EMIR 3.0: What are the high level changes on the horizon for derivative end users in the EU?

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Background

Following the publication by the European Commission of a proposal in relation to amendments to the European Market Infrastructure Regulation (Regulation (EU) No 648/2012) (**EMIR**) in December 2022 and the provisional political agreement reached between the European Parliament and Council of the EU on 7 February 2024 in relation to the proposed changes, which are known as "EMIR 3.0", on 24 April 2024 the European Parliament adopted the final texts[1] in its plenary session.

EMIR 3.0 aims to increase the safety and efficiency of EU central counterparties (**CCPs**) and encourage more clearing in the EU in order to address the financial stability risks associated with excessive exposures of EU clearing members and clients to systemically important third country CCPs (**Tier 2 CCPs**), currently LCH Limited and ICE Clear Europe Limited[2]. In addition, an accompanying directive amending the Capital Requirements Directive (Directive 2013/36/EU) (**CRD**) in relation to the treatment of concentration risk towards CCPs has been published.

This alert highlights the main changes that are likely to be of interest to derivatives end-users.

Although much press attention has focussed on the new active account requirement, which, along with the new CCP supervision provisions, were the subject of intense debate during the political negotiation process, there are several other significant changes of which derivatives end-users should be aware so that they can start thinking about the steps they might need to take in order to be able to meet the new requirements. Much of the detail still needs to be fleshed out in level 2 technical standards so counterparties will need to regularly monitor any developments going forward.

Timing

EMIR 3.0 is expected to be published in the Official Journal of the EU later this year. It will then enter into force 20 days after the date of publication, with most of the provisions except the new clearing thresholds stated to apply from that point.

However, several provisions, including the active account requirement and the new clearing thresholds, require the European Securities and Markets Authority (**ESMA**) to put in place regulatory technical standards so the precise detail in relation to those provisions will not be known until the relevant ESMA technical standards are in force, which may be sometime later in 2025.

Clearing threshold calculation changes

- Financial counterparties (**FCs**)

Going forward under EMIR 3.0, every 12 months an FC will need to do **two** separate calculations, in respect of: (i) its month-end average positions for the previous 12 months in uncleared OTC derivatives; and (ii) its aggregate month-end average positions in **cleared and uncleared** derivatives (the **aggregate threshold**).

If the FC exceeds the clearing thresholds, which are to be specified by ESMA in regulatory technical standards, or does not perform these calculations, the FC will be subject to the clearing obligation for all OTC derivative contracts in all asset classes within 4 months.

- Non-financial counterparties (**NFCs**)

NFCs have to calculate their **uncleared** positions in OTC derivative contracts every 12 months, subject to the hedging exemption, which will now be available at the group level. ESMA has 12 months after the entry into force of EMIR 3 to prepare draft regulatory technical standards setting out the clearing thresholds for the uncleared positions for NFCs and reviewing the current hedging exemption.

The changes to the clearing thresholds in EMIR 3.0 will not apply until the date of entry into force of the related ESMA RTS.

What is the new active account requirement?

EMIR 3.0 introduces a new concept of an active account requirement, the aim of which is to reduce reliance on Tier 2 CCPs and increase clearing of certain derivatives trades in the EU.

The active account requirement would apply to:

- euro or polish zloty denominated interest rate derivatives; and
- euro denominated short-term interest rate derivatives.

Which entities are in scope of the active account requirement?

FCs, as well as NFCs above the clearing thresholds (**NFC+s**), will need to have at least one operational active account open at an EU authorised CCP and, if they meet certain criteria, may need to clear at least a representative number of transactions at such CCP (see below for further detail on the 'representativeness obligation').

Any active account is subject to certain operational elements including that the account is permanently functional, with IT connectivity, legal documentation and systems in place so that the account can be used at short notice for large volumes of derivative contracts moved from a Tier 2 CCP.

There is a review clause 18 months after entry into force: ESMA is tasked with assessing the impact of EMIR 3.0 in reducing exposures to systemically important Tier 2 CCPs and proposing any measures it deems necessary, including quantitative thresholds. The European Commission then has 6 months to prepare its own report accompanied by a legislative proposal where appropriate.

What is the representativeness obligation?

FCs and NFC+s that are subject to the active account requirement with a notional clearing volume outstanding of **EUR 6 billion** or more will need to clear a representative number of derivative transactions in each of the sub-categories set out by ESMA within a certain reference period, to be determined by ESMA.

There is a de minimis threshold for entities such as pension scheme arrangements that have a limited number of trades and the resulting trades exceed half of the counterparty's total trades for the preceding 12 months.

There is also an exemption for FCs and NFC+s that clear at least 85% of their derivatives contracts in scope of the active account requirement at an EU CCP as well as for the provision of client clearing services.

Intragroup transaction exemption from margin and clearing

Currently, under EU EMIR, in order to benefit from the intragroup transaction exemption from the clearing and margin requirements for a transaction between an EU entity and a third country entity within the same group, the European Commission must have made an equivalence decision respect of that third country. EMIR 3.0 removes the need for an equivalence decision and instead there is a simpler framework, namely that the third country must not be on a list of jurisdictions for which an exemption cannot be granted, such as high-risk countries that have strategic deficiencies in their anti-money laundering regimes and counter-terrorist financing and jurisdictions that are non-cooperative for tax purposes.

Exemption from the clearing obligation for third country pension scheme arrangements

Although the exemption from the clearing obligation for pension schemes under EMIR expired on 18 June 2023, EMIR 3.0 introduces a new exemption for third country pension schemes. Where an FC or NFC+ enters into a derivative transaction with a pension scheme arrangement that is established in a third country, the transaction will be exempt from the clearing obligation under EMIR 3.0 provided that it is exempted from the clearing obligation under that third country's national law.

Clearing exemption for post-trade risk reduction (PTRR) services

EMIR 3.0 introduces a specific exemption for transactions involving qualifying PTRR services. To benefit from the exemption, the PTRR provider must be independent from the counterparties and meet certain authorisation requirements, including being authorised under MiFID II and other conditions. ESMA is tasked with developing regulatory technical standards setting out the detailed requirements within 12 months of EMIR 3.0 coming into force.

Reporting

With regards to NFC+s whose intragroup trades are exempt from the reporting obligation, there is a new requirement for their EU parent entities to report the net aggregate derivative positions of NFC+s that are part of the same group to its National Competent Authority (**NCA**) on a weekly basis.

Permanent exemption for equity options from margin

EMIR 3.0 introduces a permanent exemption for single-stock options and equity index options from the initial margin requirements, which is subject to a review by ESMA every 3 years. The current exemption was set to expire on 4 January 2024 although ESMA has published[3] regulatory technical standards extending this exemption by 2 years, until 4 January 2026, together with a no-action opinion regarding supervisory expectations until this new provision under EMIR 3.0 is in place. A permanent exemption would be a welcome change and provide a longer-term solution, removing the need for the rolling of the temporary exemption.

Implementation period for NFCs becoming subject to margin for the first time

There will also be a 4 month implementation period for NFCs who have exceeded the clearing thresholds and become subject to the requirement to exchange initial margin for the first time. This would be welcomed by NFCs as it will provide more time to put in place and test new collateral arrangements.

Uncollateralised bank guarantees as collateral

NFCs will be able to use uncollateralised bank guarantees as collateral. CCPs are to set out whether they can accept fully uncollateralised bank guarantees and ESMA is to specify the conditions under which commercial bank guarantees may be accepted

Initial margin models

EMIR 3.0 proposes a co-ordinated approach to the validation of initial margin models in recognition of the fact that many counterparties use industry wide initial margin models (such as ISDA SIMM) to comply with the initial margin requirements for OTC derivatives. The European Bank Authority (**EBA**) is given a role as a central validator and will assist NCAs in the approval process of industry-wide margin models, for a fee.

CCP supervision

ESMA is given more oversight of CCPs and a coordinating role in the supervision of CCPs. It will also establish a central database to share information on authorisations, extension of services and model validations.

Additional transparency requirements for CCPs

There are certain new transparency measures in relation to CCPs, including the requirement for CCPs to disclose fees charged to clients, report on clearing activity at third country CCPs and provide information to ESMA on the average clearing activity at EU CCPs.

Penalties

NCAs can impose penalties of up to 3% of the average daily turnover in the prior year on counterparties that do not comply with the operational active account requirement.

In addition, NCAs can impose periodic penalties of up to 1% of the average daily turnover for the prior year on entities subject to the reporting obligation where the details reported repeatedly contain manifest errors. ESMA has 12 months to submit draft regulatory technical standards setting out what constitutes systematic manifest errors.

Changes to CRD

The directive sets out more specific tools and powers under Pillar 2 in the context of excessive concentration risks arising from exposures to CCPs. The EBA is tasked with developing guidelines to specify a consistent methodology for integrating the concentration risk to CCPs in the supervisory stress testing within 18 months of entry into force of the directive.

Next Steps

The final texts now need to be translated before they can be formally adopted at Ministerial level by the Council of the EU and by the European Parliament in the autumn. It is expected that entry into force will occur later this year.

Counterparties would then be required to open an active account 6 months after entry into force, so this could be in first half of 2025. Some of the level 2 measures, such as the regulatory technical standards relating to the representativeness obligation may be in place around Q3 2025.

UK EMIR

HM Treasury has announced that certain aspects of UK EMIR will form part of the next phase of work reviewing assimilated law repealed by the Financial Services and Markets Act 2023, known as "Tranche 3" of the Smarter Regulatory Framework. Specifically, HM Treasury has said it will look at the authorisation, supervision and requirements of CCPs and interoperability arrangements. This therefore means that there will not be any review of the requirements directly impacting derivatives end users for some time so there will be some divergence of approach between EU EMIR and UK EMIR.

Final Thoughts

Whilst EMIR 3.0 does introduce various changes, much of the detailed provisions will be contained in the ESMA technical standards, some of which will be produced 12 months after EMIR 3.0 comes into force. Therefore, counterparties will not be able to assess the real impact of all of the changes for some time to come and will need to monitor the development of the technical standards and consider how to comply with the new requirements once EMIR 3.0 enters into force later this year.

This note is for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. Please contact your normal contact at Hogan Lovells if you require assistance or advice in connection with any of the above.

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References

1 Ratified texts of the EMIR 3.0 Regulation **and** EMIR 3.0 Directive

2 See ESMA https://www.esma.europa.eu/sites/default/files/library/third-country_ccps_recognised_under_emir.pdf

3 ESAs propose extending the EMIR equity option exemption (europa.eu)