On 4 May 2017, the European Commission published proposals to amend the primary European legislation on derivatives, the European Market Infrastructure Regulation ("EMIR").

Of particular importance to CLO managers and credit funds is the proposal to extend the definition of “financial counterparty” ("FC") to include securitisation special purpose entities ("SSPEs"), which includes CLO issuers, and all alternative investment funds ("AIFs"), including third-country funds.

Implications for CLOs
Counterparty classification under EMIR determines the standard of clearing obligation, risk mitigation and reporting requirements that applies to each counterparty. Financial counterparties are subject to more onerous clearing and risk mitigation obligations than non-financial counterparties ("NFCs"). Currently, most SSPEs (including CLO issuers) are NFCs. Under the new proposals, if enacted, each SSPE would be considered an FC, and would be required to value its swap positions on a daily basis and provide mark-to-market margin, i.e., post variation margin, if required. SSPEs, such as CLO issuers, are unlikely to be able to easily access eligible margin to comply with this requirement.

Implications for AIFs
The current definition of an FC excludes AIFs (EU or non-EU) managed by a non-EU manager which is not registered or authorised in the EU. The proposed change to the definition removes this carve-out. If the proposal is enacted unamended, EMIR would have extended extra-territorial reach. All AIFs—including third-country funds—would be FCs and would potentially have to comply with both the higher clearing and margining requirements.

Possible Solutions
It is not clear if the proposals would have retrospective effect, but it is generally assumed they would not and that grandfathering provisions would apply. Current CLO and credit funds asset swap arrangements may not be affected depending on their terms, but following enactment, transactions effected under the same swap agreements may be affected.

A possible solution for affected credit funds and CLOs would be to incorporate a liquidity facility to provide the entity with a funding source for its margin requirements, although this is more straightforward to incorporate into a fund structure than a CLO.

A further solution for future CLOs is to utilise liability hedging. This has been deployed successfully in the past, but it presents challenges with respect to risk retention and managers need to consider compliance with the EU and U.S. risk retention rules.
What’s Next?

The Commission’s proposals will now be considered by the European Council and Parliament. It is worth noting that the proposals appear to cut across ongoing Trilogue discussions on the Securitisation Regulation which are also considering the scope of counterparty classification. We expect this and other issues to be discussed in the upcoming legislative process for both the Securitisation Regulation and the amendments to EMIR. However the proposals as drafted would create significant difficulties for CLOs and bring third-country AIFs into scope.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London CLO, credit funds and derivatives lawyers:

Diala Minott  
44.020.3023.5181  
dialaminott@paulhastings.com

Cameron Saylor  
44.020.3023.5199  
cameronsaylor@paulhastings.com

Katherine Rainwood  
44.020.3023.5261  
katherinerainwood@paulhastings.com

Christian Parker  
44.020.3023.5161  
christianparker@paulhastings.com

Michael Smith  
44.020.3023.5170  
michaelsmith@paulhastings.com

Karen Stretch  
44.020.3023.5194  
karenstretch@paulhastings.com

For further background in relation to EMIR please see also our related Paul Hastings’ EMIR Stay Currents:

(i) the “2013 EMIR Stay Current” (https://www.paulhastings.com/docs/default-source/PDFs/staycurrent-emir-september-2013.pdf);

(ii) the “2015 EMIR Stay Current” (https://www.paulhastings.com/docs/default-source/PDFs/stay-current-european-derivatives-regulation-spotlight-on-european-markets-and-infrastructur-regulation-emir.pdf); and


3 Political negotiations and technical meetings between representatives of the European Parliament, the European Council and the European Commission, which are designed to reach agreement on a package of amendments acceptable to both the Council and Parliament.