

May 3, 2019

EMIR REFIT: What Non-EU Asset Managers Should be Doing Now

Although the pending reforms to the European Market Infrastructure Regulation (EMIR), commonly referred to as EMIR REFIT,¹ have not yet entered into force,² US and other non-EU managers of non-EU alternative investment funds (AIFs)³ should start determining now whether they will be affected, and, if so, commence preparations for compliance. Any non-EU AIF that is currently classified as a third-country non-financial counterparty (NFC) that is below the applicable EMIR clearing thresholds (NFC-) is likely to be affected.

Executive Summary

Third-country NFC-s will be impacted by EMIR REFIT in the following ways:

- such entities will be required to post variation margin and possibly initial margin on all over-the-counter (OTC) derivatives entered into with all EU counterparties that are either financial counterparties (FCs) or NFCs over the applicable EMIR clearing thresholds (FC+s and NFC+s, respectively);
- even if the affected non-EU AIFs are already posting margin to their EU-counterparties despite it not being currently required under EMIR, their EU counterparties will need to ensure all margin agreements are EMIR-compliant which may require repapering of existing documentation; and
- although less likely, it is possible that EU AIFs that are currently classified as third-country NFC-s will be required to clear all OTC derivatives subject to an EU mandatory clearing obligation through an authorised central counterparty (CCP) and trade such OTC derivatives on a regulated trading venue in the European Union.⁴

EMIR REFIT will enter into force 20 days after publication in the *Official Journal of the European Union*, which is expected to take place in May or June 2019.

Background

EMIR entered into force in 2012 as part of the EU's G20 reform measures for OTC derivatives. EMIR introduced reporting obligations for all exchange-traded and OTC derivatives and clearing and risk management obligations for OTC derivatives,

For more information, please contact the following lawyers or any members of Katten's **Financial Services** practice.

Carolyn H. Jackson
+44 (0) 20 7776 7625
carolyn.jackson@kattenlaw.co.uk

Guy Dempsey
+1.212.940.8593
guy.dempsey@kattenlaw.com

John Ahern
+44 (0) 20 7770 5253
john.ahern@kattenlaw.co.uk

Nathaniel Lalone
+44 (0) 20 7776 7629
nathaniel.lalone@kattenlaw.co.uk

Neil Robson
+44 (0) 20 7776 7666
neil.robson@kattenlaw.co.uk

¹ EMIR REFIT refers to the European Commission's Regulatory Fitness and Performance programme, which is intended to reduce the costs and increase efficiency in implementing EU policies.

² EMIR REFIT has been preliminarily agreed among the European Commission, the European Parliament and the Council of the EU.

³ All non-EU funds will be AIFs. In the EU, any fund that is not an Undertaking for the Collective Investment in Transferable Securities (UCITS) is an AIF. Thus, even US mutual funds, will be AIFs under EMIR, as would Cayman hedge funds.

⁴ Any OTC derivative subject to an EU mandatory clearing obligation can also be cleared through an equivalent third-country CCP and traded on an equivalent third-country trading venue.

including the exchange of margin on uncleared OTC derivatives. Although EMIR directly applies to entities established in the EU only, it will apply indirectly to any non-EU entities entering into OTC derivatives with EU counterparties; EU entities have to comply with the EMIR obligations on any OTC derivatives transaction they enter into, whether the counterparty is an EU or non-EU entity.

EMIR applies differently to EU entities depending upon whether they are classified as an FC or as an NFC. FCs are, broadly, those EU entities that are subject to financial regulation and supervision under an EU directive,⁵ and in the case of AIFs, those AIFs managed by an alternative investment fund manager (AIFM) authorised or registered in accordance with the Alternative Investment Fund Managers Directive (AIFMD). NFCs are further classified under EMIR as either NFC-s or as NFC+s if the entity's OTC derivatives activity is either below all or exceeds any one of five EMIR clearing thresholds, respectively. The thresholds are set at EUR 3 billion for interest rate, foreign exchange and commodity OTC derivatives and at EUR 1 billion for equity and credit OTC derivatives. The calculation is made over a 30-working day rolling average of the gross notional principal amount of OTC derivatives outstanding for the relevant asset class.⁶ FCs and NFC+s are subject to the full range of the EMIR obligations, whereas NFC-s are not subject to the clearing obligation, the obligation to exchange margin on uncleared OTC derivatives, nor the heightened reporting obligations, requiring the reporting of mark-to-market values and collateral on each derivative transaction.

All non-EU entities entering into an OTC derivative with an EU counterparty are considered third-country entities (TCEs). When entering into an OTC derivative with an EU counterparty, however, TCEs must determine whether they would be an FC, NFC+ or an NFC- if they were to be established in the EU. Under EMIR, as mentioned above, an AIF will be an FC if it is managed by an AIFM authorised or registered in accordance with the AIFMD. Many non-EU managers have taken the view that even if their non-EU AIFs were to be established in the EU, they would still not be an AIFM authorised or registered under the AIFMD and could therefore classify their non-EU AIFs as TCE NFCs. Further, if the OTC derivatives activity of such non-EU funds were under the applicable EMIR clearing thresholds, these non-EU AIFs would further be classified as TCE

Non-EU Managers Preparation for EMIR REFIT—What You Should be Doing Now

To prepare for the imminent entering into force of EMIR REFIT, Katten recommends that the managers of non-EU AIFs consider the following actions.

- Begin discussions with all EU counterparties regarding EMIR REFIT. Although it is ultimately the EU counterparties and not non-EU AIFs that are subject to EMIR, most non-EU AIFs will have made a representation as part of their existing OTC derivative documentation as to their status under EMIR. If a non-EU AIF that has classified itself as either a TCE NFC- or TCE NFC+ does not notify its EU counterparty of its change in status to that of a TCE FC- or TCE FC+, it will likely be in breach of its representations.
- Introduce policies and procedures to monitor whether the EMIR clearing threshold as modified by EMIR REFIT has been exceeded for any asset class.⁷ If the threshold has been exceeded, commence preparations to be able to clear any OTC derivatives subject to an EU mandatory clearing determination with EU counterparties, or consider alternatives (i.e., entering into OTC derivatives with counterparties not currently subject to a regulatory clearing requirement or entering into exchange traded derivatives).
- If margin is currently not being exchanged with any EU counterparty, commence putting into place an EMIR-compliant margin agreement, or consider the impact of such requirement on the business and consider alternatives (i.e., entering into OTC derivatives with counterparties not currently subject to a regulatory margin requirement or entering into exchange traded derivatives).
- If margin is currently being exchanged with any EU counterparty, review the existing margin documentation and repaper as necessary to ensure EMIR compliance.⁸
- Introduce policies and procedures to monitor the initial margin AANA calculation and, if the AANA is likely to exceed EUR 8 billion, requiring the posting of initial margin by the non-EU AIF, consider the impact of such requirement on the business and consider alternatives (i.e., entering into OTC derivatives with counterparties not currently subject to a regulatory margin requirement or entering into exchange traded derivatives).

⁵ FCs generally include investment firms, credit institutions, insurance undertakings, assurance undertakings, reinsurance undertakings and UCITS as well as certain AIFs.

⁶ The EMIR clearing threshold calculations must be made at the aggregate group level. For an AIF, this is normally at the level of the AIF and not at the level of the AIFM. Any AIFM managing more than one AIF must be able to demonstrate that the calculation at the fund level does not lead to either an underestimation of any managed fund's OTC derivatives position or a circumvention of the EMIR clearing obligation.

⁷ If the non-EU AIF chooses not to make the calculations necessary to determine if it has exceeded an EMIR REFIT clearing threshold, it will be deemed a TCE FC+.

⁸ Among other obligations, EMIR requires margin agreements for uncleared derivatives to be two-way, have a zero EUR threshold amount, have a minimum transfer amount of no more than EUR 500,000, and be calculated at least daily and generally collected same day. Eligible collateral for variation and initial margin is limited to cash, certain government bonds, corporate bonds, equities, most senior tranches of securitisation and shares or units in UCITS (subject to specified conditions).

NFC-s not subject to the EMIR clearing, margin and heightened reporting obligations. The classification of non-EU AIFs as TCE NFCs, with many being TCE NFC-s, has generally been market practice and acknowledged by European regulatory authorities, although the European Securities and Markets Authority (ESMA) in its August 2015 report of their review of EMIR⁹ commented that it was of the view that changes should be made to EMIR to ensure treatment of all AIFs equally as FCs, regardless of whether or not their AIFMs were authorised or registered under the AIFMD.

EMIR REFIT: Changes to FC Definition and EMIR Clearing Threshold Calculation

Once EMIR REFIT enters into force, the definition of an FC under EMIR will include any AIF which is either established in the EU or managed by an AIFM authorised or registered in accordance with the AIFMD.¹⁰ If, however, an AIF is set up exclusively for the purpose of serving one or more employee share purchase plans or is a securitisation special purpose entity, it will be an NFC.

A non-EU AIF will therefore always be a TCE FC once EMIR REFIT enters into force, because were it to be established in the EU, it would be an AIF established in the EU and therefore a TCE FC. The fact that the AIFM of such non-EU AIFM is not authorised or registered in accordance with the AIFMD is no longer relevant for purposes of determining the EMIR classification of the non-EU AIF.

EMIR REFIT will change the definition of FC to include two sub-categories of FCs; those above the applicable EMIR clearing threshold (FC+s) and those below (FC-s). FC-s will not be subject to the EU mandatory clearing or trading obligations.¹¹

EMIR REFIT also will change the EMIR clearing threshold calculation. The calculation will be made according to each entity's aggregate month-end position for the previous 12 months.¹² The first calculation will be required to be made on the day EMIR REFIT enters into force and annually thereafter.¹³ If an FC exceeds any one of the five applicable EMIR clearing thresholds, it will be classified as an FC+ and will have to clear all OTC derivatives subject to an EU mandatory clearing determination, even if it is not over the EMIR threshold applicable to that asset class.¹⁴ In contrast, an NFC will now only be classified as an NFC+ and obligated to clear those OTC derivatives subject to a mandatory clearing determination if it has exceeded the applicable EMIR clearing threshold for that particular asset class.

Consequences of Non-EU AIFs Becoming FCs

The change of status from a TCE NFC to a TCE FC for a non-EU AIF will have the following consequences for any OTC derivatives transaction entered into with an EU counterparty that is not an NFC:-

- the non-EU AIF will be required to post variation margin on all OTC derivatives it enters into on and after the date on which EMIR REFIT enters into force and if the non-EU AIF's average aggregate notional amount of OTC derivatives outstanding for the months of March, April and May (AANA) exceeds EUR 8 billion, it also will be required to post initial margin subject to the relevant phase-in period;¹⁵
- if the non-EU AIF exceeds any one of the five EMIR clearing thresholds, it will be required to clear and trade any OTC derivative subject to an EU mandatory clearing requirement at an authorised CCP or regulated EU trading venue, respectively.¹⁶ The affected EU AIF will have four months from the time EMIR REFIT enters into force to make appropriate clearing arrangements and will be required to commence clearing all OTC derivatives subject to a mandatory clearing determination from that date forward; EMIR REFIT does not impose a frontloading obligation. However, it is unlikely that non-EU AIFs will be affected by the clearing obligation. A non-EU AIF currently classified as a TCE NFC- should generally still remain under the EMIR clearing thresholds and therefore not be classified as a TCE FC+, despite the changes introduced to the EMIR clearing threshold calculation by EMIR REFIT; and

⁹ EMIR Review Report no. 1, Review on the use of OTC derivatives by non-financial counterparties, ESMA/2015/1251.

¹⁰ The definition of an FC also extends to the AIFM, if the AIFM is entering into OTC derivative for its own account.

¹¹ FC-s are however, subject to the EMIR margin requirement on uncleared OTC derivatives and heightened risk reporting.

¹² As mentioned above, the EMIR clearing threshold calculation must be made at a group level, which for an AIF is normally at the level of the AIF and not at the level of the AIFM.

¹³ For example, if EMIR REFIT came into force sometime in May, the calculation would be made by taking the average of the gross notional principal amounts outstanding at month end for the months commencing May 2018 and ending April 2019.

¹⁴ Any FC that chooses not to make the calculation will be deemed to be an FC+.

¹⁵ EMIR REFIT does not expressly state that the margin obligation is not retroactive, but in the absence of an express retroactive obligation, EU regulation is generally presumed not to have retroactive effect.

¹⁶ As per footnote 4, equivalent third-country CCP and equivalent third-country trading venues can also be used.

- any EU counterparty that is an FC will be required to report the value of any collateral posted and the mark-to-market value of each OTC derivative it enters into with the non-EU AIF to an EU trade repository under the EMIR heightened reporting obligations for FCs.¹⁷

Short Time Frame

Critically, as discussed above, non-EU AIFs that do not have any margin agreements in place with their EU FC and NFC+ OTC derivatives counterparties will only have 20 days from the date on which EMIR REFIT is published in the *Official Journal of the European Union* to have EMIR-compliant margin documentation in place. Even those with existing margin agreements may have to make certain amendments in order to ensure that they are EMIR-compliant. Additionally, non-EU AIFs must notify their EU OTC derivatives counterparties of their new status as either TCE FC-s or TCE FC+s on the day EMIR REFIT enters into force or risk being in breach of a representation under their existing OTC derivatives documentation. Any non-EU AIF that is classified as a TCE FC+ will only have four months to put appropriate clearing arrangements in place.

¹⁷ Non-EU AIFs as TCEs will never have any obligation to report under EMIR. All the requisite reporting obligations must be undertaken by the EU counterparty.

Katten

KattenMuchinRosenman UK LLP

www.kattenlaw.co.uk

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

Katten Muchin Rosenman UK LLP is a Limited Liability Partnership of Solicitors and Registered Foreign Lawyers registered in England & Wales, regulated by the Law Society.

A list of the members of Katten Muchin Rosenman UK LLP is available for inspection at the registered office. We use the word "partner" to refer to a member of the LLP. Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

Katten Muchin Rosenman UK LLP of England & Wales is associated with Katten Muchin Rosenman LLP, a US Limited Liability Partnership with offices in:

AUSTIN | CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | HOUSTON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SAN FRANCISCO BAY AREA | SHANGHAI | WASHINGTON, DC

5/1/19