the RTS to include provisions requiring the prior regulatory approval of risk management procedures, including initial margin models.

Supervision of CCPs

The Commission's accompanying communication on responding to challenges for critical financial market infrastructures and further developing the Capital Markets Union (CMU) indicates that the Commission will present a further legislative proposal in June 2017 to address the supervision of CCPs that are of systemic relevance in the EU.

The communication states that there is a need to enhance EU-level supervision by ESMA of systemically important EU CCPs and the role of the central bank of issue of the currencies used by EU CCPs.

The communication also states that there is a need to subject non-EU CCPs to safeguards under the EU legal framework where they play a systemic role in EU financial markets and directly impact the responsibilities of EU and Member State authorities. These safeguards would include "where necessary, enhanced supervision at EU level and/or location requirements". The Commission acknowledges the need to avoid fragmentation of the global system but notes that, following the UK exit from the EU, a substantial volume of euro-denominated transactions would not be cleared in the EU and would no longer be subject to EU regulation and supervision.

Conclusion

The legislative proposal does not respond to all the requests made by market participants to simplify and enhance the EMIR framework, for example, the request for single-sided reporting or to allow market participants to meet their clearing obligation by indirect clearing on recognised third country CCPs. However, more changes may be introduced during the legislative process. In addition, the proposal would require the Commission to produce a new report reviewing the effect of EMIR three years after the amending regulation comes into force.

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