Linklaters

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European Market Infrastructure Regulation:

Issues for pension funds

Summary

The European Market Infrastructure Regulation ("**EMIR**") came into force on 16 August 2012.[1] Some aspects are already in force with further aspects taking effect in phases. It creates a new regulatory environment for the use of derivatives across the EU and will impact all entities active in EU derivatives, whether using them for trading, hedging or investment purposes. This includes pension funds. The requirements generally apply both to existing transactions and new transactions. The three main obligations EMIR imposes are in relation to:

> **Clearing** of certain derivatives via a central counterparty ("**CCP**") – **second half of 2014** (but see pension scheme arrangements exemption);

> **Reporting** of all derivatives to a trade repository – likely to be **January 2014**; and

> **Risk mitigation techniques** for derivatives not cleared via a CCP – **March 2013/September 2013**. (see details below)

In this newsletter we address:

> why EMIR matters to pension funds;

> the temporary exemption from the clearing obligation for pension scheme arrangements; and

> what trustees should do now, particularly given that a number of obligations apply from 15 September 2013.

Why does EMIR matter to pension funds?

Unlike previous legislation covering financial regulation, which applied only to prudentially regulated entities (such as banks or investment firms), EMIR imposes obligations on all EU derivatives market participants, including pension funds.

[1] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

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It divides derivatives market participants into two categories: financial counterparties ("**FCs**") and non-financial counterparties ("**NFCs**").[2] The obligations placed on each category of entity are different and so it is important to establish the categorisation applicable to your pension fund. If a pension fund is an 'institution for occupational retirement provision' (an "**IORP**"), it will be an FC.[3] In outline, to be an IORP a pension fund must:

> operate on a funded basis;

> be established separately from any sponsoring employer; and

> be established for the purpose of providing retirement benefits in the context of an occupational activity on the basis on agreement or a contract.

Most pension funds will fall within this definition and will therefore be classed as FCs.[4]

Temporary exemption for pension scheme arrangements in relation to clearing obligations

The obligations in EMIR relating to the clearing of certain derivatives via a CCP are likely to start in the second half of 2014. However, there is a specific exemption which states that 'pension scheme arrangements' are exempt from the clearing obligation until **August 2015** at the earliest. In order to qualify for this exemption there is a two-stage test you must apply:

> your pension fund must fall within the definition of a pension scheme arrangement under EMIR; and

> the derivative must have been entered into for a particular purpose.

Notwithstanding the exemption, funds are free to subject their derivatives to clearing if they wish.

What is a "pension scheme arrangement" for this purpose?

This is a different test from the one applied to establish whether the fund is an FC or an NFC. This definition is broader and so pension funds that are not IORPs could still qualify for this exemption. A pension scheme arrangement for the purposes of this exemption includes (amongst other things):

> an IORP;

> an authorised entity responsible for managing an IORP and acting on its behalf; and

> any legal entity set up for the purpose of investment of IORPs, acting solely and exclusively in their interest (e.g. a common investment fund).

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[2] NFCs are further sub-divided into those which are above or below the clearing threshold (NFC+ and NFC-).

[3] Within the meaning of Directive 2003/41/EC (the "**IORP Directive**").

[4] If you are unsure if your pension fund falls within this definition or if you operate a common investment fund you should seek specific advice on this point.

To which derivatives does the exemption apply?

The exemption only applies to OTC derivatives that reduce investment risks directly related to the pension scheme arrangements' financial solvency. It is not a blanket exemption for all derivatives.

> ***Recommendation***:
> Consider whether the fund and its transactions qualify for the exemption.

What trustees should do now to ensure that they comply with EMIR?

The obligations under EMIR fall on trustees. To the extent that they have not already done so, trustees should be engaging with their investment managers as to the allocation of responsibility for those obligations.

Daily marking-to-market of trades – in effect since 15 March 2013

Obligation: FCs are required to have processes in place to mark-to-market the value of their outstanding non-cleared OTC derivatives on a daily basis or mark-to-model where market conditions prevent marking to market, e.g. when the market is inactive. The trustee board (or delegated committee) must understand and approve models on at least an annual basis.

> ***Recommendation***:
> Request investment advisors to review such models and advise the trustee as to whether it would be reasonable for the trustee to approve them.

Putting dispute resolution processes in place – in effect from 15 September 2013

Obligation: Before entering into a non-cleared OTC derivative, parties will need to have agreed procedures to identify disputes relating to the valuation of the contract or collateral, to record and monitor disputes and to resolve disputes in a timely manner. FCs must report any dispute in excess of EUR 15 million that is outstanding for 15 business days.

> ***Recommendations***:
> Seek comfort that managers have the requisite procedures in place.
>
> Where trustees have 'umbrella' ISDA Master Agreements, ask whether managers intend to adhere to the ISDA Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol (the "**PDD Protocol**") on their behalf.
>
> Where trustees have 'direct' ISDA Master Agreements, consider adhering to the PDD Protocol directly.
>
> The PDD Protocol is a mechanism by which existing ISDA Master Agreements can be amended to reflect the dispute resolution and portfolio reconciliation EMIR requirements.

Portfolio reconciliation – in effect from 15 September 2013

Obligation: Parties to non-cleared OTC derivative transactions must reconcile the key terms (including valuation) of their derivative portfolios in order to identify any discrepancy. The frequency of such portfolio reconciliations ranges from every business day to once a year depending on the number of transactions outstanding between the two parties and their EMIR classifications.

> ***Recommendation***:
>
> Seek comfort that managers have the requisite procedures in place. Ensure that portfolios with different managers are reconciled with the appropriate frequency. Consider adherence to the PDD Protocol as highlighted above.

Portfolio Compression – in effect from 15 September 2013

Obligation: Trustees with 500 or more non-cleared OTC derivatives with a single counterparty will need to have processes in place to regularly consider whether it is possible to conduct a portfolio compression exercise to reduce counterparty credit risk.

> ***Recommendation***:
>
> Seek comfort that managers have the requisite procedures in place.

Reporting – likely to apply from January 2014

Obligation: All EU derivative market participants will be required to report data relating to their transactions to 'trade repositories'. Trustees will need to obtain a global legal entity identifier ("**LEI**") in order to facilitate reporting.

> ***Recommendation***:
>
> Obtain an LEI. Seek comfort from managers on how they will report transactions on behalf of the trustees.

Timely confirmation of trades – already in effect since 15 March 2013

Obligation: Have processes in place for the timely confirmation of any non-cleared OTC derivatives.

> ***Recommendation***:
>
> Seek comfort from managers that they have the requisite processes in place.

Collateral – likely to be from 2015 onwards (phased in)

Obligation: To exchange collateral. Further details of the obligations are in the process of being released.

Where can I find other Linklaters client materials on EMIR and Clearing?

See below links to other Linklaters Client Knowledge Portal EMIR and Clearing materials.

BCBS/IOSCO Margin requirements for non-centrally cleared derivatives (Publication – September 2013)

Guide to the European Market Infrastructure Regulation (EMIR) (Publication – July 2013)

ISDA/FOA Client Cleared OTC Addendum – An Overview (Publication – June 2013)

What is Client Clearing (Seminar recording and materials - May 2013)

ISDA/FOA Addendum (Seminar recording and materials - May 2013)

EMIR: Obligations of non-financial counterparties coming into force from 15 March 2013 (Publication - March 2013)

EMIR Briefing (Recording and Presentation Materials - 28 February 2013)

Short video on the Implications of EMIR for Corporates (November 2012)

EMIR: Impact on Corporates - Seminar recording and slides (October 2012)

New EU Regulation on Derivatives - What Corporates Need to Know (August 2012)

Comparison table of Dodd-Frank and EMIR (Publication - May 2012)

Final Text of EMIR Released (Publication - March 2012)

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This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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