

14 October 2020

Circular on Regulation N^o 648/2012 – The European Markets Infrastructure Regulation ('EMIR'/the 'Regulation')

2020 Compliance Inspections: General Findings

Introduction

This Circular is being addressed to all market participants, particularly entities who enter into derivative contracts and which fall within the scope of EMIR, namely, financial ('FC') and non-financial counterparties ('NFC') as defined under EMIR (jointly hereinafter referred to as 'Counterparties').

Purpose of the Circular

This Circular presents the findings that were discovered during the EMIR-related compliance inspections conducted by the Authority during 2020.

Since 2014, the Authority has been conducting compliance inspections in order to verify the extent of implementation of the Regulation by the industry, and to review the relevant controls and procedures for the proper conduct of business in terms of EMIR.

MFSA officials within the Authority's Securities and Markets Supervision Function, have analyzed the results and have identified a number of issues which were commonly raised during these inspections. The majority of the identified issues related specifically to the introduction of Regulation N^o 2019/834 ('EMIR Refit') which entered into force in June 2019, with the purpose of amending and simplifying EMIR to address disproportionate compliance costs, transparency issues and insufficient access to clearing for certain counterparties.

This **Circular presents the MFSA's findings relating to how** Counterparties adhere to the respective requirements emanating from EMIR. Without prejudice, the Circular also provides recommendations of what are considered to be good practices for entities to seek to adhere to their legal obligations. Please note that such recommendations are only aimed to provide guidance and should not be in any way construed as legal advice and/or interpretation. The obligation to ensure that Counterparties satisfy the requirements of the applicable laws and that their policies and procedures are kept up-to-date, rests solely with the directors of the companies. Furthermore, this **Circular provides the MFSA's position as at the date of publication** and could be subject to change depending on any clarifications which ESMA might issue from time to time.

Findings

1. Counterparty Classification and Clearing Obligation Thresholds

EMIR Refit provides a new regime to determine when FCs and NFCs are subject to the clearing obligation.

Under the EMIR Refit, FCs and NFCs will decide whether or not to calculate their positions in OTC derivative contracts against the clearing thresholds in gross notional value¹. In the event that counterparties decide to calculate their clearing thresholds, they should every 12 months, calculate their aggregate month-end average position for the previous 12 months. Where a FC or an NFC decides not to calculate its positions against the clearing thresholds, it will become subject to the clearing obligation for all OTC derivatives pertaining to any class of OTC derivatives for which the clearing obligation is applicable.

On the other hand, if a FC calculates its positions and the result of that calculation exceeds the clearing threshold, the FC will become subject to the clearing obligation for all OTC derivative contracts pertaining to any class of OTC derivatives for which the clearing obligation is applicable. In the case of an NFC, where an NFC calculates its positions and the result of that calculation exceeds the clearing thresholds, the NFC will become subject to the clearing obligation only for the OTC derivative contracts in asset classes for which the result of the calculation exceeds the clearing thresholds.

Counterparties are required to immediately notify the Authority:

- (1) If they decide not to calculate their positions against the clearing thresholds;
- (2) When the result of the calculation exceeds the clearing threshold;
- (3) When they no longer exceed the clearing thresholds.

During the inspections, MFSA officials have encountered instances whereby Counterparties failed to provide the clearing threshold calculation in accordance with EMIR Refit. Consequently, such Counterparties were not in a position to confirm their classification for the purposes of EMIR. As aforementioned, Counterparties which do not calculate their positions against the clearing threshold would be expected to clear all OTC derivative contracts for which the clearing obligation applies. Accordingly, in the event where Counterparties do not clear their OTC derivative contracts, they are required to provide adequate substantiation to this effect.

¹EUR 1 billion for equity derivative contracts
EUR 1 billion for credit derivative contracts
EUR 3 billion for interest rate derivative contracts
EUR 3 billion for foreign exchange derivative contracts
EUR 3 billion for commodity derivative contracts and others

2. Classification: Financial Counterparties

During the inspections, MFSA officials have noticed that certain AIFs have encountered difficulties in establishing their classification as a FC in terms of EMIR Refit. EMIR Refit amends the definition of FC so that it captures alternative investment funds (AIFs) and their managers. An AIF would be considered a FC either if it is managed by an alternative investment fund manager (AIFM) authorized or registered under the Alternative Investment Fund Managers Directive (AIFMD) or if it is established in the EU regardless of the location or status of its manager.

Non-EU AIFs with non-EU AIFMs will be reclassified as third country entities that would be FCs meaning that they become subject, on an indirect basis, to the margin requirements when trading with EU dealers.

3. Reporting Delegation

Under EMIR, a counterparty or a CCP which is subject to the reporting obligation may delegate that reporting obligation. Prior to EMIR Refit, the Authority noted that many NFC- had in fact chosen to delegate their reporting obligations to their FC counterparty (but they were still liable for being compliant with the EMIR reporting rules). Such delegation requires Counterparties to have specific agreements in place. Following EMIR Refit, FCs are legally liable for the timely and accurate reporting of OTC derivative contracts on behalf of both themselves and the NFC- counterparties.

EMIR Refit also shifts the responsibility for reporting the details of OTC derivative contracts entered by a Fund to its UCITS management company or AIFM, as applicable (in respect of the fund, the 'Fund Manager'). Fund Managers only assume responsibility for reporting derivative contracts entered into by their Funds that constitute OTC derivative contracts as defined under EMIR. Following EMIR Refit:

- A Fund remains responsible and legally liable for reporting details of derivative contracts executed on its behalf on an EU regulated market or a third country market that is treated for EMIR purposes as equivalent to an EU regulated market;
- The Fund's fund manager becomes responsible and legally liable for reporting details of all other derivative contracts executed on behalf of that Fund.

During the inspections, it appeared that counterparties were not fully aware of the abovementioned changes brought about by the EMIR Refit. The Authority encourages Funds and their managers to look into the applicable requirements following the coming into force of EMIR Refit, and ensure full compliance thereto, by *inter alia* determining whether any changes to their processes and procedures would be required as a result of the amendments to EMIR.

During compliance inspections, MFSA officials have also encountered instances whereby delegation agreements were not always in place or if in place, were incomplete or not signed by

both counterparties. The Authority expects undertakings to have in place complete and finalized documentation of such agreements, which would need to be made available before or during on-site inspections.

4. Risk Mitigation Techniques

EMIR specifies that all entities should have the appropriate arrangements in place in order to mitigate risks when entering into OTC derivative contracts which are not cleared by a CCP.

As a general remark, the majority of Counterparties have sought to satisfy the requirements relating to risk mitigation techniques. Nevertheless, although carrying out risk mitigation techniques in practice, a number of Counterparties did not have the necessary documentation in place relating to the same.

It is important that all Risk Mitigation techniques are documented. During the inspections, MFSA officials have come across instances whereby although confirmation was being done, this was not documented, and parties would have verbally agreed to adopt a 'passive approach' when it comes to trade confirmations. This approach would only be possible as long as the parties would have agreed to this beforehand and in writing.

When conducting on-site visits the MFSA expects to be provided with the necessary documentation which cover all risk mitigation requirements under EMIR.

On the other hand, entities who held documentation, have either implemented tailor-made bilateral agreements with their counterparts, or chose to enter into standard master agreements such as ISDA agreements. When making use of standard master agreements, Counterparties should confirm whether the standard agreement covers all the risk mitigation requirements under EMIR. For instance, certain counterparties have opted to become EMIR-compliant by becoming signatories to specific EMIR protocols. When signing such protocols, it is important to ensure that both Counterparties are signatories to these protocols to ensure compliance. In the instance where a master agreement was in place prior to the coming into force of EMIR, Counterparties should ensure that they become compliant by having their standard master agreement updated via an amendment agreement.

MFSA officials have also come across instances whereby, similar to the delegation agreements, the agreements relating to risk mitigation techniques were incomplete or unsigned.

5. EMIR Procedures

A number of Counterparties were unable to provide a set of written procedures which establish the processes carried out in order to be compliant with the requirements emanating from EMIR. It is recommended that all Counterparties entering or intending to enter into derivative contracts, should have a detailed set of written procedures in place to ensure their compliance with EMIR.

Contacts

Should you have any queries in relation to the above, please do not hesitate to contact the EMIR team on EMIR@mfsa.mt.