

Factsheet

EMIR – European Market Infrastructure Regulation

1. Background

In response to the economic and financial market crisis, the heads of state and government of the G20 countries initiated a reform of the derivatives market in 2008/2009; aiming to improve the transparency of foreign exchange markets, reduce systemic risks and increase protection against market abuse. In this context, the European Union (“EU”) issued *Regulation (EU) No. 648/2012 on OTC¹ derivatives, central counterparties and trade repositories (known as “EMIR” - European Market Infrastructure Regulation)*, which entered into force in the EU on 16 August 2012 and has since been directly applicable in all EU countries. Following the incorporation of EMIR into the Agreement on the European Economic Area (EEA Agreement), these provisions have also been directly² applicable in the EEA/EFTA States (Iceland, Liechtenstein and Norway) since 1 July 2017. At the same time, the corresponding EMIR Implementation Act came into force in Liechtenstein. As of 31 May 2018, all key Level II legal acts, issued by the EU Commission based on EMIR, have been incorporated into the EEA Agreement³. These new requirements apply to the EEA/EFTA States, taking various transition periods into account since 1 June 2018.

With this Factsheet we would like to inform you about the key contents of the EMIR Regulation. Please also note that the information contained in this Factsheet is non-binding and no guarantee of correctness or completeness is provided. In particular: it cannot, under any circumstances, replace legal or expert advice in individual cases.

2. Which derivative contracts/transactions are affected by EMIR?

The key goal of EMIR is to make stock exchange and over-the-counter derivatives trading more transparent and secure by requesting standardised OTC derivatives being settled through central counterparties and by reporting all derivative contracts/transactions to trade repositories. The derivative contracts concerned are defined in Art. 2 (5), (6) and (7) EMIR. The definition of derivatives under EMIR is very broad and includes both exchange-traded and OTC derivatives of the following classes:

- Credit Derivatives (Credit Default Swap)
- Equity derivatives (e.g. OTC option on equities)
- Interest rate derivatives (e.g. interest rate swaps)
- Currency derivatives (e.g. forward exchange contracts)
- Commodity derivatives and other derivatives not mentioned above

3. Who is affected by EMIR?

All undertakings domiciled in the EEA that conclude derivative contracts/engage in derivative transactions are directly affected by the regulation. The term “undertaking” is not defined exhaustively in the EMIR Regulation. According to the case law of the European Court of Justice (ECJ), however, the term “undertaking” depends on the activities of a person and not on their legal form or type of financing. Accordingly, an undertaking is an entity that performs a commercial activity and is not exclusively a consumer or employee.

Economic activity is also an activity which involves providing goods or services on a given market. Consequently, any market-related conduct targeting the supply or demand of goods or services constitutes an undertaking. Conversely, the lack of profit-making intent does not constitute an exclusion criterion.

Taking into account the purpose pursued by EMIR in designating an undertaking, a certain degree of durability must also be required. This means that an entrepreneurial activity can only be assumed if there is at least a longer-term or indefinite economic activity in economic life. In addition, EMIR excludes undertakings which are exclusively active in asset management and which must be assessed on the specific circumstances of the individual case from its scope.

Taking into account the current legal situation, European case law and the objectives pursued by EMIR, a undertaking exists at least in the following cases (the non-exhaustive list):

- Agricultural undertakings
- Industrial, commercial and service companies, regardless of their legal form
- Members of the liberal professions, e.g. tax advisors, doctors, lawyers, architects, in connection with the provision of their services
- Sole traders

No economic activity and therefore no undertaking within the meaning of EMIR is to be assumed in (non-exhaustive list)

- Non-commercially active legal entities, such as solely asset managing foundations and establishments under Liechtenstein law;
- Individuals not engaged in commercial activities;
- Persons engaged in sovereign activities;
- Charitable organizations, e.g. charitable foundations, church organizations or cultural and charitable associations;
- Persons who pursue social or non-material purposes;
- Recognized religious communities;
- Investment/share clubs, provided no obligation to be licensed as a financial services provider applies.

EMIR applies, in principle, to both financial and non-financial counterparties:

3.1 Financial Counterparties (“FCs”)

Pursuant to Art. 2 (8) EMIR, these include - according to the respective European regulations/acts - banks/credit institutions, investment firms, insurance and reinsurance undertakings, investment funds (UCITS funds and alternative investment funds (AIF) managed by an authorised or registered alternative investment fund manager) and certain institutions for occupational retirement arrangements.

¹ OTC stands for over-the-counter, i.e. not via the stock exchange, but rather directly between the parties.

² Decision of the EEA joint committee No. 206/2016 of 30 September 2016

³ Decisions of the EEA joint committee No. 112/2018 and No. 113/2018 of 31 May 2018

3.2 Non-financial Counterparties (“NFCs”)

Pursuant to Art. 2 (9) EMIR, these are all other undertakings domiciled in the EEA which are not regarded as FC. NFCs are also further subdivided into NFCs below and above a certain clearing threshold:

- a) NFC- (under the clearing threshold)
- b) NFC+ (over the clearing threshold)

The term clearing threshold is explained in more detail below under clearing obligations.

3.3 Persons not affected by EMIR

The provisions of EMIR do not apply to individuals or legal entities not engaging in any commercial activity. Although this group of persons does not per se, in itself, fall within the scope of EMIR, these persons may be indirectly affected by EMIR, namely if they enter into derivative contracts with their counterparty (e.g. their bank) and their counterparty is subject to EMIR reporting requirements.

3.4 Counterparties from third countries

Counterparties located in the EEA are obliged to comply with or enforce certain EMIR requirements even regarding counterparties from third countries, which would be considered FC or NFC if they were located in the EEA. Accordingly, such third country counterparties are affected by EMIR if they enter into derivative contracts with counterparties domiciled in the EEA.

4. What obligations does EMIR impose?

4.1 Central Clearing – Clearing obligation

Certain OTC derivatives must be cleared through a central counterparty (“clearing house”) if both counterparties are subject to the clearing obligation. NFCs are only affected by this clearing obligation if the total volume of their OTC derivatives exceeds certain clearing thresholds.

The clearing threshold is calculated on the basis of the gross nominal value of the existing derivative contracts. Different clearing thresholds apply depending on the derivative category:

| Derivative category | Clearing threshold (EUR or equivalent) |
|---------------------------------|--|
| Credit derivatives | 1'000'000'000 |
| Equity derivatives | 1'000'000'000 |
| Interest rate derivatives | 3'000'000'000 |
| Currency derivatives | 3'000'000'000 |
| Commodity and other derivatives | 3'000'000'000 |

When calculating the clearing threshold, NFC must also take into account all OTC derivative contracts entered into by other NFCs belonging to its group of companies that do not serve to hedge ongoing business risks or treasury risks. The average of the gross nominal value of the last 30 business days is the decisive criterion used to determine the threshold. If the clearing threshold for a category of derivatives is exceeded, the clearing obligation applies to all categories of derivatives.

The clearing obligation is further specified in so-called technical regulatory standards (RTS). In addition, the clearing obligation for different OTC derivative categories is constantly being expanded. Different transition periods apply depending on the category of counterparty. In particular, the obligation to “frontload” derivative contracts for certain categories of market participants is cited here as an example. In the EEA/EFTA States, depending on the category of counterparty involved, the following transitional periods currently apply to certain interest rate derivatives (IRS) and credit derivatives (CDS):

| Status of the counterparty | IRS ⁴ in EUR, GBP, JPY, USD, NOK, PLN and SEK | CDS ⁵ |
|--|--|------------------|
| <i>Category 1:</i> FC that are clearing members for a category of OTC derivatives; subject to the clearing obligation at a clearing house approved for that category | 01.12.2018 | 01.06.2019 |
| <i>Category 2:</i> FC or AIF (AIF which is not FC), not in Category 1, member of a group for which the aggregate average gross nominal volume of all OTC derivatives held for the months January, February and March 2018 exceeds EUR 8 billion | 01.06.2019 | 01.12.2019 |
| <i>Category 3:</i> FC / AIF and not in Category 1 and 2 | 21.06.2019 | 21.06.2019 |
| <i>Category 4:</i> NFC+, if not in Category 1, 2 or 3 | 01.06.2020 | 01.09.2021 |

⁴ IRS in line with Delegated Regulation (EU) No. 2015/2205 and 2016/1178 as amended by Delegated Regulation (EU) No. 2017/751.

⁵ CDS in line with Delegated Regulation (EU) No. 2016/592 as amended by Delegated Regulation (EU) No. 2017/751.

ESMA establishes and maintains a public register in which the categories of OTC derivatives subject to clearing are listed (www.esma.europa.eu/regulation/post-trading/otc-derivatives-and-clearing-obligation).

When clearing/settling OTC derivative transactions via central counterparties, the counterparties must connect promptly to a clearing house or a clearing house member. If you are subject to the clearing obligation and wish to trade clearing derivatives, we recommend that you inquire immediately about the connection to a clearing house or one of its members. Neue Bank AG is not a (direct) member of a clearing house and is thus unable to offer clearing services to its clients.

4.2 Reporting obligation

EMIR provides for a reporting obligation⁶ on all (i.e. exchange-traded and OTC) derivative contracts for FC and NFC established in the EEA. In the EEA/EFTA States, derivative contracts that:

- a) were concluded before the date of entry into force of EMIR in the EEA (1 July 2017) and remain outstanding at that date,
- b) were concluded on or after the date that EMIR came into force in the EEA (1 July 2017).

are subject to reporting requirements.

Transactions must be reported to authorised or recognized trade repositories (TRs) no later than the business day following the conclusion of the transaction. The technical regulatory and implementing standards on reporting obligations were incorporated into the EEA Agreement on 31 May 2018. A transitional period applies for the start of the reporting obligation. The contracts affected by the reporting obligation must be reported for the first time as specified in the EEA Takeover Decision (i.e. within six months to or from 1 December 2018).

The intended TR report includes key information about the derivative contract, such as the type, maturity date, nominal value, price and settlement date, as well as the identity of the parties. In addition, both changes and termination of derivative contracts must be reported to the trade repository. The process of identifying parties to a derivative contract is now standardised worldwide. FC and NFC are identified in the report with the Legal Entity Identifier ("LEI"). For private individuals (without commercial activity), conversely, an anonymous client identification number ("Client code") is provided for identification purposes.

The LEI must be applied for from an approved Local Operating Unit, such as CICI Utility or WM Datenservice. For further information and providers, see www.leiroc.org.

Companies/undertakings domiciled outside the EEA do not, in principle, have their own reporting obligation under EMIR. However, they are indirectly affected by the reporting obligation of Neue Bank AG, as EMIR imposes a reporting obligation on EEA-based banks regarding any derivative contracts (i.e. exchange-traded and OTC derivatives), even with counterparties from third countries.

The execution of the report can be delegated to the Neue Bank AG. If you require further information regarding the reporting requirement, please contact your client advisor. Further information on the reporting obligation is also available from ESMA, at the following website: www.esma.europa.eu/trade-reporting.

5. Risk mitigation techniques

Art. 11 EMIR obliges market participants to apply certain risk mitigation techniques to OTC derivative contracts not cleared by a central counterparty. The relevant obligations and measures are briefly described below:

5.1 Obligation to confirm derivative contracts within defined deadlines

OTC derivatives that are not cleared centrally must be reconfirmed within certain deadlines. If so agreed between the parties, a corresponding reconfirmation can also be tacitly concluded. OTC derivative contracts between FC or NFC+ must be confirmed by both counterparties on the business day following the execution of the transaction⁷. OTC derivative contracts entered into with an NFC must be confirmed by both counterparties within two business days of the date of execution⁸.

5.2 Obligation to agree on appropriate procedures for resolving disagreements (dispute settlement procedures)

Counterparties to a derivative contract must have appropriate procedures in place to resolve disputes about individual transactions as promptly as possible. The time span of the dispute as well as the disputed amount must be recorded. Disputes that cannot be resolved within five business days must be reported monthly to the competent authority.

5.3 Obligation to reconcile and compress portfolios

To identify any discrepancies that may arise between counterparties with respect to the material terms of an OTC derivative contract, the counterparties to an OTC derivative contract shall conduct a portfolio comparison⁹ of the same.

The portfolio reconciliation covers the contract valuation of both counterparties and central transaction terms, such as counterparty reference number, product name, maturity date, scheduled payment or settlement dates, principal amount or quantity, currency, underlying, business day convention, any relevant fixed or variable interest rates and counterparty positions. The frequency of portfolio matching depends on the number of outstanding transactions and the classification of the counterparty.

The following rules apply to FC and NFC+:

- Daily portfolio reconciliation for 500 or more outstanding transactions, or
- Weekly portfolio reconciliation for 51 to 499 outstanding transactions, or
- Quarterly portfolio reconciliation for 50 or fewer outstanding transactions.

The following rules apply to NFC:

- Quarterly for over 100 outstanding transactions; or
- Annually for 100 or fewer outstanding transactions.

EEA counterparties to OTC derivative contracts are generally required to check regularly and at least twice a year with regard to each individual counterparty whether portfolio compression can be carried out. However, this rule only applies if one has at least 500 open OTC contract positions with the bank.

5.4 Obligation to value transactions on a daily basis

An EEA-based FC or NFC+ is required to determine the value of outstanding derivative contracts on a daily basis based on current prices¹⁰.

⁶ See Art. 9 of the Regulation (EU) No. 648/2012.

⁷ See Art. 12 of the delegated ordinance (EU) No. 149/2013.

⁸ See Art. 12 of the delegated ordinance (EU) No. 149/2013.

⁹ See Art. 13 of the Delegated Regulation (EU) No. 149/2013.

¹⁰ See Art. 11 (2) of Regulation (EU) No. 648/2012

5.5 Obligation to collateralise non-centrally cleared derivative contracts

FC and NFC+ are also required to establish risk management procedures to ensure the timely and appropriate exchange of collateral¹¹. In addition, an FC must have appropriate and adequate capital to hedge risks that are not covered by a corresponding exchange of collateral.

For FC and NFC+ established in an EEA/EFTA State, the corresponding obligations are not yet directly applicable as Delegate Regulation (EU) No 2016/2251 (“Margin RTS”) has not yet been incorporated into the EEA Agreement.

The Margin-RTS define the amount of collateral to be provided and the type of eligible collateral. Variation margin (“VM”) and initial margin (“IM”) are provided as collateral instruments. VM is used to regularly offset fluctuations in the value of derivative contracts. IM, conversely, is intended to cover current and expected future fluctuations in value that may arise between the last exchange of collateral and the re-coverage of the risk or sale of the position if one of the counterparties is unable to meet its contractual obligations.

It is not yet known when the Margin-RTS will be incorporated into the EEA Agreement and which transitional periods will apply. It is

already clear, however, that IM is also to be phased in in the EEA/EFTA States as a result of falling thresholds, analogous to the EU. The table below shows the phased introduction in the EU:

| from 1 September | Threshold |
|------------------|-------------------|
| 2016 | 3 trillion EUR |
| 2017 | 2.25 trillion EUR |
| 2018 | 1.5 trillion EUR |
| 2019 | 0.75 trillion EUR |
| 2020 | 8 billion EUR |

The obligation to exchange IM only applies if both counterparties belong to a group of companies whose gross nominal value of open, non-centrally cleared OTC derivative contracts exceeds the applicable threshold.

However, the security obligation only applies if both counterparties are FC or NFC+.

Further detailed information on the risk mitigation techniques to be applied is available from ESMA at <https://www.esma.europa.eu/regulation/post-trading/otc-derivatives-and-clearing-obligation>.

Summary of commitments:

| | Central clearing | Reporting obligation | Risk mitigation techniques 3) | | | | |
|--------------------|------------------|----------------------|-------------------------------|--------------------|----------------------|------------|---------------------|
| | | | Confirmation | Dispute resolution | Portfolio comparison | Evaluation | Collateral security |
| | 1) | 2) | 3.1 | 3.2 | 3.3 | 3.4 | 3.5 |
| FC | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| NFC+ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| NFC- | ✗ | ✓ | ✓ | ✓ | ✓ | ✗ | ✗ |
| Private individual | ✗ | ✗* | ✗ | ✗ | ✗ | ✗ | ✗ |

* Private individuals may be indirectly affected by EMIR if they enter into derivative contracts with their counterparty (e.g. their bank) and their counterparty is subject to EMIR reporting requirements.

We recommend that you familiarise yourself with the EMIR requirements and, if necessary, interact with a consultant to assess your personal situation. Further information on EMIR can be found on the website of the European Securities and Markets Authority (ESMA): www.esma.europa.eu.

If you have any questions about the content of this factsheet or about EMIR, please contact your client advisor.

¹¹ See Art. 11 (3) of Regulation (EU) No. 648/2012 in connection with the decision of the EEA joint committee No. 206/2016