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EMIR REFORM PROPOSALS – THE STING IN THE TAIL FOR SECURITISATIONS AND ALTERNATIVE INVESTMENT FUNDS

The European authorities have had to concede on a number of occasions that the pace of derivatives regulatory reform has been more rapid than many users of derivatives have been able to deal with. At the end of February this year the European Supervisory Authorities gave limited forbearance on the obligation to exchange variation margin.[1] More recently, the mandatory clearing obligation for financial counterparties and alternative investment funds with under €8bn in outstanding derivatives was confirmed to be delayed until June 2019, as had been recommended by ESMA last year.[2]

In this context, it was to be hoped that the European Commission's recent proposals[3] for public consultation following its mandatory review of the operation of EMIR[4] would result in a further relaxation of some of the more onerous obligations. Indeed, the Commission's proposals do contain a great deal that will be welcomed by market participants in reducing burdens. However, alongside these welcome changes, the Commission has made proposals that would impose considerably greater burdens on securitisation special purpose entities, and which would increase obligations for a number of alternative investment funds.

THE THRESHOLD FOR CLEARING OF OTC DERIVATIVES

Non-financial counterparties are subject to mandatory clearing of OTC derivatives if their volumes of those OTC derivatives are above thresholds that apply for different types of derivatives. The thresholds are:

- Credit derivatives: €1bn
- Equity derivatives: €1bn
- Interest rate derivatives: €3bn
- Foreign exchange derivatives: €3bn
- Commodity and other derivatives: €3bn

NFCs that exceed any of the thresholds are known as "NFCs+", and those that are below the thresholds are known as "NFCs-".

RECLASSIFICATION OF SECURITISATION SPECIAL PURPOSE ENTITIES

The Commission proposes that securitisation special purpose entities (SSPEs) be classified as financial counterparties (FCs), rather than non-financial counterparties (NFCs) as they typically are currently.

This change would subject SSPEs to greater regulation under EMIR, as FCs attract the most onerous obligations. The increase in obligations will be particularly stark for SSPEs that are currently NFCs below the mandatory OTC derivative clearing thresholds, known as "NFC-". (The thresholds for clearing are set out in the box opposite.)

An SSPE that currently is an NFC- does not have to clear OTC derivatives centrally nor exchange variation margin on uncleared OTC derivatives, though it still has to trade report and agree risk mitigation measures with counterparties.

If SSPEs are reclassified as FCs as currently proposed, SSPEs will need to meet greater risk mitigation obligations regarding uncleared OTC derivatives. Most significantly, SSPEs would need to exchange variation margin on uncleared OTC derivatives entered into on or after 1 March 2017. As SSPEs typically lack available excess assets that could be provided as collateral, the variation margin requirement would be likely to have a serious adverse effect on the viability of many SSPEs. In view of the funding impact of having to provide variation margin, Moody's has released a report stating the Commission's proposal is "credit negative" for SSPEs.[5]

The difficulty of satisfying the obligation to exchange variation margin could force users of securitisations to turn to other means of finance, such as private placements of debt through special purpose vehicles that do not meet the definition of an SSPE. A move to private placements would likely mean reduced transparency on market activity for the regulators.

Discouraging securitisation runs counter to the European Commission's own proposals to boost high-grade securitisation[6] on which the Council of the EU and the European Parliament

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[1] The statements of the regulatory authorities with regard transitional relief have been collated by the International Swaps and Derivatives Association here

[2] *Commission Delegated Regulation (EU) 2017/751 of 16 March 2017 amending Delegated Regulations (EU) 2015/2205, (EU) 2016/592 and (EU) 2016/1178 as regards the deadline for compliance with clearing obligations for certain counter parties dealing with OTC derivatives*

[3] *Proposal for a Regulation of the European Parliament and of the Council 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 derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories* (COM/2017/0208)

[4] *Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories*

[5] *"European Commission Proposal to Include Securitisation Swaps in Margining Rules Is Credit Negative"* by Moody's Investors Service, 11 May 2017

[6] *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* (COM(2015) 472 final)

reached an agreement on 30 May 2017[7]. It is to be hoped that the Commission recognises the unwanted effect of the proposal on the securitisation market and modifies it to alleviate their impact.

INCREASED OBLIGATIONS ON ALTERNATIVE INVESTMENT FUNDS

Alternative investment funds[8] (AIFs) are currently only categorised as FCs if they have a manager that is authorised or registered under AIFMD. Other AIFs are classed as NFCs (if they themselves are within the EU) or "deemed the equivalent" of NFCs (if outside the EU). A non-EU entity that is deemed equivalent of an NFC or FC is not obliged to comply with EMIR directly, but the deemed equivalent status of the non-EU entity can result in a different level of obligations being imposed on any EU counterparty to that entity.

The Commission now proposes that all AIFs be categorised as FCs, regardless of the jurisdiction of the AIF.

As currently drafted, the proposal treats non-EU AIFs with non-EU managers as direct FCs, rather than treating them as third-country deemed equivalents to FCs. This approach implies that an AIF with no direct connection with the EU would be obliged to comply with EMIR directly. It is unusual for EU legislation to seek to impose direct obligations on entities with no connection to the EU and it would make enforcement by EU regulatory authorities problematic. We expect that the application of EMIR to entities with no direct connection to the EU is unintended, and so the proposal will be modified such that AIFs that are neither incorporated in the EU nor have an EU manager are reclassified as third-country deemed equivalents to FCs rather than direct FCs.

Assuming that the proposal is modified as we suggest it will, the reclassification of AIFs as FCs would lead to the following changes:

- An EU NFC- AIF that is reclassified as an FC would now be directly obliged to exchange variation margin.
- A third-country NFC- AIF that is reclassified as a deemed FC and that faced an EU FC or NFC+ could expect that its EU counterparty will request that the parties agree contractually to exchange variation margin, so that the EU counterparty can meet its EMIR obligations.
- The required frequency of derivatives portfolio reconciliation would increase for an EU AIF that had been NFC-; and an EU FC or NFC+ facing a third-country AIF that had been an NFC- would similarly require that the AIF engage in more frequent reconciliation.
- As an FC, an EU AIF would also need to:
  - Put in place risk management policies and procedures that underpin the requirement to exchange variation margin.
  - Report and record unconfirmed trades outstanding for more than five days.
  - Report to the regulators any disputes on OTC derivatives or collateral if the amount of the dispute is over €15m and is outstanding for at least 15 business days.

As a separate matter under the proposals, the manager of an AIF, instead of the AIF itself, would become responsible for the AIF's trade reporting.

WHAT HAPPENS NEXT?

The proposals are now subject to public consultation closing on 18 July 2017, following which the proposals will be subject to trilogue negotiations between the Commission, European Parliament and European Council. The timing of any resulting legislation cannot be predicted with certainty, but could potentially come into force towards the end of 2018.

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[7] *"Capital markets union: agreement reached on securitisation"* by the Council of the EU, press release 314/17, 30 May 2017

[8] As defined in Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD)

SCHEDULE

SUMMARY OF THE SIGNIFICANT CHANGES FOR DERIVATIVES END USERS PROPOSED BY THE EUROPEAN COMMISSION

STREAMLINED TRANSACTION REPORTING REQUIREMENTS

- Exchange-traded derivatives would be reported by the central counterparty on behalf of both counterparties. As currently drafted, this appears to only cover the transaction between clearing members, and any back-to-back transactions between clearing members and clients or indirect clearing members would still need to be separately reported.
- Derivatives between an FC and an NFC- would be reported by the FC on behalf of both counterparties.
- Intragroup derivatives would no longer have to be reported if at least one of the counterparties is an NFC.
- The "backloading" obligation would be removed. As a result reporting on historic transactions would no longer be required.

NON-FINANCIAL COUNTERPARTIES

- An NFC that exceeds a clearing threshold for a class of OTC derivatives would only need to clear that class, rather than all OTC derivative classes as is currently the case.

FINANCIAL COUNTERPARTIES

- Currently all FCs are subject to the derivatives clearing obligation. The proposals would apply clearing thresholds to FCs identical to those for NFCs, meaning that FCs that are smaller users of derivatives would gain relief from the clearing obligation. However, unlike NFCs, if an FC exceeds a clearing threshold for one class of OTC derivative then all classes of derivatives must be cleared.
- SSPEs, AIFs and central securities depositories would all be classified as FCs.

TIMING OF CALCULATION OF WHETHER THE CLEARING OBLIGATION APPLIES

- Whether a counterparty has exceeded a threshold for clearing of OTC derivatives is currently calculated based on a 30-day rolling average of outstanding OTC derivative volumes. This would be replaced by an annual test based on aggregate month-end average positions for March, April and May.

PENSION FUNDS

- Pension funds are currently subject to a temporary exemption from clearing derivatives. The Commission proposes a new three–year exemption for pension funds, and further that the Commission be given the power to extend this exemption by an additional two years.

REMOVING BARRIERS TO CLEARING

- In recognition of the difficulties that smaller users of derivative have had in getting clearing members to offer client access to clearing, the Commission proposes that clearing members (including indirect clearing members) that provide clearing services to clients must provide those services on *"fair, reasonable and non-discriminatory commercial terms".* The Commission would be able to issue a delegated act that specifies the conditions under which those commercial terms are considered to be compliant.

REMOVING THE "FRONTLOADING" OBLIGATIONS

- The "frontloading" obligation would be removed. Under frontloading derivatives become subject to clearing from the date that the central counterparty is authorised or recognised to clear a class of derivatives, rather than the date that clearing becomes mandatory.

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