The Delta Report

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At a glance

Brexit update

- With the UK's snap general election resulting in a hung parliament, the task of legislating for Brexit through the 'Repeal Bill' and other related primary and secondary legislation has undoubtedly become more onerous.
- Much remains unclear in respect of the likelihood, shape or duration of any transitional arrangements and the resulting impact on UK based financial institutions and their ability to 'passport' services and product sales across the EU. As a result, we note many client institutions are already significantly advanced with their plans for a post-Brexit trading environment.
- A development related to Brexit is the newly advanced legislative proposals in the form of the 'EMIR Review' from the EU Commission. These proposals suggest that it may become mandatory for large, systemically important clearing houses who clear large volumes of euro denominated derivatives to relocate within the physical territory of an EU member state.

A comparison of the reporting obligation under EMIR and under MIFIR

This article is a comparison of the reporting obligation under EMIR[1] and under MIFIR[2]. In summary we note that:

- The scope of entities caught by the relevant reporting obligation is wider under EMIR, which captures both dealers and end-users, than under MIFIR, which captures only investment firms authorised under MIFID II.
- The range of instruments caught is broader under MIFIR than under EMIR, since the reporting obligation under MIFIR hinges on the newly expanded definition of "financial instrument" under MIFID II which includes instruments other than derivatives.
- The nature of transactions to be reported is broadly similar between EMIR andMIFIR however MIFIR contains clear exemptions for certain transactions;
- The timing for delivery of reports is the same (i.e. on a T+1 basis);
- The content of reports is broadly similar in length; and
- Whereas reports under EMIR are delivered to reported to a registered or recognised trade repository, under MIFIR reports are delivered to the relevant competent authority.

Reflections upon the proposed amendments to EMIR

- This article on the EMIR Review analyses in detail the main changes in the legislative proposals published on 4 May 2017 and how they may affect entities that enter into OTC derivatives. In particular, our note pauses on the consequences of reclassifying securitisation special purpose vehicles as financial counterparties and how the EMIR margin obligations may therefore be satisfied. In addition, changes in respect of clearing and reporting are also explained.

1 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

2 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012

Brexit update

Nathaniel Crowley

Overview

In the May 2017 edition of the Delta Report, we provided a case review of the landmark Article 50 ruling handed down by the UK Supreme Court and described the UK government's current strategy on implementing Britain's exit from the European Union ("**EU**") as outlined in a recently published White Paper[3]. The White Paper set out the key elements of how to legislate for withdrawal including a 'Great Repeal Bill'(now known as the 'Repeal Bill'), which would end the supremacy of EU law (known as the '*acquis communautaire*') in the UK by repealing the European Communities Act 1972 and lift all existing EU laws directly onto the UK statute book where Parliament could then look to amend and/or repeal them as appropriate.

On 8 June 2017, the UK held a snap general election which was widely expected to provide a large parliamentary majority in the House of Commons for incumbent Prime Minister Theresa May's Conservative and Unionist Party. Instead, the general election resulted in the government losing its majority in the House of Commons making the task of passing the 'Repeal Bill' and an additional, vast amount of primary and secondary legislation to legislate for withdrawal even more daunting.

Nevertheless, it would appear, as of the time of publication, that the government has been able to establish a working majority in the House of Commons with the support of the Democratic Unionist Party of Northern Ireland and Mrs May's government has stated that it will keep to the EU's timetable for talks. Negotiations around the exit arrangements duly commenced on 19 June 2017 followed by the 'Queen's Speech' on 21 June 2017 setting the legislative agenda for a special 2017 – 2019 (i.e. 2 year instead of 1 year) Parliament. In the speech it was stated that the government would press ahead with the 'Repeal Bill' which would be complemented by legislation to ensure that the UK "*[establishes] new national policies on immigration, international sanctions, nuclear safeguards, agriculture, and fisheries*".

As to the approach to the negotiations, the EU's negotiating guidelines[4] (as approved by the 27 other Member States of the EU) stipulate that the UK and the EU must first make "*sufficient progress*" in respect of agreeing the amount of the UK's existing and contingent liabilities to the EU before talks can commence on the future trading and political relationship between them[5]. While the UK had insisted that these two processes were carried out in parallel (given the longstop date by which exit will automatically occur (unless otherwise agreed) is 2 years from the date of service of the Article 50 notice[6]), it would seem that the UK has acceded to this position and agreed to follow the EU's mandated approach[7].

Despite the general election result for the government, their position appears to have been left unchanged in respect of the form that Brexit will take. In her Lancaster House speech in January 2017[8], Mrs May stated that the government's position would be for the UK to leave the European Single Market[9] as well as the EU 'Customs Union' and negotiate in their place a bespoke free trade arrangement. No further detail on what this would encompass has yet been released.

The way forward – UK Financial services and the derivatives market

In summary, the position for the UK's future trade relationship with the EU, the likelihood, shape or duration of any transitional arrangements and the impact on UK financial institutions and their ability to 'passport'[10] across Europe remain wholly unclear at this stage.

Since the Lancaster House speech, media comment and discussions with clients have indicated a significant step-up in planning for a post-Brexit environment where financial institutions based in the UK will no longer be able to rely on passporting arrangements. In particular, increasing focus has been given to a scenario where the UK exits the EU with no transitional arrangements in place and with no future trading relationship agreed (a so-called 'cliff-edge Brexit'). Clearly, such a scenario would have a significantly detrimental impact on the ability of London based financial institutions to provide financial services and sell financial products within the EU.

3 White Paper, 'Legislating for the United Kingdom's withdrawal from the European Union'

4 http://www.consilium.europa.eu/en/press/press-releases/2017/04/29-euco-brexit-guidelines/

5 A range of figures have been quoted in media globally and by various representatives of the EU institutions. However, it would appear that the opening position for the negotiations is that the UK will be liable for a gross amount of approximately EUR 100 billion

6 Article 50, Treaty on European Union

7 https://www.bloomberg.com/politics/articles/2017-06-16/u-k-said-to-accede-to-eu-demand-brexit-talks-tackle-split-first

8 https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech

9 https://www.gov.uk/government/policies/european-single-market

10 Subject to its fulfilment of conditions under the relevant single market directive, a firm authorised in a European Economic Area (EEA) state is entitled to carry on permitted activities in any other EEA state by either exercising the right of establishment (of a branch and/or agents) or providing cross-border services. This is referred to in the UK Financial Services and Markets Act 2000 (as amended) as an 'EEA right' and the exercise of this right is known as 'passporting'

Consideration has been given to the possibility of relying on '*equivalence*'[11] arrangements but this has been given short shrift as the current regime only covers certain financial products[12] and decisions made by the EU that a regime is '*equivalent*' can be revoked on 30 days' notice. Instead, and as noted in the media, a number of our clients are instead looking at the EU's requirements for trading out of an EU based branch or subsidiary. This in turn requires consideration of issues such as whether (i) the EU based entity would need to be separately capitalised and 'hived off' from the UK entity, (ii) key ancillary functions such as risk and compliance would also need to be handled within that entity, and (iii) personnel will need to be physically relocated to the jurisdiction where that entity is based.

Separately, much consideration has also been given to the future of the UK's well established euro derivatives clearing business. In 2015, the ECJ ruled in favour of the UK government[13] against the 'location policy' of the European Central Bank (the "**ECB**"). This policy (while not actually implemented at the time) could have forced clearing house operators to be based in the Eurozone when handling significant euro-denominated business but was viewed by the ECJ as being outside the legal mandate scope of the ECB.

The European Commission is now proposing to amend[14] the European Market Infrastructure Regulation[15] ("**EMIR**") in order to implement a two tier system[16] for clearing houses. Pursuant to the EMIR Review, 'Tier 1' (i.e. smaller) clearing houses would continue to operate within the parameters of the existing framework, which allows equivalence decisions to be taken where the clearing house is located outside of the EU.

However, for 'Tier 2' (i.e. 'systemically important') clearing houses, it is proposed that stricter requirements will be applied. The European Commission states that "*a limited number of these systemically important clearing houses may be of such systemic importance, that the requirements are deemed insufficient to mitigate the potential risks (so called 'substantially systemically important'). In such instances, a decision may be taken allowing a CCP to provide services in the [EU] if it is authorised under EMIR and establishes itself in the EU*". In short, such legislation could be utilised to mandate the relocation of large clearing houses based in third countries (which the UK will become upon exit) to within the EU if the proposal should pass into law.

On 23 June 2017, the ECB also released a statement recommending[17] that Article 22 of the Statute of the European System of Central Banks and of the European Central Bank be amended to provide it with clear legal competence in the central clearing sector and thereby giving the bank greater oversight of systemically important clearing houses outside the EU if they handle significant amounts of euro-denominated transactions (e.g. as contemplated by the EMIR Review).

Deliberations by the EU institutions aside, this issue will likely be the subject of further discussion in the Brexit negotiations. We will be monitoring this matter closely and assessing the likely impact on our derivatives clients and the market generally in future issues of the Delta Report once it becomes clearer what action (if any) will be taken.

A comparison of the reporting obligation under EMIR and under MIFIR

Richard Blackburn

Entities within scope

EMIR

Under Article 9 of EMIR, the reporting obligation applies to entities established in the EU who enter into, modify or terminate certain derivatives transactions.

Note that under Article 1(4) of EMIR, the members of the European System of Central Banks and other Member States' bodies performing similar functions and other EU public bodies charged with or intervening in the management of the public debt and the Bank for International Settlements are exempt from EMIR and would not be subject to the reporting obligation.

Note also that whilst third country entities are not subject to the reporting obligation in EMIR, they will nevertheless need to furnish any EU counterparty with which they transact

11 Equivalence is the concept that the regulatory regime of a third country (as it relates to a particular sector) is of an 'equivalent' standard to that applicable under EU law. For the purposes of financial services, such an assessment will typically be made by the European Commission, based on advice given by one of the European Supervisory Authorities

12 The concept of 'equivalence' in the context of access to markets is currently only available as an option in two sets of legislation: namely MiFID II and the AIFMD. This means that, unless there are significant changes to EU financial services legislation, equivalence in the context of access to markets will not be relevant to large proportion of the UK's financial services sector

13 https://curia.europa.eu/jcms/upload/docs/application/pdf/2015-03/cp150029en.pdf

14 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs (the "**EMIR Review**"). For further detail, please see the article on these legislative proposals in this edition of the Delta Report

15 Regulation (EU) No 648/2012.

16 http://europa.eu/rapid/press-release_MEMO-17-1583_en.htm

17 https://www.ecb.europa.eu/press/pr/date/2017/html/ecb.pr170623.en.html

appropriate details in order to allow that EU counterparty to discharge its reporting obligations. Therefore, although there is no legal obligation to report, third country entities will need to cooperate with its EU counterparties.

MIFIR

Under Article 26(1) of MIFIR, the reporting obligation applies to investment firms authorised under MIFID II[18] from 3 January 2018.

Note however pursuant to Article 26(7) of MIFIR, the reports are required to be made to the competent authority either by the investment firm itself, an approved reporting mechanism ("**ARM**") acting on its behalf (to whom the relevant investment firm has delegated the obligation) or by the trading venue through whose system the transaction was completed.

Under Article 26(5) of MIFIR, an operator of a trading venue is required to report details of transactions in financial instruments traded on its platform which are executed through its systems by a firm which is not subject to MIFIR.

Under Article 26(7) of MIFIR, where an investment firm reports details of those transactions through an ARM which is acting on its behalf or a trading venue, the investment firm is not responsible for failures in the completeness, accuracy or timely submission of the reports which are attributable to the ARM or trading venue but rather the ARM or trading venue is responsible for those failures.

There is an exemption from the reporting obligation under Article 3(2) of RTS 22[19], pursuant to which an investment firm is not deemed to have executed a transaction where it has transmitted an order in accordance with Article 4 of RTS 22.

Instruments within scope

EMIR

The reporting obligation applies in respect of all derivative contracts (i.e. OTC and exchange-traded). The report must be made to a registered trade repository within the EU or a recognised third-country trade repository. A trade repository is defined in EMIR as an entity that centrally collects and maintains records of derivative contracts.

MIFIR

Article 26(2) of MIFIR states that the reporting obligation applies to:

(a) financial instruments which are admitted to trading or traded on a trading venue or for which a request for admission to trading has been made;

(b) financial instruments where the underlying is a financial instrument traded on a trading venue; and

(c) financial instruments where the underlying is an index or a basket composed of financial instruments traded on a trading venue.

The obligation shall apply to transactions in financial instruments referred to in points (a) to (c) irrespective of whether or not such transactions are carried out on the trading venue.

Definition of "financial instrument": "Financial instruments" is defined as follows in MIFID II:

(1) Transferable securities;

(2) Money-market instruments;

(3) Units in collective investment undertakings;

(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;

(5) Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;

(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled;

18 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

19 Commission Delegated Regulation (EU) 2017/590 of 28 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the reporting of transactions to competent authorities.

(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 of this definition and not being for commercial purposes, which have the characteristics of other derivative financial instruments;

(8) Derivative instruments for the transfer of credit risk;

(9) Financial contracts for differences;

(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this definition, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, organised trading facility ("**OTF**"), or a multilateral trading facility ("**MTF**");

(11) Emission allowances consisting of any units recognised for compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme).

Definition of "trading venue": Trading venue is defined in MIFID II as a regulated market, an MTF or an OTF.

Transactions to be reported

EMIR

From 12 February 2014, counterparties were required to report details of any derivative contract (i.e. OTC and exchange traded) they have concluded, or which they have modified or terminated, to a registered or recognised trade repository. Contracts entered into on or after 12 August 2012 but which were not outstanding on or after 12 February 2014 should have been reported to a trade repository by 12 February 2017.

MIFIR

Transactions to be reported (Article 2 RTS 22)

(1) An acquisition or disposal of a financial instrument.

(2) An "**acquisition**" is defined to include the following:

- (a) a purchase of a financial instrument;
- (b) entering into a derivative contract;
- (c) an increase in the notional amount of a derivative contract.

(3) A "**disposal**" is defined to include the following:

- (a) sale of a financial instrument;
- (b) closing out of a derivative contract;
- (c) a decrease in the notional amount of a derivative contract.

(4) Note that a transaction also includes a simultaneous acquisition and disposal of a financial instrument where there is no change in the ownership of that financial instrument but post-trade publication is required under Articles 6, 10, 20 or 21 of MIFIR.

Exempted transactions (Article 2(5) RTS 22)

The following transactions are exempt from the reporting obligation:

(a) securities financing transactions (other than securities financing transactions to which a member of the European System of Central Banks is a counterparty);

(b) a contract arising exclusively for clearing or settlement purposes;

(c) a settlement of mutual obligations between parties where the net obligation is carried forward;

(d) an acquisition or disposal that is solely a result of custodial activity;

(e) a post-trade assignment or novation of a derivative contract where one of the parties to the derivative contract is replaced by a third party;

(f) a portfolio compression;

(g) the creation or redemption of units of a collective investment undertaking by the administrator of the collective investment undertaking;

(h) the exercise of a right embedded in a financial instrument, or the conversion of a convertible bond and the resultant transaction in the underlying financial instrument;

(i) the creation, expiration or redemption of a financial instrument as a result of pre-determined contractual terms, or as a result of mandatory events which are beyond the control of the investor where no investment decision by the investor takes place at the point in time of the creation, expiration or redemption of the financial instrument (other than initial public offerings or secondary public offerings or placings, or debt issuance);

(j) a decrease or increase in the notional amount of a derivative contract as a result of pre-determined contractual terms or mandatory events where no investment decision by the investor takes place at the point in time of the change in the notional amount;

(k) a change in the composition of an index or a basket that occurs after the execution of a transaction;

(l) an acquisition under a dividend re-investment plan;

(m) an acquisition or disposal under an employee share incentive plan, or arising from the administration of an unclaimed asset trust, or of residual fractional share entitlements following corporate events or as part of shareholder reduction programmes where all the following criteria are met:

  (i) the dates of acquisition or disposal are pre-determined and published in advance;

  (ii) the investment decision concerning the acquisition or disposal that is taken by the investor amounts to a choice by the investor to enter into the transaction with no ability to unilaterally vary the terms of the transaction;

  (iii) there is a delay of at least ten business days between the investment decision and the moment of execution;

  (iv) the value of the transaction is capped at the equivalent of EUR 1 000 for a one-off transaction for the particular investor in the particular instrument or, where the arrangement results in transactions, the cumulative value of the transaction shall be capped at the equivalent of EUR 500 for the particular investor in the particular instrument per calendar month;

(n) an exchange and tender offer on a bond or other form of securitised debt where the terms and conditions of the offer are pre-determined and published in advance and the investment decision amounts to a choice by the investor to enter into the transaction with no ability to unilaterally vary its terms;

(o) an acquisition or disposal that is solely a result of a transfer of collateral.

Timing for delivery of transaction reports

EMIR

Under Article 9(1) of EMIR, the details of the trade must be reported no later than the working day after the conclusion, modification or termination of the contract (i.e. on a T+1 basis).

MIFIR

Under Article 26(1) of MIFIR, investment firms which execute transactions in financial instruments must report complete and accurate details of such transactions to the competent authority as quickly as possible, and no later than the close of the following working day (i.e. on a T+1 basis).

Content of reports

EMIR

The format of reports is set out in RTS and ITS relating to EMIR[20].

MIFIR

Table 2 (*Details to be reported in transaction reports*) of RTS 22 sets out the required format for reports.

Note in particular that:

(A) For transactions not carried out on a trading venue, the reports shall include a designation identifying the types of transactions in accordance with the measures to be adopted pursuant to Article 20(3)(a) and Article 21(5)(a)[21].

(B) For commodity derivatives, the reports shall indicate whether the transaction reduces risk in an objectively measurable way in accordance with Article 57 of MIFID II.

(C) Article 8 (*Identification of person or computer algorithm responsible for the investment decision*) of MIFIR requires that where a person or computer algorithm within an investment firm makes the **investment decision** to acquire or dispose of a specific financial instrument, that person or computer algorithm shall be identified. The investment firm shall only identify such a person or computer algorithm where that investment decision is made either on behalf of the investment firm itself, or on behalf of a client in accordance with a discretionary mandate given to it by the client.

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20 (i) Commission Delegated Regulation (EU) No 148/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards on the minimum details of the data to be reported to trade repositories; and (ii) Commission Implementing Regulation (EU) No 1247/2012 of 19 December 2012 laying down implementing technical standards with regard to the format and frequency of trade reports to trade repositories according to Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories.

21 These Articles set out requirements for ESMA to develop draft regulatory technical standards on (i) identifiers for the different types of transactions published under Article 20 of MIFIR, distinguishing between those determined by factors linked primarily to the valuation of the financial instruments and those determined by other factors and (ii) identifiers for the different types of transactions published in accordance with Article 21 of MIFIR, distinguishing between those determined by factors linked primarily to the valuation of the financial instruments and those determined by other factors.

(D) Article 9 (*Identification of person or computer algorithm responsible for execution of a transaction*) of MIFIR requires that where a person or computer algorithm within the investment firm which **executes a transaction** determines which trading venue, systematic internaliser or organised trading platform located outside the EU to access, which firms to transmit orders to or any conditions related to the execution of an order, that person or computer algorithm is to be identified.

Where to report to

EMIR

Under Article 9(1), counterparties in the EU and central counterparties ("**CCPs**") shall ensure that the details of any derivative contract they have concluded and of any modification or termination of the contract are reported to a trade repository registered in accordance with Article 55[22] or recognised in accordance with Article 77 of EMIR.

MIFIR

Under Article 26(1) of MIFIR, investment firms should report transactions to the relevant competent authority.

Note, however, in the case that an investment firm executes transactions wholly or partly through its branch, Article 12(1) of RTS 22 requires it to report such transactions to the competent authority of its home Member State unless otherwise agreed by the competent authorities of the home and host Member States.

Note also that in the case of a transaction executed by branch of a third country firm, Article 12(5) of RTS 22 requires such firm shall submit the transaction report to the competent authority which authorised the branch.

The EMIR Review

On 4 May 2017, the European Commission published various proposals to amend EMIR, (the "**EMIR Review**")[23] which, if implemented, would bring reporting obligation under EMIR closer to that under MIFIR. In particular, the EMIR Review reduces the burden of compliance by allowing legal liability to transfer to any entity to which responsibility for the reporting obligation has been delegated in a similar way to MIFIR:

- in respect of exchange-traded derivatives contracts, it is proposed that the CCP should have legal liability, for reporting on behalf of both counterparties (similar to MIFIR reporting via an ARM under Article 26(7) of MIFIR, as discussed above);
- in respect of a transaction between an financial counterparty and a non-financial counterparty below the clearing threshold, the FC would have legal liability for reporting on behalf of both counterparties to the transaction (similar to Article 26(1) of MIFIR which places the reporting obligation only investment firms authorised under MIFID II);
- the manager of a UCITS that is a counterparty to an OTC derivative contract would have legal liability for reporting on behalf of that UCITS; and
- an alternative investment fund manager would have legal liability for reporting on behalf of an alternative investment fund (AIF) that is a counterparty to an OTC derivative contract.

Note additionally that it is proposed that the requirement to backload historic transactions that were not outstanding on the starting date of the reporting obligation on 12 February 2014 should be deleted and that intragroup transactions where one where one of the counterparties is a non-financial counterparty should be exempted from the reporting obligation.

Reflections upon the proposed amendments to EMIR

Eduardo Barrachina

Background

Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") entered into force on 16 August 2012. Most of the obligations that EMIR imposes have, however, been subsequently developed by technical standards. Pursuant to Article 85(1) of EMIR, the European Commission was mandated, by August 2015, to review EMIR and to prepare a general report for submission to the European Parliament and Council.

EMIR was approved with the objective to reducing systemic risk by increasing the safety and efficiency of the OTC derivatives market. On 4 May 2017, the European Commission published a proposal to amend certain provisions of EMIR (the "**EMIR Review**")[24]. Although EMIR's prime objective is to reduce systemic risk, the last 5 years have

22 The list can be found here: https://www.esma.europa.eu/supervision/trade-repositories/list-registered-trade-repositories

23 https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-208_en

24 Available at: https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-208_en

shown that EMIR has imposed onerous and expensive obligations on certain market participants. Taking this into account, the EMIR Review aims to apply EMIR in a more efficient way by reducing certain regulatory requirements.

Germane to the EMIR Review, is the European Commission's proposal published on 13 June 2016 to develop a more robust supervision of central counterparties ("**CCPs**") (the "**CCP Proposal**")[25]. The CCP Proposal is directly linked to the broader EMIR Review in the European Parliament and introduces a more pan-European approach to the supervision of EU CCPs, to ensure further supervisory convergence and accelerate certain procedures. The CCP Proposal aims to ensure closer cooperation between supervisory authorities and central banks responsible for EU currencies. Both the EMIR Review and the CCP Proposal herald a new derivatives regulatory framework shaped not only by the previous crisis but also by the last 5 years of experience since EMIR came into force.

The main aim of the EMIR Review is to ease access to central counterparty clearing and improve transparency. The EMIR Review is particularly focused on small and medium-sized entities that have low volume trading and are nevertheless subject to unduly onerous requirements. However, it also introduces a significant change for securitisation special purpose entities ("**SSPEs**") since it reclassifies them as financial counterparties. It is envisaged that the EMIR Review, if approved in its current form, will require the European Securities and Markets Authority ("**ESMA**") to update or develop five technical standards.

Counterparty classification under EMIR is essential since it determines the set of obligations with which an entity will have to comply. Under EMIR, entities are primarily classified as "financial counterparties"[26] ("**FC**") or "non-financial counterparties"[27] ("**NFC**"), in each case established in the European Union ("**EU**"), or third country entities equivalent to FCs or NFCs. An NFC will be classified as an "**NFC+**" if the rolling average gross notional position over 30 working days of the OTC derivative contracts it has entered into (including all the OTC derivative contracts entered into by other NFCs within its group) has exceeded any of the following thresholds (with the result that the relevant entity will be classified as an NFC+):

- EUR 1 billion for equity or credit derivatives; or
- EUR 3 billion for interest rate, foreign exchange or commodities derivatives,

(in each case excluding eligible hedging transactions).

The key obligations under EMIR relate to (a) the clearing of OTC derivative contracts; (b) the reporting of OTC derivative contracts and exchange traded derivative contracts; and (c) risk mitigation requirements in respect of OTC derivative contracts not subject to clearing (which includes margin exchange).

An FC and an NFC will each have to comply with the above set of obligations. On the other hand, as long as the NFC does not exceed the above clearing threshold, it is subject to the reduced set of obligations under EMIR (in this case, the entity is referred to as "**NFC-**").

Summary of the key proposed amendments

SPVs subject to clearing and margin exchange

A material and unexpected[28] change included in the EMIR Review is the reclassification of SSPEs as FCs. The immediate consequence of this change is that SSPEs would have to comply with both the clearing obligation, subject to a threshold test, and margin exchange obligation. The EMIR Review, if it goes ahead, would change the definition of "*financial counterparty*" so that includes:

- *"a securitisation special purpose entity as defined in Article 4(1)(66) of Regulation (EU) No 575/2013 of the European Parliament and of the Council ("**CRR**")"*
- *"a central securities depository authorised in accordance with Regulation (EU) No 909/2014 of the European Parliament and of the Council"; and*
- *"an AIF as defined in Article 4(1)(a) of directive 2011/61/EU".*

In particular, Article 4(1)(66) of the CRR defines a SSPE as a:

"*a corporation trust or other entity, other than an institution, organised for carrying out a securitisation or securitisations, the activities of which are limited to those appropriate to accomplishing that objective, the structure of which is intended to isolate the obligations of the SSPE from those of the originator institution, and in which the holders of the beneficial interests have the right to pledge or exchange those interests without restriction.*"

25 Available at: http://ec.europa.eu/finance/docs/law/170613-emir-proposal_en.pdf

26 Investment firms, credit institutions, insurance/reinsurance undertakings, Undertakings for Collective Investment in Transferable Securities (UCITS) and their management companies, certain pension schemes and alternative investment funds managed by alternative investment fund managers, in each case authorised or registered in accordance with the relevant EU Directive.

27 Any entity which is not a FC and which is established in the European Union.

28 Surprisingly, this change was not included in the Impact Assessment on EMIR conducted by the European Commission. Executive Summary available at: https://ec.europa.eu/transparency/regdoc/rep/10102/2017/EN/SWD-2017-149-F1-EN-MAIN-PART-1.PDF

It is clear that the above definition captures only securitisation vehicles, such that special purpose vehicles which have a nature or purpose that differs from the scope of this definition will remain classified as NFCs[29].

This amendment is not qualified by any specific conditions that must be met before SSPEs are considered FCs. Likewise, the EMIR Review does not include any transitional provisions that confirm existing contracts entered into by SSPEs are excluded.

Pursuant to the classification provided by EMIR, SSPEs are currently classified as NFCs. This was also confirmed by ESMA which stated that "*securitisation special purpose vehicles do not meet the definition of financial counterparties and should be considered as non-financial counterparties for the purpose of EMIR*"[30].

The margin requirements set out in Article 11 of EMIR were promulgated pursuant to Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 (the "**Margin Rules**").[31] Therefore, the Margin Rules left SSPEs who had not exceeded the clearing threshold (i.e. NFC-s) outside the scope of any margin exchange obligation.

- **Clearing obligation**: By being reclassified as FCs, SSPEs will be subject to the broadest set of obligations under EMIR, which includes clearing of certain OTC derivative contracts. However, SSPEs may be able to benefit from a change that we will discuss more extensively below. If the EMIR Review is approved, FCs with small volume of trading activity will be able to benefit from a new clearing exemption, if the applicable aggregate notional amount is below the relevant clearing threshold. In principle, most SSPEs should be able to benefit from this exemption as typically they are only using OTC derivatives for hedging purposes.
- **Margin exchange obligation**: Article 10(2) of EMIR established the general framework of entities that are subject to margin exchange, which includes FCs and NFC+s as well as certain third country entities. This was subsequently developed by the Margin Rules.

The Margin RTS entered into force on 4 January 2017. From 4 February 2017, counterparties who each have a group aggregate average notional amount of EUR 3 trillion for non-cleared OTC derivatives have to post both initial margin ("**IM**") and variation margin ("**VM**") (with a phase-in for IM then commencing on such date through to 1 September 2020 for EUR 8 billion[32]). From 1 March 2017, all FC's and NFC+'s within scope became subject to the obligation to post VM in accordance with the Margin Rules[33]. VM is the minimum level at which counterparties must maintain margin and is based on a daily mark-to-market calculation IM is posted separately to cover potential losses due to a default.

The application of the Margin Rules to SSPEs will cause material issues in the European securitisation market and will restrict the ability of SSPEs to purchase obligations not denominated in the currency of the securitisation notes issued and/or hedge any interest rate risk relating to such notes. In addition, SSPEs will need to consider alternative financing to ensure they are able to post collateral.

For example, SSPEs may be structured so that cash reserves are established to allow for margin payments to be made. This would negatively affect how these entities work. A way to get round this problem may be by structuring these entities with one tranche only outside of the classification as an SSPE.

Alternatively, the originator or a third party liquidity provider could place cash for margining in the SSPE at the time of origination. The SSPE could then post its entire potential margin requirements from day one such that no daily posting is required. Or the SSPE could consider a party to act as an additional liquidity facility provider, specifically to provide margin when needed. However, third party arrangements may pose a number of credit risk issues for the liquidity provider since it will be only be relying on the collateral of the SSPE.

Since SSPEs will have to design alternative arrangements to comply with the Margin Rules, there is reasonable risk that various bespoke structures will begin to be implemented within the securitisation market adding additional layers of complexity and divergence between deals. No single solution

29 Article 4(1)(66) of the CRR refers to the definition of a 'securitisation' in Article 4(1)(61) wherein it is defined as a "*transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched*".

30 ESMA, Q&As, Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR). General Answer 3(iii), page 13, 3 April 2017. Available at: https://www.esma.europa.eu/press-news/esma-news/esma-updates-its-emir-qa-3

31 Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN

32 From 4 February 2017: any covered entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds EUR 3.0 trillion.
From 1 September 2017: any covered entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds EUR 2.25 trillion.
From 1 September 2018: any covered entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds EUR 1.5 trillion.
From 1 September 2019: any covered entity belonging to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives exceeds EUR 0.75 trillion.

33 See, however, the published forbearance advice applicable in the EU. This was described in our May 2017 edition of the Delta Report and can be found at: https://www.whitecase.com/publications/article/variation-margin-requirements-relief

will fit every securitisation structure, for each transaction often has unique features. It may, however, be that a common approach develops over time.

In addition, if this measure is approved, it is likely to negatively impact the current regulatory progress towards creation of a European securitisation framework (the "**Securitisation Regulation**")[34]. The European Parliament and the Council are currently considering a draft European Commission proposal for a securitisation regulation under which securitisation vehicles could be given exemptions from both the clearing and margin exchange requirements under EMIR, but only if the transactions qualify as "simple, transparent and standardized" securitisations ("**STS**") (i.e. securitisations meeting certain structural and legal requirements and not issuing any positions which do not meet these requirements). Treatment of non-STS securitisation vehicles will remain dependent on the vehicle falling below the clearing and margin thresholds applicable from time to time.

Currently, there would appear to be an inconsistency between the Securitisation Regulation and the EMIR Review as the former notes that it should not be necessary to apply the margin-exchange obligation to such arrangements since it is market practice that counterparties to securitisation swaps benefit from a senior ranking entitlement and the security package provided to senior creditors.

Potential consequences of the SSPE reclassification

Clearing	Margin
▫ Obligation to clear all types of OTC derivative contracts (it would not be able to benefit from the proposed new rule for NFCs which mandates clearing only in respect of the type of derivative contract in respect of which the applicable clearing threshold has been exceeded). ▫ If below the applicable clearing threshold, it would be exempted from clearing.	**IM**: from the relevant phase-in date, only if the aggregate month-end average notional amount of uncleared OTC derivative contracts of both the SSPE and its group is above EUR 8 billion. **VM**: will apply to all uncleared OTC derivative contracts. At present, it is unclear whether transitional provisions will allow grandfathering of existing contracts.

Changes in respect of clearing

Suspension of the clearing obligation

The EMIR Review would introduce a regime for suspension of the clearing obligation, in respect of a particular class of OTC derivative or type of counterparty, a mechanism which EMIR does not currently contemplate. Suspension of the clearing obligation may be effected only in three specific cases:

(i) the criteria that made a specific class of OTC derivative subject to clearing no longer apply;

(ii) a CCP is likely to cease clearing services for such particular class of OTC derivative and no other CCP is able to clear that class of OTC derivative without interruption; or

(iii) to avoid or address a serious threat to the financial stability of the EU.

Summary of the clearing suspension

Who makes the request to suspend?	ESMA
Is the request public?	No
Who makes the decision?	The European Commission
How long has the European Commission to respond?	Within 48 hours of the request
How is the European Commission's decision made public?	It will be published in the Official Journal of the EU, on the European Commission's website and in ESMA's public register
How long will the suspension be valid for?	3 months from the date of the publication in the Official Journal of the European Union
Can the suspension be extended?	Yes, for additional periods of 3 months without exceeding 12 months

The fact that the request is not made public may be problematic since the market will not be prepared for such

34 Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012

event. The OTC derivative market would benefit from greater transparency in respect of which classes of OTC derivatives or types of counterparty the clearing obligations may be suspended. In addition, a 3 month period, whilst it may provide flexibility to the regulators, in practice it may be disruptive since mandatory clearing of a specific asset class OTC derivative may be subject to continuous suspensions.

Exempting small FCs from clearing

The current classification of FCs and NFCs is fairly simple since it results in that as long as an entity is not listed as being authorised pursuant to a specific piece of European legislation, such entity will be an NFC-.

This approach is relatively straightforward and has the benefit of clarity. However, it is likely that a number of very small FCs with no significant hedging activity have been captured by the FC umbrella. For these types of entities, central clearing is not economically feasible because of the small volume of activity. These entities do not pose any systemic risk and yet are subject to the same regime as a large financial entity.

To benefit from the exemption proposed in the EMIR Review, an FC will have to calculate annually its aggregate month-end average position for the months of March, April and May[35]. If it exceeds any of the clearing thresholds, it will become subject to clearing for future OTC derivative contracts irrespective of the asset classes for which the relevant clearing threshold has been exceeded.

Please note that, in respect of FCs below the clearing thresholds, the EMIR Review would remove the requirement to clear certain transactions but will maintain the margin exchange obligation.

New calibration of clearing threshold for NFCs

The current Article 10(2) of EMIR mandates that the relevant clearing threshold of a NFC be calculated in respect of "*its rolling average position over 30 working days*". The EMIR Review suggests that for the purpose of calculating where the relevant threshold has been exceeded, the relevant period would be "t*he aggregate month-end average position for the months, March, April and May*". This will not affect the hedging exemption, i.e. OTC derivative contracts that constitute hedging will not be taken into account for the purposes of the calculation. If finally implemented, counterparties currently classified as NFCs will have to assess whether this new calibration period moves them above the relevant clearing threshold.

NFCs to clear only in respect of a particular type of OTC derivative contract

NFCs are generally corporates that enter into OTC derivatives for the purpose of hedging their exposure to a particular risk. This usually involves interest rate or currency exchange swaps. Their hedging activity is usually confined to market standard instruments and only to the extent that they must hedge a particular risk.

If an NFC exceeds the relevant clearing threshold it will become an NFC+ and therefore will be subject to the clearing as well as margin exchange obligation. EMIR currently does not distinguish between types of OTC derivatives, so once the clearing threshold for interest rate derivatives has been exceeded, such entity would have to clear any other classes of OTC derivatives, subject to mandatory clearing, e.g. foreign exchange and commodity derivatives, etc.

Under the EMIR Review, NFC+s would only have to clear OTC derivative contracts subject to mandatory clearing in respect of the asset classes where they exceed the applicable clearing threshold. This reduces the clearing burden on such NFC+ entities.

However, this will not affect the current margin regime. Once an NFC becomes an NFC+, it must comply with the applicable margin rules in respect of all types of OTC derivatives.

Removal of frontloading

The frontloading requirement is currently laid down in Article 4(1)(b)(ii) of EMIR. Frontloading is the obligation to clear OTC derivative contracts (pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation) entered into or novated on or after notification by a competent authority to ESMA on the authorisation of a CCP but before such clearing obligation takes effect, if they have a remaining maturity higher than the "*minimum remaining maturity*" determined in the relevant technical standards[36]. The EMIR Review proposes to remove this obligation and only apply the clearing obligation to those contracts entered into or novated on or after the date from which the clearing obligation takes effect.

Pension scheme arrangements – extension of the exemption

Certain pension scheme arrangements ("**PSA**") will benefit from a further 3 year (post entry into force) exemption from clearing, extendable by a further 2 years.

35 This will include all OTC derivative contracts entered into by the FC or by entities within the group to which such FC belongs.

Article 85(2) of EMIR mandates the European Commission to develop technical solutions for the transfer by PSAs of non-cash collateral as variation margins. However, no viable solution has been arranged yet which justifies the European Commission's decision to extend the exemption regime. Work on this issue will continue and will involve CCPs, PSAs, clearing members, ESMA and other European regulatory bodies.

A new "Fair, Reasonable and Non-discriminatory" requirement

Small and medium entities have had difficulties in accessing central clearing, either as a client or through indirect client arrangements. The European Commission has concluded that the requirement to facilitate indirect clearing on reasonable commercial terms has not been efficient.

The EMIR Review would therefore impose a stricter set of standards so clearing services will have to be provided and fair, reasonable and non-discriminatory commercial terms. These new measures will be imposed on clearing members in relation their clearing and indirect clearing offered to clients, and will be further elaborated in technical standards by ESMA.

Changes in respect of reporting

Under EMIR small and medium enterprises are subject to the same reporting obligations as that of FCs. In some cases, these requirements may result in disproportionate costs. The EMIR Review is looking at streamlining reporting for those entities that represent a low risk due to their trading volumes. The main drivers behind the proposed changes are to rationalise the reporting process by removing the obligation on NFC-s when facing FCs to report as experience shows that it is disproportionally expensive for NFCs or of little use to regulators. FCs would be responsible for reporting in this case.

The EMIR Review has introduced a change in practical and legal consequences for NFCs, which frequently are less familiar with the reporting obligation and must delegate such obligation to their FC counterparties. Under the EMIR Review, NFC-s would automatically delegate reporting to FC counterparties, with responsibility for report accuracy also falling on the FC.

Although in practice this is already the case (since parties typically enter into a reporting delegation agreement whereby the NFC delegates its reporting obligations to the FC), the liability and responsibility to report and the accuracy thereof remained on the side of the NFC.

Removal of the 'backloading' requirement

Backloading requires reporting of derivatives transaction entered into on or after 16 August 2012 but no longer outstanding on 12 February 2014. The EMIR Review recognises that backloading has resulted in a high reporting failure rate and poor quality of reported data. This measure has been adopted with a view to reducing costs and burdens on counterparties on reporting data that is unlikely to be used.

NFCs will not have to report their intragroup trades

As in the case of backloading, the same rationale applies here. As recent experience suggests, NFCs have low trading volumes which do not justify onerous reporting requirements. Although the "picture" of trading volumes will no longer be fully accurate due to less reporting, this should not affect the monitoring abilities of the regulators.

Next steps

The EMIR Review will now be discussed and amended by the European Parliament and the Council, with agreement likely in the second half of 2018 at the earliest. The delivery of technical standards is due 9 months after the entry into force of the EMIR Review. It is generally felt that this 9 month period is unlikely to be sufficient for ESMA to consider all the issues and amend the relevant technical standards. Entities will have to consider internally a number of potential changes and how they may impact them since the changes may take effect 20 days after publication in the Official Journal of the European Union.

Conclusions

It is clear that the rationale of the EMIR Review is indeed to rectify requirements imposed by EMIR that recent experience has shown were not necessarily helpful. Most notably, the EMIR Review will alleviate the burden on small and medium sized enterprises which will be subject to a more lenient regime. This will help them in reducing compliance costs.

However, more details and further discussion are required in respect of the proposed suspension of the clearing obligation, which lacks in transparency.

More importantly, the proposal to make SSPEs subject to the Margin Rules is likely to significant structural and commercial issues in the securitisation market and may also hamper the intended goal of transparency.

36 Please see Article 4 of Commission's Delegated Regulation (EU) 2015/2205 of 6 August 2015, Commission's Delegated Regulation (EU) 2016/1178 of 10 June 2016 and Commission's Delegated Regulation (EU) 2016/592 of 1 March 2016.

Summary of the proposed changes

Type of Entity Affected	Current EMIR position	Proposed EMIR position
NFC–s (SSPEs)	SSPE are classified as NFC–s as long as they do not exceed the relevant clearing threshold, in which case they become an NFC+	SSPEs will be classified as FCs
FCs	All FCs are subject to clearing	Only those FCs that exceed the relevant clearing threshold
NFCs	□ Clearing thresholds of NFCs calculated in respect of "its rolling average position over 30 working days"	□ Clearing thresholds of NFCs calculated in respect of "the aggregate month end average position for the months March, April and May"
	□ NFCs that exceed a particular threshold, must clear all OTC derivative contracts subject to clearing	□ Clearing obligation will only apply in respect of the asset class for which the clearing threshold has been exceeded
	□ No automatic reporting delegation to FC counterparties	□ Automatic reporting delegation to FC counterparties
	□ NFCs must report intragroup trades	□ No longer applicable
FCs and NFC	Backloading of reporting applies	No longer applicable
FCs and NFC+s	Frontloading of clearing applies	No longer applicable

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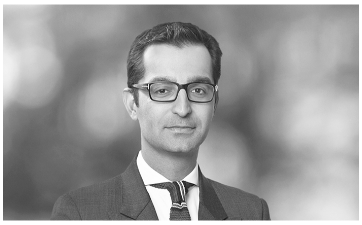

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