SLAUGHTER AND MAY

Fixing EMIR? The Commission's proposal

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Many firms have been focused in recent months on the impact of margining rules under the European Market Infrastructure Regulation ("**EMIR**") for non-cleared over-the-counter ("**OTC**") derivatives (see our December 2016 briefing for more details). The next significant phase of developments under EMIR is likely to result from the European Commission's legislative proposal to amend EMIR published on 4 May 2017.

The Commission's proposal aims to make the clearing obligations, risk-mitigation techniques and other rules under EMIR simpler and more proportionate and so reduce the compliance burden and associated costs for smaller financial services firms, corporates and pension funds. However, in its current form the Commission's proposal would significantly increase the burden on some entities, particularly securitisation issuers.

The proposal is currently being reviewed by the European Parliament. While it is not expected to take effect until 2018 at the earliest, it is not too soon to look at the proposed changes and consider how the proposal might steer the compliance agenda for various market participants. For details of the categorisation of market participants, please refer to our previous briefing.

Non-financial counterparties ("NFCs")

The scope and burden of compliance is expected to be reduced by the following changes:

- An NFC+ would only have to clear products that are subject to mandatory clearing where the NFC+ exceeds the clearing threshold for the asset class in question. Under the current regime, an NFC+ must clear all products that are subject to the clearing obligation if it exceeds the clearing threshold in any one asset class;

- intragroup transactions involving any NFCs will be exempted from the reporting obligation;

- the reporting burden for NFC- firms would be reduced compared to the current regime as the liability and responsibility for reporting would automatically be delegated to FC counterparties; and

- the frequency with which NFCs will be required to re-assess their status with regard to the clearing threshold will be reduced to once a year on the average activity over the months March, April and May. The current regime requires ongoing assessment on a 30-day rolling average position.

Hedging activities will continue not to count towards the clearing thresholds in respect of an NFC.

If these provisions become effective, NFCs above or near the clearing threshold should consider reviewing the size of their exposure in each class of derivatives that is subject to mandatory clearing. It is not yet clear whether firms will develop systems and procedures to treat NFC counterparties as NFC+ for a limited number of derivative classes.

Small financial counterparties

Financial counterparties ("**FCs**") with derivatives activity below the threshold levels applied for the purpose of the NFC+/- test will fall under a new category of "small financial counterparty" ("**FC-**"). FC- firms will be exempted from clearing. However, according to the current proposal, FC- firms will still be required to comply with margin rules for non-cleared OTC derivatives and other risk mitigation obligations.

A re-assessment of the entity's status with regard to the clearing threshold would need to be undertaken once a year (as is also proposed for NFCs, see above).

Unlike for NFC+ firms, the clearing obligation would apply to all classes of OTC derivatives once an FC has reached the threshold for one asset class.

The hedging exemption (when determining the clearing threshold) would not be available to FCs. In addition, an FC would need to include the notional amount of all derivatives contracts entered into by any member of the group to which it belongs when determining the clearing threshold calculation.

Securitisation issuers

In a significant departure from the current EMIR regime, the Commission has proposed that securitisation special purposes entities ("**SSPEs**") should be classified as FCs. This would catch a wide range of transactions including some private asset-backed transactions as well as public securitisations, as the term 'SSPE' refers back to the broad definition of 'securitisation' in the CRR.[1] Classifying securitisation issuers as FCs would potentially directly subject them to the EMIR clearing obligations and margin requirements for non-cleared OTC transactions.

This proposal has come as an unwelcome surprise to many in the market. Although in many cases the volume and nature of the derivatives entered into by an SSPE mean than it would not need to clear its trades, the SSPE would still be required to acquire and post margin under the non-cleared OTC margin rules. In particular, SSPEs with derivatives activity below the clearing threshold (which is EUR 3 billion for interest rate derivatives and foreign exchange derivatives[2]) would be given FC- status and so would not be subject to the clearing obligation, but this would not exempt them from the non-cleared OTC margin requirements.

In most cases SSPEs will not be in a position to post margin because, in order to maintain an efficient funding structure, there is typically no free cash or liquid assets left in the vehicle beyond specific, limited reserves. Likewise, the SSPE's cashflows are typically set up simply for hedging the mismatch between the receivables and obligations, not for the provision of collateral against market movements in the value of the hedging contracts.

Accordingly, if the Commission's proposal were introduced in its current form, securitisation structures might have to retain more cash to meet the collateral needs, introduce additional third-party liquidity, avoid hedging altogether or be restructured to minimize currency and interest rates mismatches. Each of these options may result in significant costs, an impact on ratings and a reallocation of risk. Whether existing trades would be subject to this new treatment for SSPEs will depend on whether grandfathering is available: under the current proposal, it is not. In either case, it would seem likely that some transactions would cease to be economically viable.

The impact of the Commission's proposal would be lower for certain transactions if the proposed new EU Securitisation Regulation is implemented at the same time. The current draft Securitisation Regulation exempts transactions which qualify as "simple, transparent and standardised" ("**STS**") securitisations from both the clearing and (to some extent) margin requirements under EMIR. However, some classes of securitisation, such as CLOs, would not fall within the STS and would not benefit from this exemption.

The Commission's proposal would not affect asset-backed financing vehicles which for technical reasons fall outside the definition of an 'SSPE', for example repackaging vehicles that do not issue multiple tranches of debt. This may create a greater incentive for the use of such vehicles.

As a final observation, this part of the Commission's proposal appears inconsistent with the promotion of the greater use of securitisation an alternative funding mechanism, which is part of the Commission's capital markets union initiative. It may therefore be that the combination of industry reaction and other political

[1] Regulation (EU) No 575/2013.

[2] Note that the hedging exemption available to NFCs would not apply to SSPEs.

pressures will result in the SSPE proposal being re-considered.

Alternative investment funds (AIFs)

Currently only AIFs managed by a manager authorized or registered under Alternative Investment Fund Managers Directive ("**AIFMD**") are FCs. The proposal suggests that all AIFs registered under national law (that is, including third country funds) will be classified as FCs, with no mention of the requirement for a regulated manager and regardless of the regulatory regime applicable at fund or manager level.

This change, if it becomes part of legislation, would bring many more entities directly within the scope of clearing, margining and other obligations under EMIR.

The proposal will also clarify that (as is the case for UCITS) the manager is responsible, and legally liable, for reporting the details of OTC derivative contracts entered into by or on behalf of the AIF they manage.

Pension schemes

A viable technical solution has not yet emerged for the transfer by pension schemes of non-cash collateral in order to satisfy variation margin requirements. As such, the Commission has in the past twice extended the exemption for clearing under EMIR for pension funds, with the stated aim of allowing time for the development of a solution that enables pension schemes to participate in central clearing without negatively impacting pensioner revenues. The current exemption will expire in August 2018. The Commission's proposal would extend the existing temporary exemption by three years, with the option of a further two-year extension. It remains to be seen whether this will give enough time for a workable solution to be found.

Other proposed changes

There are a number of other changes put forward in the proposal and we outline a few of these below:

- capturing central securities depositories, UCITS and investment firms falling within MiFID II[3] instead of MiFID I[4] in the definition of FC;
- requiring institutions which offer clearing services to do so under fair, reasonable and non-discriminatory (FRAND) commercial terms; and
- clarification that assets and positions recorded in client accounts would not be used as part of the CCP or clearing member's insolvency, which may increase incentives for smaller counterparties to clear their swaps on a voluntary basis;
- removing the existing "front-loading" requirement (which has applied to clearing members and FCs trading high volumes of derivatives) and removing the back-loading obligation to report historic data;
- expanding the technical standards governing margining for non-cleared OTC transactions to include upfront supervisory approvals; and
- developing technical standards in relation to reporting standards and formats.

[3] Directive 2014/65/EU

[4] Directive 2004/39/EC

If you would like to discuss further, please do not hesitate to contact a member of our team.

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