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Brexit SI Series: EMIR

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This paper is part of a series of briefings for clients and contacts of Allen & Overy on the review of financial services statutory instruments (**SIs**) to be laid down under the European Union (Withdrawal) Act 2018 (the **Withdrawal Act**).

The purpose of the SIs is to help with a range of legal issues caused by the UK's exit from the EU and to prevent, remedy or mitigate any failure of EU law to operate effectively or any other deficiency in retained EU law. SIs are not intended to make policy changes, other than to reflect the UK's new position outside the EU.

The European Market Infrastructure Regulation (Regulation (EU) 648/2012) (**EMIR**) introduces a number of key obligations for counterparties to derivatives contracts, namely, (i) mandatory clearing through authorised or recognised central counterparties (**CCPs**) of certain OTC derivatives contracts (the **Clearing Obligation)**; (ii) risk mitigation (including margin) requirements for OTC derivatives contracts not cleared by a CCP; and (iii) mandatory reporting of all derivatives contracts to a registered or recognised trade repository (**TR**) (the **Reporting Obligation**). EMIR also introduces requirements for CCPs and TRs themselves including CCP authorisation, TR registration and, for non-EU CCPs and TRs, recognition requirements.

What does the EMIR SI do?

Broadly, the draft Over the Counter Derivatives, Central Counterparties and Trade Repositories (Amendment, etc., and Transitional Provision) (EU Exit) Regulations 2018 (the **EMIR SI**) seeks to provide a backstop that ensures the continued functioning of EMIR and related UK legislation in the UK, were the UK and EU to fail to come to agreement on a withdrawal deal by 29 March 2019. The changes in the EMIR SI will not take effect on 29 March 2019 if a transitional agreement with the EU is reached. For the purposes of this paper, we refer to EMIR as amended by the EMIR SI (and the CCP SI and the TR SI each as defined below) as "**UK onshored EMIR**".

The key consequences of the amendments are:

EU entities and financial market infrastructure will become third country entities for the purposes of UK onshored EMIR

EU entities previously categorised as financial counterparties (**FCs**) and non-financial counterparties (**NFCs**) for UK purposes under EMIR will no longer fall within the FC or NFC definition and will instead be categorised as third country FCs (**TCE FCs**) or third country NFCs (**TCE NFCs**) under UK onshored EMIR.

Entities will need to analyse whether this will have any significant impact on the regulatory obligations applicable to a particular counterparty pairing.

Equally, EU CCPs, TRs and regulated markets will be categorised as third country CCPs, TRs and regulated markets under UK onshored EMIR. To the extent that non-UK CCPs and TRs are not recognised under UK onshored EMIR, UK entities will not be able to satisfy their UK onshored EMIR Clearing Obligation or Reporting Obligation by using a non-UK CCP or TR (see further below). To the extent that EU regulated markets are not equivalent third country markets under UK onshored EMIR, this could impact which derivatives contracts are regarded as "OTC derivatives" for the purposes of UK onshored EMIR (see further below).

Amendments to definitions and other references in EMIR to refer to the relevant UK or onshored UK legislation as opposed to EU legislation

In line with the primary aim of exiting the EU, the draft EMIR SI amends references from EU to UK legislation. This impacts EMIR in a number of areas including the scope of exempt entities under Article 1(4) and the definition of "FC". As discussed further below, this narrowing of scope introduces mismatches between the scope of EMIR and the UK onshored EMIR in several places which may, in turn, affect the application of certain EMIR obligations and the availability of certain exemptions.

Transfer of functions, deletion of cooperation arrangements and incorporation of equivalence decisions

Consistent with the other SIs, the draft EMIR SI transfers functions performed under EMIR by EU authorities (for example, the European Commission, the European Securities and Markets Authority (**ESMA**), the European Insurance and Occupational Pensions Authority, the European Systemic Risk Board and the European Banking Authority) to the corresponding UK authorities and gives responsibility for Binding Technical Standards (**BTS**) to the relevant UK regulators. It also deletes provisions relating to supervision of CCPs by colleges, information sharing and cooperation with EU authorities.

Generally, HM Treasury has been transferred the functions of the European Commission (for example, making equivalence decisions) and the Bank of England, the Prudential Regulation Authority (**PRA**) and/or the Financial Conduct Authority (**FCA**), as applicable, have been transferred the functions of ESMA (such as responsibility for making BTS, including responsibility for correcting deficiencies in EMIR BTS so that they operate effectively immediately on exit day and remain fit for purpose after exit). This is consistent with the position under the Financial Regulators' Powers (Technical Standards etc) (Amendment etc) (EU Exit) Regulations 2018.

Existing equivalence decisions will be incorporated into UK law other than in the case of equivalence decisions in respect of third country CCPs (taken under Article 25 of EMIR) which will be remade.

The FCA will be responsible for the registration of UK TRs and recognition of non-UK TRs and the Bank of England will be responsible for the authorisation of UK CCPs and recognition of non-UK CCPs (see further below).

There have also been changes to the powers of the UK regulators under UK domestic legislation to enable them to carry out their expanded duties and take enforcement action under UK onshored EMIR.

New power to suspend the Reporting Obligation

The draft EMIR SI provides that the FCA may suspend the UK onshored EMIR Reporting Obligation when there are no TRs available to which reports can be made for up to one year (which period may be extended by HM Treasury). We note that there is currently no ability to suspend the Reporting Obligation under EMIR nor is one currently contemplated under the ongoing review of EMIR Part 1 or Part 2 (together, **EMIR Refit**). Where the UK onshored EMIR Reporting Obligation has been suspended, derivatives contracts (plus modifications and terminations) must be reported to a TR once

the suspension has been lifted with the FCA required to specify a date on which the suspension will end and by which it anticipates counterparties and CCPs will be able to report. The draft EMIR SI does not specify the period by which entities must report events which have occurred within the suspension period (rather this will be specified by the FCA at the relevant time).

Pension scheme arrangements and exemption from the Clearing Obligation

The definition of "pension scheme arrangement" and wording in Article 89 of EMIR relating to the exemption from clearing for pension schemes is unamended. The existing EMIR exemption expired on 17 August 2018 (although we note that ESMA has stated it does not expect competent authorities to prioritise their supervisory actions in this regard pending an expected extension of the exemption by EMIR Refit and EU regulators, including, for this purpose, the FCA, have confirmed they intend to take this approach). The explanatory note accompanying the EMIR SI (draft published on 22 October 2018) provided that as the exemption has lapsed, it does not form part of retained EU law and so does not need to be onshored. However, the explanatory note went on to provide that should EMIR Refit come into force before the UK leaves the EU, the EU exemption will be onshored and continue to apply to UK pension schemes.[1] We note, in addition, that the Financial Services (Implementation of Legislation) Bill published in November 2018[2] specifically contemplates the situation where EMIR Refit is not onshored prior to exit day and contemplates in that scenario that the Government be given powers to implement EMIR Refit for up to two years following exit day.

Pending the application of EMIR Refit, firms will need to consider whether the existing regulatory forbearance statements continue to apply to a UK/EU relationship following exit day.

Exclusion for certain C6 energy derivative contracts (new Article 89a)

This exemption (previously in Article 95 of Directive 2014/65/EU (**MiFID II**)) has been moved into the UK onshored EMIR.

New UK supervision and enforcement provisions relating to TRs

The draft EMIR SI prescribes supervision and enforcement provisions relating to TRs replacing those in EMIR with similar provisions to those already in the Financial Services and Markets Act 2000 (**FSMA**). Certain BTS relating to TR fees and procedure for penalties for TRs are revoked and replaced with provisions that align with existing FSMA provisions. The criminal offence of misleading the FCA is expanded to cover TRs (both UK and non-UK).

Establishment of a temporary intragroup exemption regime in respect of clearing and uncleared margin

The draft EMIR SI prescribes transitional provisions relating to intragroup exemptions from clearing and uncleared margin requirements which are to apply, or to continue to apply, after exit day pending the making of an equivalence determination by HM Treasury in respect of a third country in which a non-UK counterparty is established. The intragroup exemption will last for up to three years from exit day and may be further extended.

Careful consideration needs to be given to how the draft EMIR SI will interact with the Central Counterparties (Amendment, etc., and Transitional Provision) (EU Exit) Regulations 2018 (the **CCP SI**) and the Trade Repositories (Amendment and Transitional Provision) (EU Exit) Regulations 2018 (the **TR SI**) which both also make certain amendments to EMIR as well as certain other onshored EU and amended UK domestic legislation (such as FSMA) which is cross referenced in the draft EMIR SI.

[1] We note, however, that discussion of the pension scheme exemption was not included in the explanatory memorandum published with the EMIR SI laid before Parliament.
[2] The Bill and accompanying policy note can be found at: https://publications.parliament.uk/pa/bills/lbill/2017-2019/0143/18143.pdf and https://www.gov.uk/government/publications/the-financial-services-implementation-of-legislation-bill-policy-note.

HM Treasury has proposed a temporary transitional power for UK regulators (the **Temporary Transitional Power**) which may be exercised to provide temporary relief from the impact of new or amended regulatory obligations arising as a result of Brexit for up to two years in certain circumstances. Thus, transitional relief may be possible in some areas (although we have no current indication of whether it will be used in an EMIR context).

Legislation amended or revoked by the EMIR SI

EU Legislation

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**)
Commission Delegated Regulation (EU) 1003/2013 of 12 July 2013 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to fees charged by the European Securities and Markets Authority to trade repositories (**TR Fees Delegated Regulation**)
Commission Delegated Regulation (EU) 667/2014 of 13 March 2014 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to rules of procedure for penalties imposed on trade repositories by the European Securities and Markets Authority including rules on the right of defence and temporal provisions (**TR Penalties Delegated Regulation**)

In the context of the intragroup exemption only:

- Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk mitigation techniques for OTC derivative contracts not cleared by a central counterparty (**Margin BTS**)
- Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation (**G4 Rates Clearing BTS**)
- Commission Delegated Regulation 2016/592 of 1 March 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation (**Index CDS Clearing BTS**)
- Commission Delegated Regulation 2016/1178 of 10 June 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation (**Additional Rates Clearing BTS**)

UK Legislation

Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013 (SI 2013/504) (**2013 Regulations**)
Financial Services and Markets Act 2000 (**FSMA**)

Areas identified by industry as requiring further consideration

Recognition of third country CCPs

If the UK onshored EMIR Clearing Obligation applies to a counterparty pairing, the parties must clear in-scope transactions through a CCP authorised or recognised by the Bank of England under UK onshored EMIR. In respect of the recognition of non-UK CCPs, non-UK CCPs authorised or recognised under EMIR will no longer be authorised or recognised under UK onshored EMIR post-exit day. However, the CCP SI introduces temporary deemed recognition provisions and provisions relating to recognition of third country CCPs aimed at ensuring the continued provision of clearing services in the UK by non-UK CCPs post-exit day.

The same recognition issue arises in the context of EMIR as regards EU access to UK CCPs post-exit day as if UK CCPs are not permitted to continue to provide clearing services to EU market participants post-exit day, this could cause significant market disruption. From this perspective, the European Commission has published a contingency action plan[3] stating that it will adopt a temporary and conditional equivalence decision in order to ensure that there will be no disruption to central clearing and ESMA has published a public statement[4] providing that it is engaging with the European Commission to plan the preparatory actions for the recognition process of UK CCPs, in case of a no-deal scenario and has started engaging with UK CCPs to carry out preparatory work. As of December 2018, the European Commission was pressing ahead with this equivalence decision process.

Recognition of non-UK TRs

Counterparties and CCPs must report the details of any derivative contract they have concluded, modified or terminated within one working day following such conclusion, modification or termination to a TR registered or recognised by the FCA in accordance with UK onshored EMIR. Pursuant to changes made by the TR SI, UK TRs will be able to benefit from the transitional registration provisions set out in the TR SI and UK affiliates of EU TRs which are currently registered under EMIR will be able apply for deemed registration in the UK for up to a three year transitional period. However, there is no transitional period envisaged for such EU TRs themselves whereby their existing registration under EMIR would continue to be respected under UK onshored EMIR. To the extent UK entities are currently using an EU TR to satisfy the Reporting Obligation, they will need to assess whether the relevant TR will be recognised under UK onshored EMIR post-exit day and if it is not, consider whether it is necessary (and operationally possible) to move to an alternative UK TR and how lifecycle reporting in respect of existing transactions reported will work going forward. It may be that transitional relief is provided (for example, by way of the Temporary Transitional Power) although we do not yet have any clear indication on this point.

The same recognition issue arises in the context of EMIR as regards EU access to UK TRs post-exit day. From this perspective, there are currently no transitional provisions envisaged for UK TRs to ensure recognition under EMIR following exit day. ESMA has published a public statement[5] inviting market participants to contact any relevant TRs to verify whether continuity of service will be ensured after Brexit. ESMA is preparing for the eventuality that some counterparties may need to request their existing UK TR to port their data to an EU27 TR. However, if UK TRs are not permitted to continue to provide reporting services to EU market participants post-exit day, this could cause significant operational disruption.

[3] Available here (dated 13 November 2018): https://ec.europa.eu/info/sites/info/files/brexit_files/info_site/communication-preparing-withdrawal-brexit-preparedness-13-11-2018.pdf.
[4] Available here (dated 23 November 2018): https://www.esma.europa.eu/sites/default/files/library/esma70-151-1948_managing_risks_of_a_no-deal_brexit_in_the_area_of_central_clearing.pdf.
[5] Available here (dated 9 November 2018): https://www.esma.europa.eu/sites/default/files/library/esma80-187-149_public_statement_brexit_cras_trs.pdf.

Exempt entities under Article 1(4)

Under UK onshored EMIR, "exempt entities" will no longer include members of the European System of Central Banks and other member states' bodies performing similar functions and other union public bodies charged with or intervening in the management of public debt. Absent amendment or transitional provision, this could trigger obligations under UK onshored EMIR in respect of counterparty pairings which were previously exempt and dis-incentivise trading between UK market participants and EU central banks.

The EMIR SI provides that HM Treasury may amend the list of exempt entities set out in Article 1(4) pursuant to Article 1(6) of UK onshored EMIR. There is no indication as to the proposed timing. It is possible that the Temporary Transitional Power could be used but again we have no indication of whether the power is likely to be used in this context.

The same issue arises under EMIR in terms of transactions with equivalent UK exempt entities to the extent that EMIR applies. We do not have any clarity on whether/how this will be resolved from an EU perspective.

OTC derivative definition and equivalence of EU27 regulated markets

EU regulated markets will no longer be "regulated markets" and may not (at least immediately) be equivalent third country markets for the purposes of Article 2a of UK onshored EMIR. The consequence is that derivatives traded on EU regulated markets will be regarded as "OTC derivatives" under UK onshored EMIR rather than "derivatives" as previously. This has numerous consequences under UK onshored EMIR including: (a) consideration of the UK onshored EMIR obligations that apply to those contracts; (b) impact on contracts which count towards the clearing threshold and, consequently, whether some entities are categorised as NFC+ or NFC-; and (c) the operational process of reporting those contracts.

The FCA has stated that EU regulated markets will be required to apply for recognition in the UK to operate post-Brexit although a temporary recognition regime is not envisaged. It is not yet clear whether the Temporary Transitional Power will be exercised in this context.

The same issue arises under EMIR in terms of UK regulated markets and the definition of "OTC derivatives" under EMIR to the extent that EMIR applies. We do not have any clarity on whether/how this will be resolved from an EU perspective.

Treatment of pension schemes for clearing purposes

The UK regulators have not explicitly stated whether, post-exit day, they will continue not to enforce against UK pension schemes in breach of the UK onshored EMIR Clearing Obligation (in line with the existing ESMA and FCA forbearance statements) pending the expected implementation of the exemption in EMIR Refit. Firms will need to consider whether the existing regulatory forbearance statements continue to apply to a UK/EU relationship following exit day.

In addition, assuming that the exemption from clearing is extended for UK pension schemes under UK onshored EMIR, it is likely that EU pension schemes will no longer be included under the definition of "pension scheme arrangement" and will, therefore, no longer be able to benefit from the exemption from clearing which, absent amendment or transitional provision, could trigger UK onshored EMIR obligations in respect of counterparty pairings which were previously exempt and disincentivise trading between UK market participants and EU pension scheme arrangements. It remains to be seen whether the Temporary Transitional Power could be a potential source of temporary relief in this context.

We note in addition that UK pension schemes may no longer satisfy the definition of "pension scheme arrangement" under EMIR post-exit day and this is expected to cause a reciprocal issue under EMIR for UK pension schemes.

Suspension of the reporting obligation

Whilst this is a welcome development in general, from a practical perspective, firms will still have to have procedures in place to continue to track and record all the details of transactions and be ready to report once the suspension has been

lifted. This will also result in a huge upload of data at the end of the suspension period.

We note that there is no such ability to suspend the Reporting Obligation in EMIR, nor is one currently contemplated by the texts under discussion for EMIR Refit.

EMIR Refit

We understand that HM Treasury also plans to make amendments to UK legislation to address EMIR Refit if that legislation is finalised and the provisions apply prior to exit day although the timing of finalisation of EMIR Refit will dictate the mechanism used. In addition, the Financial Services (Implementation of Legislation) Bill specifically contemplates the situation where EMIR Refit is not onshored prior to exit day and contemplates in that scenario that the Government be given powers to implement EMIR Refit for up to two years following exit day. If the changes are not incorporated into UK law (either before or after exit day), this could lead to mismatches as between UK onshored EMIR and EMIR.

Changes to existing EMIR BTS

Whilst the existing EMIR BTS will become part of UK law on exit day and, generally speaking, existing EMIR implementing acts (including the Article 13 risk mitigation implementing act on equivalence in respect of the CFTC) will be adopted, the EMIR BTS will also require appropriate amendments to ensure that derivatives markets can continue to operate effectively after exit day. Pursuant to the EMIR SI, the PRA, the FCA and the Bank of England may make regulations/technical standards under the EMIR SI covering the same areas as existing technical standards. Following the publication of the EMIR SI, the Bank of England, the PRA and the FCA are publicly consulting on these standards in respect of appropriate amendments. The outcome of these consultations will consequently be important (although we note that it may be challenging to make the necessary operational and documentation changes prior to exit day absent any transitional relief).

The Withdrawal Act provides that provisions in existing BTS which are in force but are not operative immediately before exit day will not automatically become part of "retained EU law" and, consequently, UK law on exit day. In respect of the EMIR BTS, neither initial margin phase 4 and 5 start dates nor the start dates for certain clearing obligations for Category 3 and 4 counterparties apply before exit day. In respect of initial margin phase 4 and 5, the draft onshored BTS make it clear that these obligations will not automatically become part of UK law on exit day (although the PRA has indicated in its related consultation paper that UK firms should plan on the basis that that IM phase 4 and 5 will apply). In respect of the start dates for certain clearing obligations for Category 3 and 4 counterparties, we note that the approach in the draft onshored BTS is unclear in this respect although it is not clear whether a difference in approach is intended. If the changes are not incorporated into UK law after exit day, this could lead to mismatches as between UK onshored EMIR and EMIR.

What does this mean for you?

Market participants will need to review the proposed changes (both in a UK onshored EMIR and EMIR context) to assess the potential impact on particular counterparty pairings and transactions. In particular, UK market participants will need to assess (in the context of UK onshored EMIR):

- whether they can continue to rely on existing or new exemptions and whether any practical steps are required to do so;
- whether there is any impact on counterparty classifications and the potential impact;
- whether they can continue to clear OTC derivatives transactions with non-UK CCPs and report derivatives transactions to non-UK TRs to the extent they do so currently;

- whether they can rely on transitional provisions and whether any practical steps are required to do so;
- documentation impact; and
- whether any changes to operational and internal practices or procedures are required.

UK market participants should also assess the revised position under EMIR following exit day and how this will impact transactions with EU counterparties.

EU market participants will also need to make equivalent assessments from an EU perspective in respect of both EMIR and UK onshored EMIR.

The above list focuses on market participants other than CCPs and TRs but clearly CCPs and TRs in both the EU and the UK will need to assess the revised position as well.

Next steps

- The FCA, the PRA and the Bank of England are in the process of consulting on changes to the EMIR BTS. Relevant consultations and updates already published include:
    - CP18/28: Brexit: proposed changes to the Handbook and Binding Technical Standards – first consultation (FCA consultation paper published on 10 October 2018) available here (note this includes proposed changes to various BTS relating to TRs);
    - CP26/18: UK withdrawal from the EU: Changes to PRA Rulebook and onshored Binding Technical Standards (PRA consultation paper published on 25 October 2018) available here (note this includes proposed changes to the Margin BTS);
    - CP25/18: The Bank of England's approach to amending financial services legislation under the European Union (Withdrawal) Act 2018 (Joint Bank of England and PRA consultation paper published on 25 October 2018) available here;
    - UK withdrawal from the EU: Changes to FMI rules and onshored Binding Technical Standards (Bank of England consultation paper published on 25 October 2018) available here (note this includes proposed changes to EMIR BTS relating to extra-territoriality, CCPs and clearing);
    - Dear CEO Letter from Sir Jon Cunliffe, Deputy Governor Financial Stability, Bank of England to non-UK CCPs updating them on the approach to Bank of England's preparations for EU withdrawal (published 25 October 2018) available here; and
    - CP18/36: Brexit: proposed changes to the Handbook and Binding Technical Standards – second consultation (FCA consultation paper published on 23 November 2018) available here (note this includes proposed changes to various BTS relating to reporting, indirect clearing, NFCs, risk mitigation and TR data).
- Market participants should consider responding to relevant consultations on the EMIR BTS, ensure they monitor the proposed changes and assess the impact.
- As discussed above, transitional relief may be possible in some contexts. See "Proposal for a temporary transitional power to be exercised by UK regulators" (HM Treasury proposal published 8 October 2018) available here.
- Entities should monitor the progress of EMIR Refit to ascertain how the changes may impact them, whether changes

will be onshored prior to exit day and the potential impact of the Financial Services (Implementation of Legislation) Bill.

- Market participants should also continue to monitor the outcome of UK/EU political discussions particularly in the areas of equivalence and recognition.

Contacts

For further information please speak to your usual Allen & Overy contacts.