

EMIR REFIT: Bringing the EU and the US Closer Together?

EMIR REFIT came into force on 17 June 2019, helping to level the playing field between the EU and the US.

Key Points:

- Alternative investment funds will bear the brunt of the changes as EMIR REFIT closes an exemption many have relied upon for years to avoid mandatory clearing and margining of OTC derivatives. For such entities there is no grandfathering for existing trades.
- Small financial counterparties and non-financial counterparties benefit from relief with respect to several obligations they originally faced under EMIR.
- Many of these changes bring the EU and US regulatory regimes into closer alignment.

Almost seven years after the publication of the European Market Infrastructure Regulation (EMIR)¹ — the greatest regulatory overhaul of the European derivatives market — EMIR REFIT² has been introduced with the aim of making EMIR simpler and more proportionate, and reducing regulatory and administrative burdens.³ Several of these changes bring more consistency with equivalent US regulation.

Financial counterparties

Funds

Prior to EMIR REFIT, alternative investment funds (AIFs) were only captured in the category of “financial counterparties” under EMIR if they had a manager authorized or registered under EU regulation.⁴ This classification exempted many AIFs from margining and clearing under EMIR as this meant that:

- AIFs could be established in the EU but not count as a financial counterparty (so long as they had a non-EU manager).
- AIFs with a non-EU manager did not count as entities that would be financial counterparties if they were established in the EU for the purposes of categorizing their status when trading with EU entities.

Following EMIR REFIT, this exemption has closed and all AIFs established in the EU are now financial counterparties (even if the manager is non-EU), as well as AIFs with a manager authorized or registered under EU regulation (EU AIFs).⁵ As a result all EU AIFs are subject to mandatory margining for uncleared over-the-counter (OTC) derivatives and clearing (but, in the case of clearing, only if they breach the clearing threshold). Moreover, non-EU AIFs now also have to comply with the same margining and clearing requirements when trading with EU banks. There is no grandfathering

for existing trades, which has placed a heavy burden on market participants who faced an immediate deadline for compliance of 17 June 2019.

Broadly speaking, this change brings closer alignment with the US position, which generally considers all AIFs trading with US banks as “financial end-users” subject to margining requirements and “financial entities” subject to clearing requirements, regardless of where they are jurisdictioned or what licenses they have. Moreover, US AIFs that were trading with EU banks and thereby avoiding margining will no longer be able to benefit from such regulatory mismatch between the US and the EU.

Securitization special purpose entities

Following industry lobbying, securitization special purpose entities (and also AIFs for employee share purchase plans) are excluded from the definition of financial counterparty,⁶ meaning that — as non-financial counterparties — mandatory margining and clearing will only apply if they breach the relevant thresholds.

Small financial counterparties

Small financial counterparties below the clearing thresholds (the same thresholds that apply for non-financial counterparties) are no longer required to clear. Whether a financial counterparty is below the clearing thresholds will be based on the aggregate month-end average OTC derivative contracts position for the previous 12 months (calculated by reference to all entities in its group, or in the case of undertakings for collective investments in transferable securities (UCITS) and AIFs at the level of the fund). Once a financial counterparty breaches a clearing threshold for any asset class, it must clear all in-scope asset classes (unlike non-financial counterparties).⁷

Unlike non-financial counterparties, small financial counterparties still need to margin under EMIR regardless of whether they breach the clearing thresholds.

Notably, under US regulation, certain small financial institutions are exempt from clearing requirements.

Pension funds and central securities depositories

Pension schemes have a further two-year extension (to 18 June 2021) of relief from the clearing obligation.⁸ Existing margin requirements on pension schemes are not amended.

Central securities depositories are now financial counterparties,⁹ and therefore subject to mandatory margining and (if they breach the clearing threshold) clearing under EMIR.

Non-financial counterparties

Clearing and margin thresholds

Non-financial counterparties above the clearing thresholds will only need to clear the relevant asset class of OTC derivative contracts for the threshold exceeded (instead of all in-scope asset classes).¹⁰

Once a non-financial counterparty breaches a clearing threshold for any asset class, it must margin all asset classes of OTC derivative contracts under EMIR. This requirement was originally the case under EMIR, but is stricter than earlier proposals during the discussion phase of EMIR REFIT when it was suggested that a non-financial counterparty would only be required to margin an asset class if such non-financial counterparty breached the clearing threshold for that particular asset class.

The calculation of whether a non-financial counterparty is above or below the clearing threshold will be made yearly (by looking at its aggregate month-end average position in OTC derivative contracts

for the previous year), instead of over a rolling 30 days (as was the case under EMIR originally), with the first calculation being made on 17 June 2019.¹¹

Application of variation margin to physically settled FX swaps and forwards

Rules are expected to be introduced so that mandatory variation margin for physically settled foreign exchange (FX) swaps and forwards only apply to transactions between the most systemic counterparties going forward, which should offer relief for non-financial counterparties.¹² This is set out in the recitals but not the body of EMIR REFIT. As such, delegated acts are expected to be published separately making this change.¹³

As a point of comparison, under US regulation, physically settled FX swaps and FX forwards are exempt entirely from margining requirements.

Reporting

Instead of each party to an OTC derivative contract being independently responsible for ensuring reporting is carried out (as was originally the case under EMIR), financial counterparties will be solely responsible for reporting trades both for themselves and on behalf of their counterparties who are non-financial counterparties below the clearing threshold going forward (unless such non-financial counterparty chooses to report for itself).¹⁴ This change will take effect from 18 June 2020.¹⁵ This will align the EU position with the current position under US regulation, which treats the swap dealer as the sole reporting party in this scenario.

Intragroup derivative contracts involving at least one non-financial counterparty (without a financial counterparty parent) will no longer need to be reported (provided that both entities are included in the same consolidation on a full basis; both entities are subject to centralized risk evaluation, measurement, and control procedures; and the relevant competent authorities are notified).¹⁶ This change is likely to ease a key regulatory burden on corporate groups.

Amendments affecting all counterparty types

Other key amendments under EMIR REFIT include:

General changes to clearing

- Henceforth, only OTC derivative contracts that have been entered into after the clearing obligation takes effect will need to be cleared (*i.e.*, there will no longer be frontloading).¹⁷
- Clearing services must be provided under “fair, reasonable, non-discriminatory and transparent” terms (including as to fees),¹⁸ with effect from 18 June 2021.¹⁹ The European Commission is empowered to adopt delegated acts setting out the conditions under which commercial terms will be considered “fair, reasonable, non-discriminatory and transparent.”²⁰
- The European Commission may temporarily suspend clearing for a specific OTC derivative asset class, or a specific type of counterparty, for up to three months (*e.g.*, if clearing houses cease clearing that asset class, or to avoid a threat to financial stability). Such suspension could be extended for further three-month periods up to a total suspension period of 12 months.²¹
- By 18 December 2020, the European Commission shall prepare a report assessing whether trades resulting from compression should be exempt from clearing, and whether EMIR / Markets in Financial Instruments Regulation (MIFIR)²² reporting could be reduced or simplified for non-OTC transactions.²³

- With effect from 18 December 2019,²⁴ Member States' national insolvency laws should not prevent assets in client clearing accounts of clearing houses from being applied separately from assets of defaulting clearing members, in accordance with EMIR.²⁵

General changes to reporting

- Backloading of derivative contract reporting will cease to apply (*i.e.*, only trades outstanding on or entered into after the reporting obligation came into effect on 12 February 2014 need to be reported, instead of 16 August 2012 as originally required under EMIR).²⁶

Conclusion

Non-financial counterparties and small financial counterparties benefit most from EMIR REFIT, whereas many AIFs will find themselves newly subject to mandatory margining and (if they breach the clearing threshold) clearing of OTC derivative contracts.

The position under EU regulation is now more closely aligned with US regulation in respect of small financial counterparties, physically settled FX swaps and forwards, trade reporting, and AIFs. Most notably, US AIFs that were trading with EU banks, thereby avoiding margining that would have applied if they were trading with US banks, will no longer be able to take advantage of such regulatory difference.

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Endnotes

- 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 (EMIR).
- ² [Regulation \(EU\) 2019/834](#) of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories, and the requirements for trade repositories (EMIR REFIT).
- ³ Recital 2 of EMIR REFIT.
- ⁴ Article 2(8) of EMIR.
- ⁵ Article 1(1) of EMIR REFIT.
- ⁶ Article 1(1) of EMIR REFIT.
- ⁷ Article 1(3) of EMIR REFIT.
- ⁸ Article 1(26) of EMIR REFIT.
- ⁹ Article 1(1) of EMIR REFIT.
- ¹⁰ Article 1(8)(a) of EMIR REFIT.
- ¹¹ Article 1(8)(a) of EMIR REFIT.
- ¹² This follows on from the [statement from European Supervisory Authorities dated 24 November 2017](#), containing a proposal to amend the EMIR variation margin requirements to capture only transactions between credit institutions and investment firms, and stating that until such time as the amendments take effect, the European Supervisory Authorities expect competent authorities to "apply their risk-based supervisory powers in their day-to-day enforcement of applicable legislation in a proportionate manner."
- ¹³ Recital 21 of EMIR REFIT.
- ¹⁴ Article 1(7)(b) of EMIR REFIT.
- ¹⁵ Article 2(b) of EMIR REFIT.
- ¹⁶ Article 1(7)(a) of EMIR REFIT.
- ¹⁷ Article 1(2)(a)(ii) of EMIR REFIT.
- ¹⁸ Article 1(2)(b) of EMIR REFIT.
- ¹⁹ Article 2(c) of EMIR REFIT.
- ²⁰ Article 1(2)(b) of EMIR REFIT.
- ²¹ Article 1(6) of EMIR REFIT.
- ²² [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 (MIFIR).
- ²³ Article 1(24)(c) of EMIR REFIT.
- ²⁴ Article 2(a) of EMIR REFIT.
- ²⁵ Article 1(11) of EMIR REFIT.
- ²⁶ Article 1(7)(a) of EMIR REFIT.