# EMIR Refit Regulation—Impact on Asset Managers

**May 13, 2019**

The EU legislative process for the review of EMIR (the Regulation on OTC derivative transactions, central counterparties (CCPs) and trade repositories (648/2012)) (the "EMIR Refit Regulation"[1]) is almost complete, with publication on 6 March 2019 by the Council of the European Union of the final text.

This note focuses on the impact of the EMIR Refit Regulation on non-EU investment managers and funds. By broadening the definition of "Financial Counterparty", the EMIR Refit Regulation brings into scope EU funds managed by non-EU managers (as EU Financial Counterparties) and, prospectively, non-EU funds managed by non-EU managers (as "hypothetical" EU Financial Counterparties), with the consequence that those funds may be subject to the requirements to exchange margin for their uncleared derivative trades under EMIR. Non-EU funds managed by non-EU managers (for instance, US managed hedge funds) that trade with EU dealers may be subject to these requirements for the first time—although private equity funds that only enter into derivatives that are physically settled FX forwards will continue to be out of scope of EMIR margining rules, as the EMIR Refit Regulation confirms that these types of trades are exempt.

Debevoise & Plimpton

In addition, EMIR introduces a new category of "Small" Financial Counterparties that may exempt EU and non-EU funds from the mandatory clearing obligation.

## Timing of Entry into Force

The EMIR Refit Regulation will enter into force and apply 20 days after its publication in the European Union's Official Journal, although certain new requirements for central counterparties and trade repositories have delayed application. In a public statement given on 28 March 2019, ESMA expects the final text could be published in the Official Journal as early as May 2019 and thus enter into force at the end of May 2019.

[1] "REFIT" refers to the European Commission's Regulatory Fitness and Performance programme.

## Changes to "Financial Counterparty" Definition

### Change to Treatment of EU Alternative Investment Funds

In relation to investment funds, EMIR's Financial Counterparty ("FC") definition currently covers alternative investment funds ("AIFs") managed by alternative investment fund managers ("AIFMs") authorised or registered under the Alternative Investment Fund Managers Directive (the "AIFMD")—currently only encompassing EU AIFMs, as only EU AIFMs may be authorised or registered under the AIFMD.

Under the EMIR Refit Regulation, the definition of Financial Counterparty will comprise (i) all EU AIFs (regardless of whether the AIFM is established in the EU) and (ii) all AIFs (EU or non-EU) managed by an AIFM authorised or registered under the AIFMD.

Non-EU investment advisors directly managing EU AIFs (as the "AIFM") that previously classified the AIF as a Non-Financial Counterparty ("NFC") will therefore need to ensure compliance by the AIF with those EMIR obligations that apply to Financial Counterparties. As a consequence, EU AIFs that were categorised as Non-Financial Counterparties above the clearing threshold ("NFC+") (by reference to the volume of over-the-counter ("OTC") derivative contracts entered into by them and other non-financial entities in their group), which are now categorised as Financial Counterparties ("FC") above the clearing threshold ("FC+") will continue to be subject the clearing and margining obligations (the same obligations that applied to them, when categorised as NFC+). However, AIFs that were categorised as Non-Financial Counterparties below the clearing threshold ("NFC-") (and, as such, outside the margining requirements) and are now categorised as FC below the clearing thresholds ("FC-" ) will become newly subject to the obligation to exchange regulatory margin for uncleared transactions.[2]

### Change to Treatment of Non-EU Alternative Investment Funds and Non-EU Managers

The change to the definition of "Financial Counterparty" may also affect the status of non-EU AIFs with non-EU AIFMs. These will remain as third country entities ("TCEs") and will not be directly subject to EMIR obligations unless they transact with EU counterparties or in other circumstances where there is a "direct, substantial and foreseeable effect" within the EU (e.g. where one of the parties has a branch or guarantor in the European Union). Where they are subject to EMIR obligations, TCEs

---

[2] Commission Delegated Regulation (EU) 2016/2251 with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty.

must determine their own hypothetical classification under EMIR (as FC or NFC) in order to determine the obligations that apply to them.

As a result of the new definition, which treats all EU-established AIFs as FCs, it is likely that a non-EU AIF will be treated as a hypothetical FC, because the categorization applicable to it, if it were established in the EU, would be an "FC." There is no regulatory guidance yet as to whether that was indeed the purpose of the change—and this conclusion is subject to any regulatory guidance to the contrary. If the change in hypothetical classification is correct, a non-EU AIF with a non-EU AIFM, when trading with EU FCs (such as EU dealers), may find that the EU dealer will require exchange of margin for uncleared transactions under its new classification. This will not depend on the non-EU fund exceeding the clearing threshold—while an FC- is exempted from clearing requirements, it is still subject to mandatory exchange of margins under EMIR.

The EMIR "equivalence" doctrine continues to permit third country entities to satisfy such clearing and margining requirements by complying with clearing and margining requirements in jurisdictions that are deemed to be equivalent to EMIR (e.g., clearing and margining requirements under U.S. regulations).

Note that special purpose vehicles ("SPVs") established by EU or non-EU AIFs will continue to be treated as NFCs.

## New Clearing Threshold for Small Financial Counterparties

To provide regulatory relief to those FCs with a low volume of derivatives who would otherwise have to clear their derivatives under EMIR, the EMIR Refit Regulation introduces a new category of Financial Counterparties below the clearing threshold ("FC-") that will be exempted from the mandatory clearing requirement.

The status of FC- is available to both FCs and TCEs that are hypothetical FCs. To benefit from this exemption, an FC or hypothetical FC must calculate the notional value of all OTC derivative contracts entered into by it and members of its group on an annual basis, and if such notional value falls below the clearing thresholds for all asset classes of derivatives currently applicable to an NFC,[3] such FCs or hypothetical FCs can be treated as FC-s that are exempted from mandatory clearing. Unlike NFCs, FCs and hypothetical

[3] The current clearing thresholds for NFCs are: credit derivatives—gross notional value of EUR1 billion; equity derivatives—gross notional value of EUR1 billion; interest rate derivatives—gross notional value of EUR3 billion; foreign exchange—gross notional value of EUR3 billion and commodity derivatives and other OTC derivatives—gross notional value of EUR3 billion.

FCs cannot exclude derivatives transactions entered into for hedging purposes from the FC- determination.

However, if an FC- exceeds the clearing threshold for any asset class of derivative, it must immediately notify the European Securities and Markets Authority ("ESMA") (and its relevant competent authority) and, within four months, establish clearing arrangements for derivatives in all asset classes, and clear those trades (in classes of OTC derivatives subject to the clearing obligation) in respect of trades entered into or novated more than four months after the date of notification. FCs (and NFCs) that elect not to perform the annual determination to establish whether their derivatives volume exceeds the applicable clearing thresholds will be treated as having exceeded the clearing threshold for all classes of derivative and will be required to clear.

Note that while FCs (and NFCs) generally make this calculation at group level, it is clarified that, for a fund, the positions are calculated only at the level of the fund. An AIFM will therefore not need to aggregate positions amongst all funds under management, although it will need to aggregate trades entered by an AIF and by any SPV owned by the AIF for this calculation.

It is unknown whether EU or non-EU counterparties will classify themselves as FC- in practice. An FC- must exchange margin when facing an EU dealer for any trade that it does not clear—acting as a disincentive to trade in uncleared derivatives. Non-EU counterparties that are exempt from local clearing obligations may decide to classify themselves as FC- and thereby avoid the EMIR clearing obligation, in circumstances where they comply with EMIR as an equivalent regime to local law by way of substituted compliance.

In a statement issued in January 2019, ESMA noted that the phase-in for clearing for "Category 3 counterparties" under existing rules in EMIR will apply on 21 June 2019, which may be before the EMIR Refit Regulation (with its new category of small FCs) applies—meaning that there may be a period when FC-s will need to clear derivative contracts before they are no longer required to do so under the EMIR Refit Regulation. In that regard, ESMA expects competent authorities not to prioritise supervisory actions and show regulatory forbearance towards those FCs whose positions are expected to be below the clearing threshold under the EMIR Refit Regulation.

Separately, the "frontloading" requirement to clear OTC derivatives entered before the clearing obligation under EMIR comes into effect (where the relevant derivative has a prescribed minimum remaining maturity) has been removed.

## Change to Clearing Threshold for Non-Financial Counterparties

The EMIR Refit Regulation changes the way the clearing threshold for NFCs is calculated and applied. An NFC will become subject to the clearing obligation if its aggregate month-end average position for the previous 12 months exceeds the clearing thresholds, with this calculation made annually. The current test in EMIR is whether the rolling average position over 30 working days exceeds the thresholds. ESMA has stated (in its public statement of 28 March 2019) that NFCs should be ready to apply this new calculation on the date that EMIR Refit Regulation enters into force.

The EMIR Refit Regulation also amends EMIR so that the clearing obligation will apply only for the asset class or classes for which the NFC has exceeded the clearing threshold. Currently, if an NFC exceeds the clearing threshold in respect of one asset class, it becomes subject to the clearing obligation for all asset classes.

## Summary of EMIR Obligations on "Financial Counterparty" and "Non-Financial Counterparty"

Under EMIR, EU FCs are required to:

- report OTC derivative trades to a trade repository;
- comply with the full set of "risk mitigation" requirements for uncleared derivatives (including the exchange of regulatory margin), when trading with other FCs and NFCs that exceed certain thresholds calculated by reference to the OTC derivative contracts entered into by them and other non-financial entities in their group (the clearing threshold) ("NFC+s"); and
- clear derivative transactions in those asset classes that have been designated as required to be cleared, when trading with other FCs and NFC+s.[4] By contrast, EU NFCs that are subject to clearing will only be required to clear trades in those asset classes for which they exceed the clearing threshold.

EU NFCs are subject to the same reporting requirement as FCs, but are only subject to risk mitigation obligations relating to the exchange of margin and to mandatory clearing if they exceed the clearing threshold (and, as in the case of FCs, trade with other FCs or NFCs+).

---

[4] Various interest rate and credit default derivatives have been designated as eligible to be cleared.

When EU counterparties trade with non-EU counterparties, EU counterparties must determine the hypothetical classification under EMIR (as FC or NFC) of those non-EU counterparties in order to determine the obligations that apply. As outlined above, EU dealers that trade with non-EU AIFs managed by non-EU AIFMs may take steps to change the hypothetical classification of these counterparties, with consequential changes to margining requirements.

See the table below for the changes to classification and EMIR obligations.

| **Fund counterparty** | | **EMIR classification** | | **Reporting obligation** | | **Margin obligation** | | **Clearing obligation** | |
|---|---|---|---|---|---|---|---|---|---|
| | | **Current** | **EMIR Refit** | **Current** | **EMIR Refit** | **Current** | **EMIR Refit** | **Current** | **EMIR Refit**[5] |
| **EU AIFM** | **EU AIF** | FC | | Obligation applies | | Obligation applies | | Obligation applies | Obligation applies if above clearing threshold (FC+) |
| | **Non-EU AIF** | | | | | | | | |
| **Non-EU AIFM** | **EU AIF** | NFC | FC | Obligation applies | | Obligation applies if above clearing threshold (NFC+) | Obligation applies | Obligation applies if above clearing threshold (NFC+) | Obligation applies if above clearing threshold (FC+) |
| | **Non-EU AIF** | Third country entity and hypothetical NFC | Third country entity and hypothetical FC | No | | Indirectly applies if hypothetical NFC+ and when trading with EU FC or NFC+ | Indirectly applies when trading with EU FC or NFC+ | Obligation applies if hypothetical NFC+ and when trading with EU FC or NFC+ | Obligation applies if hypothetical FC+ and when trading with EU FC+ or NFC+ |

[5] This table assumes all AIFs will be either FCs or hypothetical FCs (NFC+ are also subject to clearing obligations in those asset classes for which they exceed the clearing threshold)."

## Treatment of Physically Settled FX Derivatives

Under a new recital in the EMIR Refit Regulation, the mandatory exchange of collateral as variation margin for physically settled FX forwards and physically settled FX swaps will only apply to transactions between "the most systemic counterparties". Earlier drafts of the Regulation specified these counterparties as EU credit institutions and investment firms. This brings EMIR into line with the approach in other jurisdictions. FCs and NFCs+ that have to date traded physically settled FX forwards and swaps on an uncollateralised basis (on the basis of regulatory forbearance) will continue to be able to do so.

## Changes to Reporting Requirements

There are a number of notable changes to the reporting requirement:

- There is a new exemption from the reporting obligation for intra-group transactions which applies where at least one of the counterparties is an NFC (or hypothetical NFC if it is a third country entity).

- EU FCs will be responsible and legally liable for reporting trades on behalf of both counterparties when they execute a trade with an NFC- (although an NFC- can continue to report if it wishes). This provision applies 12 months from the date of entry into force of the EMIR Refit Regulation. If an NFC- faces a third country entity, the NFC- is exempt from reporting the trade where the third country entity has reported the trade under a regime treated as equivalent to EMIR.

- There is also a statement that the AIFM of a fund is now responsible and legally liable for reporting OTC derivatives on behalf of the fund counterparty.

* * *

Please do not hesitate to contact us with any questions.

## NEW YORK

Byungkwon Lim
blim@debevoise.com

Jeff Robins
jlrobins@debevoise.com

Emilie T. Hsu
ehsu@debevoise.com


## LONDON

Patricia Volhard
pvolhard@debevoise.com

John Young
jyoung@debevoise.com