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EMIR - application to Jersey and Guernsey

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This note provides a high-level overview of the EMIR requirements and their application to the Bailiwicks of Jersey and Guernsey.

Background

Jersey and Guernsey are long established jurisdictions for the establishment of hedge funds and funds of hedge funds; alternative investments are at the core of the islands' fund industry. Regulated funds are authorised and subject to ongoing supervision by the Jersey Financial Services Commission and Guernsey Financial Services Commission as applicable. Jersey and Guernsey have a special relationship with the EU; the Islands are treated as part of the EU for the purposes of free trade in goods, but otherwise are not part of the Union. The formal relationship is set out in Protocol 3 of the UK's 1972 Accession Treaty and confirmed in what is now Article 355 (5) (c) of the EU Treaties. Entities domiciled in Jersey or Guernsey are accordingly treated as "Third Country Entities" (TCE) under EU regulations including EMIR.

EMIR (*Regulation 648/2012*) imposes a number of requirements on counterparties to derivative contracts, central counterparties (CCPs) and trade repositories. EMIR came into force on 16 August 2012, although some of the requirements (such as some level 2 provisions relating to clearing and risk mitigation) were phased-in. On 17 June 2019, the EMIR Refit Regulation (or EMIR 2.0) came into force making certain amendments aimed at simplifying requirements and making obligations on smaller counterparties more proportionate. This note will treat EMIR and EMIR Refit as one.

EMIR- main requirements

- Mandatory central clearing of certain classes of OTC derivatives entered into between certain types of counterparty
- Collection of margin in respect of uncleared OTC derivatives between certain types of counterparty
- Reporting of all eligible OTC derivatives to authorised trade repositories
- Certain other risk mitigation requirements for OTC derivatives

EMIR - who is within scope?

EMIR applies to counterparties to derivative trades, CCPs and trade repositories. Certain EU central banks and other public bodies are exempted as well as central banks/public debt management bodies in the USA and Japan.
EMIR's obligations apply differentially according to a counterparty's categorisation - financial counterparty (FC) or non-financial (NFC). NFC's are

further categorised according to the extent of their derivative trading.

Note that as an EU Regulation EMIR can only have direct effect on entities that are "established in the Union". EMIR has no **direct** effect on TCEs.

Financial counterparties

Financial Counterparty is defined by Article 2(8) of EMIR. The category comprises the following regulated entities: credit institutions, investment firms, insurance companies, certain pension scheme arrangements (PSAs) and alternative investment funds (AIFs) managed by alternative investment managers (AIFMs) authorised or registered under the AIFMD. EMIR Refit introduces a new concept of a "small financial counterparty" (FC-). An FC- will be exempted from the clearing obligation, but remains subject to the risk mitigation requirements, including the obligation to exchange VM\IM.

The determination for whether an entity is an FC or an FC- will be made using the same clearing thresholds that apply to non-financial counterparties (NFCs)[1], on the basis of an annual calculation aggregating the preceding year's month end notional averages, at the group level or fund level for UCITS and AIFs.

EMIR Refit Regulation expands the FC definition to include an AIF (as defined by Art 4(1)(a) AIFMD) which is itself established in the EU, irrespective of the registration\authorisation of its managers[1].

This relatively minor change is more consequential in its second-order effect. Under EMIR 1.0 a non-EU AIF managed by a non-EU AIFM would have been classified as a third country hypothetical NFC. By contrast, under EMIR Refit, applying the test "What would this entity be if it were established in the EU?" - the same non-EU AIF/non-EU AIFM will be categorised as a third country hypothetical FC. As a hypothetical NFC and below the clearing thresholds (NFC-), the AIF was exempt from margin requirements in transactions with EU FCs. As a fellow (albeit hypothetical) FC+\-, the exemption no longer applies. The following combinations are now in indirect scope for some but not all of the EMIR obligations:

- Non-EU AIFs managed by a non-EU AIFM;
- Close-ended non-EU AIFs managed by an EU AIFM exempt under AIFMD; and
- The managers of the above funds.

Clearing Obligation

When trading with an EU FC+/- or NFC+, non-EU AIFs will become indirectly subject to the clearing obligation, but only to the extent that they also meet the clearing threshold.

[1] Exemptions exist in respect of AIFs exclusively established to serve one or more employee share purchase plans, or an AIF that is a securitisation special purpose entity (as referenced by Art. 2(3)(g) AIFMD).

Margin Requirements

Third-country counterparties (e.g. non-EU AIFs) trading with an EU FC or NFC+ may indirectly be required to comply with the margin requirements. In particular, non-EU AIFs previously categorised as third-country equivalent to NFC-s, will now be indirectly required to comply with margin requirements when facing an EU FC (or EU NFC+). Third-country entities trading with funds that will now be FCs may find that this is a new requirement as the clearing threshold no longer plays a part in whether the fund must exchange margin.

Note that special purpose vehicles ("SPVs") established by EU or non-EU AIFs will continue to be treated as NFCs.

Non-financial counterparties

A non-financial counterparty is defined in Article 2(9) of EMIR as "an undertaking which is established in the Union", other than a CCP or a financial counterparty. Recital 29 to EMIR acknowledges that NFC's use OTC derivative contracts to protect themselves against commercial risks directly linked to their commercial activities. Therefore, EMIR takes into account the purpose for which NFC's use OTC derivatives and the size of their exposure to such instruments.

It divides non-financial counterparties into two groups: counterparties whose trading exceeds the EMIR clearing threshold and those which do not. This test is used to determine whether the clearing obligation (will apply to the counterparty and to what extent the risk mitigation techniques will apply. The reporting requirement applies to contracts entered into by all non-financial counterparties irrespective of how much derivatives trading they carry out.

What products are within scope of EMIR?

The clearing requirements and risk mitigation requirements for uncleared trades under EMIR apply to derivative contracts as defined in Annex 1 Section C (4) to (10) of the MiFID II Directive when these products are traded OTC. This includes certain options, futures, swaps, forwards and contracts for differences (CFDs). The clearing requirement applies only to those contracts that have been identified as suitable for central clearing.

The reporting requirements relate to all derivative contracts (irrespective of whether they are traded on-exchange or OTC).

There are exemptions with respect to the margin requirements for certain OTC FX products. Initial Margin does not need be collected on physically settled FX forwards and swaps or on the exchange of principal and interest in currency swaps. On 18 December 2017, the ESAs submitted to the Commission a draft RTS to disapply the requirement to collect variation margin for physically settled foreign exchange forward contracts where one of the counterparties is not a credit institution or investment firm subject to the Capital Requirements Regulation, or equivalent counterparty outside the Union. In the meantime, the ESAs have

encouraged regulatory forbearance in advance of the RTS amendment.

EMIR extra-territoriality

EMIR does have **direct** extra-territorial effect on those trades between two TCEs which have a "direct, substantial and foreseeable effect within the Union". This appellation has been clarified by Commission Delegated Regulation (EU) 285/2014 and includes contracts under which at least one of the TCEs benefits from a guarantee by an FC established in the Union, if the guarantee covers a notional amount over EUR 8 billion (or a proportion of that threshold equal to the percentage of the liability covered by the guarantee), and is equal to at least 5% of the guarantor FC's total exposures to OTC derivative contracts.

EMIR application summary

With / Organisation	CCP (EU)	FC+	FC-	NFC+	NFC-	TCE*
CCP (EU)	n/a	1,2	n/a	n/a	n/a	n/a
FC+	1,2	1, 2, 3	2,3	1, 2, 3	2	**3**
FC-	2	1,2,3	2,3	1, 2, 3	2	**3**
NFC+	1,2	1,2,3	2,3	1, 2, 3	n/a	n/a
NFC-	n/a	n/a	n/a	n/a	n/a	n/a
TCE*	n/a	**3**	**3**	n/a	n/a	n/a

*e.g. Jersey and Guernsey entities

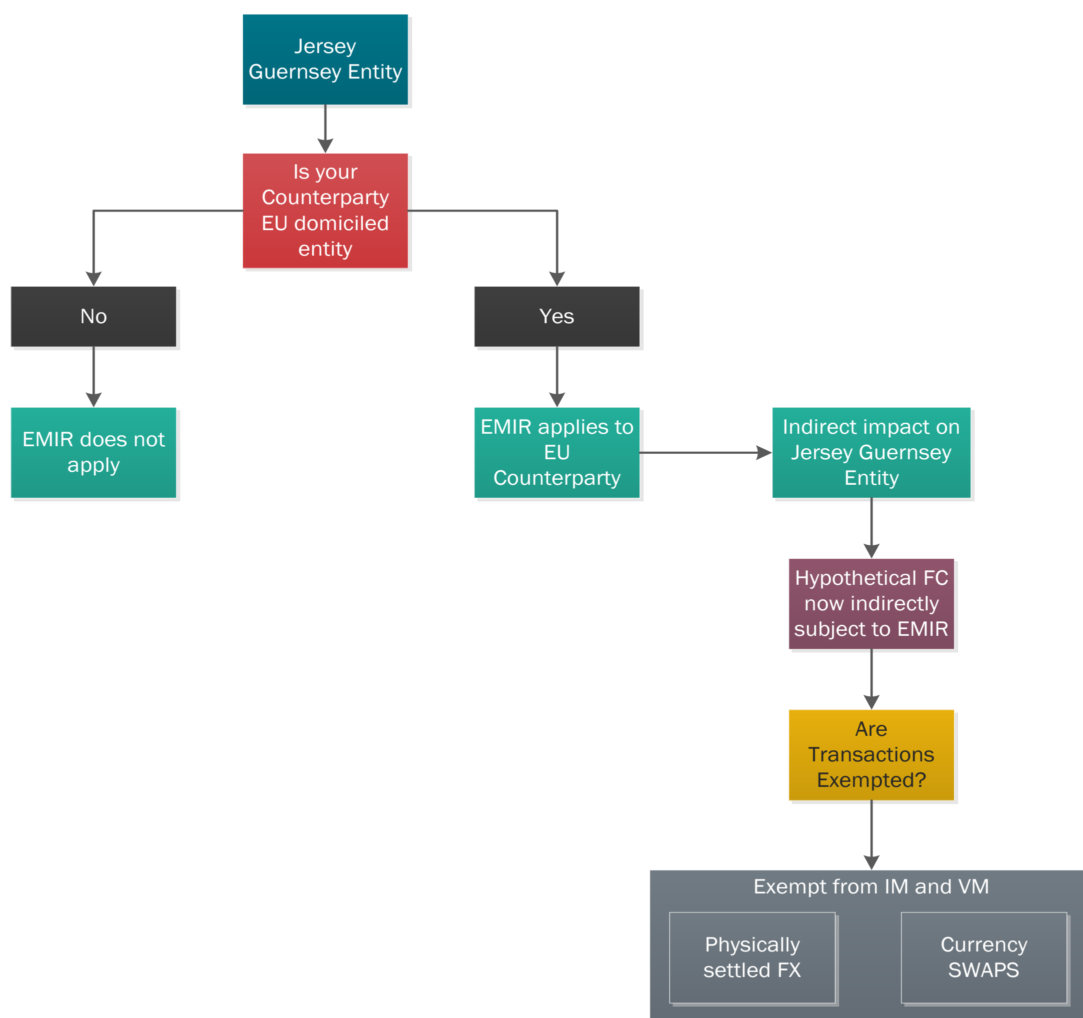
Key

1: Clearing Obligation

2: Reporting Obligation

3: Risk Mitigation

EMIR- am I affected?



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