December 2020

EMIR Update: Extension of relief on Brexit-related novations

Introduction

The loss of EU financial passporting rights after end of the Brexit transition period will have implications for cross-border OTC derivatives trading between UK and EU counterparties. The Brexit transition period is set to expire on 31 December 2020.

Post 31 December 2020, counterparties established in the UK will no longer be able to provide certain services across the EU. In particular, such UK firms will not be able to execute so-called "life-cycle events" on existing OTC contracts with EU counterparties (such as novations, unwinding by entering into an offsetting transaction, compression with new replacement contracts, etc.).

Novation of existing OTC derivative contracts with UK counterparties

Whilst many market participants will already have moved their OTC derivatives contracts from UK to EU entities during the Brexit transition period, many others will not have done so and such contracts may be subject to "life cycle" events post 31 December 2020.

For those firms which have not yet moved their OTC derivatives contracts from UK to EU entities, the concern which arises is that the novation of such contracts may trigger new clearing or margin requirements under the European Market Infrastructure Regulation[1] (**EMIR**). This is an issue for so-called "legacy contracts" i.e. existing contracts in respect of which the parties had not been required to apply the new procedures on the exchange of collateral (bilateral margins) and/or clearing obligations, either because the relevant dates for application had not taken effect or because the contracts have not been novated after those dates.

For further information on any of the issues discussed in this article please contact:

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[1] European Market Infrastructures Regulation – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories.

In light of the fast approaching end of year deadline, ESMA and the ESAs have announced further extensions of relief on Brexit-related novations of OTC derivative legacy contracts with UK counterparties.

Final Reports published by the ESAs and ESMA

On 23 November 2020, the European Supervisory Authorities (**ESAs**) published a final report (**ESA Final Report**) containing revised draft regulatory technical standards (**RTS**) amending the Delegated Regulation[2] on risk mitigation techniques for non-centrally cleared OTC derivatives (bilateral margining) under EMIR (**Risk Mitigation RTS**). On the same date, the European Securities and Markets Authority (**ESMA**) published a final report (**ESMA Final Report**) containing draft RTS amending the three Delegated Regulations[3] on the clearing obligation under EMIR (**Clearing RTS**). The draft Risk Mitigation RTS replaces the versions submitted and published on 4 May 2020 and December 2019, whilst the new draft Clearing RTS replaces two earlier Commission Delegated Regulations addressing this issue (**Novation RTS**)[4].

The draft RTS set out in the ESA and ESMA Final Reports provide a window of time within which counterparties may novate contracts from a UK to an EU counterparty without triggering the EMIR bilateral margining requirements and the EMIR clearing obligations under certain conditions. This transitional relief seeks to ensure a level playing field between EU counterparties and the preservation of the regulatory and economic conditions under which the contracts were originally entered into. The measures set out in the draft RTS in respect of Brexit-related novations are time limited and will expire 12 months from the date of application of the revised RTS.

These measures follow calls issued by the International Swaps and Derivatives Association (**ISDA**) and the Association for Financial Markets in Europe (**AFME**) (together, the **Joint Associations**) to the European Commission and the ESAs[5] for the amendments to the Novation RTS so that the transitional relief will start to apply as soon as possible and continue to be available for a period of 12 months from 31 December 2020.

Separately, the revised RTS address the following additional items:

- Intragroup Transactions: the temporary exemption from the clearing obligation and the bilateral margin requirements for intragroup transactions relating to intragroup transactions with a third country entity, in the absence of an equivalence decision, has been extended from 21 December 2020 to 30 June 2022.

- Equity Options: the draft RTS on bilateral margining requirements extend the temporary exemption from the margin requirements for single equity and index options from 4 January 2021 to 4 January 2024.

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[2] Commission Delegated Regulation (EU) No 2016/2251 of 4 October 2016.
[3] Commission Delegated Regulations (EU) 2015/2205 of 6 August 2015, (EU) 2016/592 of 1 March 2016 and (EU) 2016/1178 of 10 June 2016.
[4] Commission Delegated Regulations (EU) No. 2019/396 and No. 2019/565.
[5] Letter of 27 August 2020 addressed to Fabrizio Planta, Head, Markets Department ESMA and to Patrick Pearson, Head, Financial Markets Infrastructures, European Commission.

Timelines / Regulatory Forbearance

The revised version of the Risk Mitigation RTS and the Clearing RTS have now been submitted by the ESAs to the European Commission for endorsement. Once endorsed, the RTS are subject to non-objection by the European Parliament and the Council.

As this may take some time, the ESA Report and the ESMA Report indicate that the ESAs and ESMA expect competent authorities to exercise regulatory forbearance and to apply the margin requirements and clearing requirements "*in a risk-based and proportionate manner*" until the proposed revisions enter into force.

Action Points

Counterparties should commence the negotiation of the novation of their legacy OTC transactions if they wish to avail of the relief from the EMIR margining and clearing requirements as provided for in the RTS.

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December 2020

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