

EMIR REFIT: Application to alternative investment funds (AIFs)

THIS NOTE IS NOT INTENDED TO CONSTITUTE LEGAL OR PROFESSIONAL ADVICE AND DOES NOT PURPORT TO BE AND SHOULD NOT BE CONSIDERED A GUIDE TO OR AN EXPLANATION OF ALL RELEVANT ISSUES OR CONSIDERATIONS IN CONNECTION WITH EMIR OR THE EMIR REFIT REGULATION. DERIVATIVES MARKET PARTICIPANTS SHOULD EVALUATE THE INFORMATION CONTAINED IN THIS NOTE IN THE CONTEXT OF THEIR OWN SPECIFIC SITUATION AND REGULATORY OBLIGATIONS AND CONSULT WITH ANY LEGAL AND OTHER ADVISOR THEY MAY CONSIDER APPROPRIATE. ISDA ASSUMES NO RESPONSIBILITY FOR ANY USE TO WHICH ANY OF ITS DOCUMENTATION OR OTHER DOCUMENTATION MAY BE PUT.

What is EMIR REFIT?

As part of the European Commission's Regulatory Fitness and Performance programme in 2016 (the "EMIR REFIT"), the existing requirements under EMIR were assessed to determine whether they could be simplified and whether it was possible to eliminate instances in which the costs of compliance were considered disproportionate. This has led to the preparation of a new Regulation which will directly amend certain provisions of the existing EMIR Regulation (648/2012).

Why is it relevant to alternative investment funds?

The EMIR REFIT will result in an expansion of the scope of AIFs¹ that are considered to be a "financial counterparty" ("FC") for the purposes of EMIR. This is an important change because the application of a number of obligations under EMIR are dependent on the classification of an entity as an FC under EMIR (in particular, the mandatory clearing and uncleared margin requirements).

Prior to the EMIR REFIT, EMIR has categorised any EU or non-EU AIF that is managed by an EU AIFM authorised or registered under the AIFMD as an FC.² The EMIR REFIT Regulation extends that definition to also include:

- any EU AIF, irrespective of the location or status under the AIFMD of its manager; and
- where relevant, a fund's AIFM established in the EU.

The amended FC definition does however specifically exclude from its scope AIFs that are (i) set up exclusively for the purposes of serving one or more employee share purchase plans or (ii) that are securitisation special purpose entities³ ("SSPEs").

What is the effect of these changes?

AIFs that are newly caught by the extended FC classification will be required to comply with a number of additional obligations under EMIR. This includes the clearing obligation (unless they are considered a "small FC"), margin requirements for uncleared OTC derivatives, trade reporting (as amended by the EMIR REFIT) and changes to the obligations under certain of the other risk mitigation requirements based on EMIR classification.

¹ An AIF can be an EU AIF or a non-EU AIF. "AIFs" are defined in point (a) of Article 4(1) of the AIFMD as non-UCITS collective investment undertakings which raise capital from investors with a view to investing it according to a defined policy for the benefit of those investors. Entities should consult their legal advisors if the status of a fund is uncertain.

² Subject to the extension of the passport under Article 37 of the AIFMD, the current regime also extends to AIFs managed by non-EU AIFMs authorised under Directive 2011/61/EU (the "AIFMD").

³ As referred to in point (g) of Article 2(3) of the AIFMD.

In addition, the EMIR REFIT will introduce:

- a new category of “small FC” which will not be subject to the clearing obligation (although still subject to the margin requirements for uncleared OTC derivatives) – this new category will apply where the level of the relevant AIF’s OTC derivatives trading activity is below *all* of the clearing thresholds;⁴ and
- the responsibility of the AIFM to report the details of OTC derivative contracts to which the relevant AIF is a counterparty.⁵

Is this also relevant to non-EU alternative investment funds?

Yes, as the change in scope of the FC definition in relation to EU AIFs outlined above will also impact the *equivalent* categorisation of non-EU AIFs not caught directly by EMIR.

Where EU entities that are subject to the relevant EMIR provisions trade with a non-EU AIF not otherwise caught directly by EMIR, Article 4 (mandatory clearing) and Article 11 (risk mitigation requirements for uncleared OTC derivatives) of EMIR already make clear that the obligations of the EU entity will be determined by reference to the *equivalent* categorisation of that non-EU AIF (determined as if such AIF were established in the EU). After the EMIR REFIT takes effect, this means that any non-EU AIF not directly caught by the revised definition of FC (i.e. those managed by non-EU AIFMs) will be categorised as *equivalent* to an “FC” (unless either of the employee share purchase plan or SSPE exemptions apply). Non-EU AIFs with limited trading activity in OTC derivatives may however be exempt from the clearing obligation if they can be considered equivalent to an FC which is below all clearing thresholds as per the new category of “small FC” introduced under the EMIR REFIT.

This means that when an in-scope EU entity trades with a non-EU AIF that is not directly caught by EMIR, that EU entity will now be required to satisfy (a) the clearing obligation (unless the relevant AIF is considered a “small FC” or equivalent thereto and, therefore, not under an obligation to clear), (b) the margin requirements for uncleared OTC derivatives (which will include the requirement to exchange variation margin and, potentially, initial margin), and (c) certain of the other risk mitigation requirements based on EMIR classification.

Subject to the exclusions in respect of AIFs set up exclusively for the purposes of serving one or more employee share purchase plans or AIFs that are SSPEs, non-EU AIFs that are managed by an AIFM *authorised or registered* under the AIFMD will remain directly caught by EMIR as FCs and therefore directly subject to the relevant obligations under EMIR.

What is the timetable for these changes?

ESMA’s public statement⁶ on the implementation of the new EMIR REFIT regime dated 28 March 2019 indicated that the final EMIR REFIT Regulation text could be adopted and published in the Official Journal of the European Union in May 2019, with entry into force 20 days after publication. The counterparty classification changes set out above will have an immediate impact on AIFs with respect to new OTC derivative transactions. If the EMIR REFIT Regulation enters into force after 21 June 2019 (the Category 3 FC clearing obligation commencement date), AIFs that will not qualify as

⁴ Pursuant to an ESMA public statement of 28 March 2019 (see link in footnote 6), if an AIF would like to utilise the “small FC” category it is required to have calculated its aggregate month-end average position for the previous 12 months as at the date the EMIR REFIT Regulation enters into force.

⁵ This change will apply from 12 months after the EMIR REFIT Regulation enters into force.

⁶ https://www.esma.europa.eu/sites/default/files/library/esma70-151-2181_public_statement_on_refit_implementation_of_co_regime_for_fcs_and_nfcs.pdf.

“small FCs” will immediately be subject to the clearing obligation when the EMIR REFIT Regulation enters into force.⁷

What do you need to do next?

With the changes to the FC definition in relation to AIFs in mind, fund managers should reassess any AIFs that they manage in order to verify their categorisation under the new EMIR REFIT Regulation and be ready, where applicable, to immediately notify ESMA of their FC or “small FC” categorisation on the day the EMIR REFIT Regulation enters into force. It is also likely that counterparties to AIFs will be revisiting counterparty status representations from those AIFs to ensure that they remain accurate after the EMIR REFIT takes effect.

Where a change in counterparty classification of their AIF counterparty(ies) is likely, entities that are subject to EMIR should consider the possible new compliance obligations with respect to the AIF(s) and to establish a line of communication with their AIF counterparty(ies) as necessary. Entities should also consider consulting with their legal advisors, as required.

⁷ Any AIF that is already subject to the obligation to clear prior to the entry into force of the EMIR REFIT Regulation shall, unless it is considered a “small FC”, continue to be subject to that obligation after the EMIR REFIT takes effect. An AIF that was not previously obliged to clear but that will become an FC as a result of the EMIR REFIT (such as an EU AIF with a non-EU AIFM), will only be required to clear derivatives contracts after a four-month period has elapsed (subject to it not being a “small FC”). Notably, no transitional provisions currently exist in respect of the margin requirements for uncleared derivatives.