GIBSON DUNN

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EMIR 3 – EUROPEAN PARLIAMENT'S PROPOSED AMENDMENTS

To Our Clients and Friends:

On 13 June 2023, the European Parliament published a draft report[1] (the "**Parliament Proposal**") on the proposal made by the European Commission on 7 December 2022[2] (the "**Commission Proposal**") which sets out contemplated amendments to the European Market Infrastructure Regulation ("**EMIR**").

The Commission Proposal resulted from a targeted review of EMIR, relating in particular to the supervisory arrangements for central counterparties ("**CCPs**"), which the Commission was required to carry out by 2 January 2023.[3] As part of the standard EU legislative process, it was then up to the Parliament to be involved, which led to the Parliament Proposal.

The primary aim of the changes contemplated by the Commission and the Parliament, referred to as EMIR 3, is to improve the attractiveness and resilience of the EU clearing system and reduce the exposure of EU entities to third-country CCPs. EMIR 3 also draws lessons from some specific issues that became apparent during the recent energy crisis, and includes other targeted modifications of EMIR.

In this context, the Parliament Proposal does entail some key divergences from the Commission Proposal, which this alert outlines.

I. The active account requirement

This is arguably the most impactful and debated provision considered by EMIR 3.

The Commission Proposal included an obligation for financial counterparties ("**FCs**") and non-financial counterparties ("**NFCs**") subject to the clearing obligation (such NFCs being often referred to as "NFC+s") to hold active accounts at CCPs established in the EU. It also required these counterparties to clear in such accounts at least a certain proportion of specific systemic derivative contracts, namely:

a. interest rate derivatives denominated in euro and Polish zloty;

b. credit default swaps ("**CDS**") denominated in euro; and

c. short-term interest rate derivatives denominated in euro.

The relevant proportion to be cleared at EU CCPs was to be determined by ESMA through regulatory technical standards.[4]

This approach, known as the "quantitative" approach, has been criticized by various market participants, including ISDA,[5] on the grounds that it would prove costly and jeopardize the competitiveness of EU firms.

Taking these concerns into account, the Parliament Proposal maintains the active account requirement, but provides for it to be gradually phased-in with a two-step approach.

1. During the first phase, the quantitative approach would be replaced with a qualitative one. EU counterparties would be required to exchange initial and variation margins in an account at a EU CCP, and to regularly enter into new positions on that account. ESMA would be charged with establishing the frequency of trading needed for it to be considered "regular", which could vary depending on the type of entity considered.[6] Eighteen months after the entry into force of EMIR 3, ESMA and the Joint Monitoring Mechanism[7] would produce a report assessing whether such qualitative approach proves sufficient to relocate clearing activities to the EU clearing system and thus protect the stability of the EU financial system.[8]

2. If, at the end of the first phase, the qualitative approach proves not to have been sufficient, then the second, quantitative phase would be implemented and ESMA would determine the proportion of derivative contracts to be cleared in the EU CCPs' active accounts.[9]

In addition, the Parliament Proposal removes euro-denominated CDS from the list of derivatives subject to the active account requirement and instead refers to other categories of derivative contracts pertaining to clearing services to be identified by ESMA as being of substantial systemic importance.[10]

II. Exemption from reporting obligation for NFC intragroup transactions

In 2019,[11] EMIR was amended to include an exemption from the reporting obligation for over-the-counter derivatives between counterparties within a group, where at least one of the counterparties is a non-financial counterparty and the parent undertaking is established in the EU[12]. The rationale for such exemption was that NFC intragroup transactions were not seen as a posing a significant systemic risk. However, in light of some of the difficulties revealed during the energy crisis, the Commission Proposal removed this exemption to ensure more visibility on NFC intragroup transactions.[13]

The Parliament Proposal considers that such removal of the exemption could be premature, as it would lead to additional burdens for corporate end-users of derivatives, without the potential supervisory upside having been established. Consequently, the Parliament Proposal reinstates the exemption and encourages ESMA to prepare a cost-benefit analysis, before reassessing whether to remove the exemption.[14] We note that other jurisdictions, such as the United States, provide relief for non-financial companies from the reporting of intragroup transactions and that in the UK, any intragroup transaction where at least one counterparty is a non-financial counterparty (or would be qualified as a non-financial counterparty if it were established in the UK) may be exempt from the reporting obligation provided that specific circumstances are met.

III. Margining exemption for single-stock and equity index options

To ensure a level playing field for EU firms and avoid regulatory arbitrage with other jurisdictions where they are exempted from margining requirements (e.g., the United States), temporary exemptions for single-stock and equity index options have been repeatedly extended, so that they would not be subject to initial margin and variation margin requirements under EMIR. The exemption is now set to expire on 4 January 2024. We note that the UK regulators are consulting on extending the UK exemption further until 4 January 2026.

The Parliament Proposal contemplates including in EMIR 3 a phase-in approach in respect of these transactions. The exemption, which would now be directly included in the Level 1 text, would be of a temporary nature. ESMA would monitor the regulatory developments in other jurisdictions and report on them every two years. On the basis of the report, the Commission would determine whether maintaining the exemption is justified. If the Commission concludes that it is not, it will specify the adaptation period at the end of which parties will need to comply with margin requirements in respect of their single-stock and equity index options, such period not to exceed 30 months.[15]

IV. Clearing exemption for transactions resulting from PTRR services

The Parliament Proposal contemplates an exemption to the clearing obligation in respect of transactions resulting from post-trade risk reduction (“**PTRR”**) services. Such services, which include portfolio compression, portfolio optimisation and rebalancing services, are deemed by the Parliament to reduce systemic and operational risk.[16] To encourage the use of PTRR services, it is thus proposed to exempt from the clearing obligation transactions which result from them (as opposed to the original trades which are the subject of the PTRR services and which would remain subject to the clearing obligation to the extent applicable). However, strict conditions would need to be complied with for the exemption to apply. In particular, the PTRR services must be performed by a provider independent of the market participants, and be a market risk neutral exercise not contributing to price formation. In addition, parties intending to benefit from the exemption must notify their competent authorities thereof.[17]

V. Centralization with ESMA of the supervision of EU CCPs

The Parliament Proposal would empower ESMA with a direct supervisory role with respect to EU CCPs, transferring decision-making authority on many matters from national authorities to ESMA. The aim is, through such centralized supervision, to better monitor clearing services in an increasingly cross-border and interconnected context and reduce the potential differences in the interpretation of EMIR between the Member States.[18]

VI. Equivalence approach in respect of margining requirements

The Commission Proposal removed the equivalence mechanism set out in Article 13 of EMIR in respect of reporting, clearing and margining obligations. This mechanism provided that counterparties were deemed to comply with such obligations as set out in EMIR to the extent that they were already subject to equivalent requirements in the jurisdiction in which they were established. This dealt with duplicative or conflicting rules applicable in different jurisdictions, and thus avoided excessive burdens on participants.

Noting that it had proven useful for market participants, the Parliament Proposal reinstates such equivalence mechanism in respect of the sole risk-mitigation techniques set out in Article 11 of EMIR, in particular the margining obligation.[19]

VII. Reporting by counterparties established outside the EU

The Parliament Proposal extends to counterparties established outside the EU, but belonging to a group subject to consolidated supervision in the EU, the requirement to report to trade repositories the conclusion (i.e. the execution), modification or termination of their derivatives. The stated intention of such change is to cover the offshore activities of EU supervised groups.[20]

VIII. Transparency in respect of clearing costs of CCPs

Under the Parliament Proposal, clearing services providers (whether clearing members or clients) would be required to inform their clients of the costs associated with the clearing services of the different CCPs where clearing of the relevant position is possible.[21]

IX. Transparency and control in respect of risk-mitigation techniques

In this respect, the Parliament Proposal entails two new requirements.

a. FCs and NFCs shall be required to notify the European Banking Authority ("**EBA**") and their competent authorities of their initial margin calculation models, at the latest 60 working days prior to first using them. If they find such models not to comply with the applicable conditions, such authorities may object to their use, in which case the relevant entities will be required to cease using them and instead use another model within a year.

b. FCs shall be required to report information on their risk-management procedures (including, where applicable, in relation to the initial margin models used) to the EBA and their competent authorities and disclose key information therein.[22]

X. No prior authorization for CCPs' "business as usual" changes

Taking one step further the "non-objection procedure" put forward in the Commission Proposal, the Parliament Proposal would create a new subset of "business as usual" changes, which CCPs could make without prior authorization. The changes would, however, be reviewed and reported on by ESMA on a regular basis.[23]

XI. Next steps

As illustrated above, the revisions that may result from EMIR 3 may have broad impacts for EU market participants (and their affiliates), including for non-financial corporates. However, there are still a number of points which require further discussions for a compromise to be reached. The Council, Commission and Parliament will need to engage in further exchanges to ultimately produce an agreed text.

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[1] https://www.europarl.europa.eu/doceo/document/ECON-PR-749908_EN.pdf.

[2] Available *here*.

[3] Article 85(7) of EMIR.

[4] Article (I) (4) of the Commission Proposal.

[5] https://www.isda.org/a/a6ygE/ISDA-commentary-EMIR-3.pdf

[6] Amendments 30 to 32 of the Parliament Proposal.

[7] This new mechanism, introduced by the Commission Proposal, is intended to bring together the various bodies involved in the supervision of EU CCPs, clearing members and clients.

[8] Amendment 38 of the Parliament Proposal.

[9] Amendment 38 of the Parliament Proposal.

[10] Amendment 35 of the Parliament Proposal.

[11] Article 1(7) of Regulation (EU) 2019/834.

[12] This need for the parent undertaking to be established in the EU in order to benefit from the exemption has been clarified by the Commission (TR answer 51(m) in ESMA's Q&A relating to EMIR - available *here*).

[13] Article (I)(5) of the Commission Proposal.

[14] Amendment 50 of the Parliament Proposal.

[15] Amendment 60 of the Parliament Proposal. It is worth noting that, on 13 June 2023, the EBA, EIOPA and ESMA sent a letter to the Commission, Parliament and Council seeking for a permanent treatment of single-stock and equity index options with respect to margin requirements, indicating that EMIR 3 provides a good opportunity to clarify this issue (available *here*).

[16] Amendment 3 of the Parliament Proposal.

[17] Amendment 29 of the Parliament Proposal.

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[18] Explanatory statement included in the Parliament Proposal.

[19] Amendment 64 of the Parliament Proposal.

[20] Amendment 49 of the Parliament Proposal.

[21] Amendment 42 of the Parliament Proposal.

[22] Amendment 59 of the Parliament Proposal.

[23] Amendment 101 of the Parliament Proposal.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact the Gibson Dunn lawyer with whom you usually work in the firm's Global Financial Regulatory, Financial Institutions or Derivatives practice groups, or any of the following:

***Paris**:*
Vincent Poilleux (+33 (0) 1 56 43 13 00, vpoilleux@gibsondunn.com)
Farida Ouriachi (+33 (0) 1 56 43 13 00, fouriachi@gibsondunn.com)
Emma Lavaysse di Battista (+33 (0) 1 56 43 13 00, elavaysse@gibsondunn.com)

***United Kingdom**:*
Michelle M. Kirschner (+44 (0) 20 7071 4212, mkirschner@gibsondunn.com)
Martin Coombes (+44 (0) 20 7071 4258, mcoombes@gibsondunn.com)

***United States**:*
Jeffrey L. Steiner – Washington, D.C. (+1 202-887-3632, jsteiner@gibsondunn.com)
Adam Lapidus – New York (+1 212-351-3869, alapidus@gibsondunn.com)