Client Alert

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Clearing Derivative Transactions in the EU: What You Need To Know

Key Highlights

- All counterparties within scope of the European Market Infrastructure Regulation ("EMIR") and subject to the clearing obligation will soon be required to centrally clear their applicable derivatives transactions.
- Draft regulatory technical standards ("RTS") have now been published, establishing the basis for a clearing obligation to apply with respect to certain over the counter ("OTC") interest rate, credit and foreign exchange derivative transactions.
- The phase-in dates for the central clearing of transactions will apply equally as between counterparties established in the EU and outside of the EU.
- Non-EU counterparties trading OTC derivatives with EU counterparties, or with other non-EU counterparties where there is a significant connection to the EU, should be aware of their classification under EMIR and categorisation as presented in the RTS.

Background

EMIR places a number of obligations on counterparties to OTC derivative transactions. These include the central clearing of trades deemed to be subject to a 'clearing obligation', trade reporting and other risk-mitigation requirements for uncleared trades (such as portfolio reconciliation and trade collateralisation). While the requirements apply mostly to institutions established in the EU, a number of EMIR's provisions (including the clearing obligation) also have extraterritorial effect. As a consequence, certain entities established outside of the EU (so-called 'third-country entities'), may have positive obligations under EMIR, dependent upon what their status would be under EMIR if they were hypothetically established in the EU and upon the extent to which they are either (i) trading with EU counterparties, or (ii) entering into derivatives trades which have a "*direct, substantial and foreseeable*" effect within the EU[1].

Although EMIR has been in force for over two years, a number of the obligations have been phased in gradually. The reporting requirement, for example, came into effect on February 12, 2014. The clearing requirement, however, has taken longer to implement and confirmation of its effective date for different asset classes and counterparties has remained dependent upon a number of factors, not least of which includes the requirement for the European Securities and Markets Authority ("**ESMA**") to determine which derivatives trades should, in

[1] An obligation may also arise where it is necessary or appropriate to prevent the evasion of any of the provisions of EMIR.

accordance with EMIR's criteria, be mandatorily clearable.

On July 11, 2014, ESMA published its initial consultation on the clearing of certain OTC credit derivatives (the "CD Consultation")[2]. On October 1, 2014, ESMA published its final report covering draft technical standards on the clearing obligation, in respect of Interest Rate OTC Derivatives ("IRS Report")[3]. Simultaneously, it published a consultation on the clearing obligation to be applied with respect to foreign exchange non-deliverable forwards ("FX NDF Consultation")[4]. Each of these publications sets out the extent to which particular derivatives trades might be appropriate for central clearing, in accordance with the criteria required to be satisfied under Article 5(4) of EMIR (the "Criteria"). For example, consideration is given to, amongst other things, the degree of standardisation of contractual terms, the volume and liquidity of the market for such transactions and the availability of relevant pricing information. The publications then go on to state when the applicable clearing obligation might apply and with respect to whom.

Interest Rate Derivatives

The IRS Report specifies that the interest rate derivative products available for central clearing fall broadly into four categories:

- Fixed-to-Floating Interest Rate Swaps (plain vanilla IRS);
- Floating-to-Floating Interest Rate Swaps (known as basis swaps);
- Forward Rate Agreements (FRA); and
- Overnight Index Swaps (OIS).

These categories are then further broken down in order to define the applicable class that is subject to the clearing obligation. Characteristics used for this purpose include settlement currency (primarily EUR, GBP, USD and JPY), maturity (e.g., between 28 days and 50 years for a basis swap, or between 3 days and 3 years for an FRA), the existence of any optionality and the notional type (constant or variable).

The draft RTS in the IRS Report set out the complete list of clearable derivative classes in Annex 1 thereto. However, ESMA makes clear that it continues to assess the scope of other interest rate derivatives denominated in non-G4 currencies and that it can "*add at any moment classes that were not previously declared to be subject to the clearing obligation*".

Credit Derivatives

Unlike the clearing of interest rate and foreign exchange derivatives, the market for credit derivatives is typically more bespoke and less standardised. As a consequence, there are fewer transaction types which satisfy the Criteria and therefore lend themselves to clearing. Nevertheless, given that the credit market represented circa $21 trillion in outstanding notional at the end of 2013[5], ESMA recognises the significance of the market and the priority need to try and clear such trades where possible. In particular, it proposed in the CD Consultation that the clearing obligation should be applied to trades referencing certain untranched indices, specifically the iTraxx Europe Main Index and the iTraxx Europe Crossover Index. Such trades should reference Series 11 of the relevant index onwards, have a 5 year maturity and settle in EUR. It remains to be seen how (if at all) these conclusions might be amended following publication of ESMA's final report on the clearing of credit derivatives.

[2] http://www.esma.europa.eu/system/files/2014-800.pdf.
[3] http://www.esma.europa.eu/system/files/esma-2014-1184_final_report_clearing_obligation_irs.pdf.
[4] http://www.esma.europa.eu/system/files/esma-2014-1185.pdf. It should be noted that separately, ESMA has also consulted on the clearing obligation as it might be applied to credit derivatives.
[5] Bank for International Settlements, statistics at December 2013 - http://www.bis.org/statistics/derdetailed.htm.

Foreign Exchange Derivatives

In the FX NDF Consultation, ESMA makes clear that it considers non-deliverable forward transactions ("NDFs") to be cash-settled foreign exchange forward contracts. Such transactions will typically specify an exchange rate against the currency of delivery (the convertible currency[6]), a notional amount of the non-convertible currency and a settlement date. Given the cash-settled nature of these transactions, there is no physical delivery of the designated currency at maturity. Instead, at the time of settlement, spot market exchange rates are compared to forward rates and the trades are cash-settled on a net basis, in the convertible currency, based on the notional amount. Such NDFs are commonly referred to in the context of a particular currency-pair, such as Taiwan Dollar (TWD) / U.S. Dollar (USD) or Brazilian Real (BRL) / U.S. Dollar (USD).

Based on its analysis of the market and the required Criteria, ESMA has provisionally concluded that the following NDF currency pairs should be subject to a clearing obligation (assuming cash settlement in USD with a maturity range between 3 days and 2 years):

- Brazilian Real (BRL) / U.S. Dollar (USD)
- Chilean Peso (CLP) / U.S. Dollar (USD)
- Chinese Yuan (CNY) / U.S. Dollar (USD)
- Colombian Peso (COP) / U.S. Dollar (USD)
- Indonesian Rupiah (IDR) / U.S. Dollar (USD)
- Indian Rupee (INR) / U.S. Dollar (USD)
- Korean Won (KRW) / U.S. Dollar (USD)
- Malaysian Ringgit (MYR) / U.S. Dollar (USD)
- Philippine Peso (PHP) / U.S. Dollar (USD)
- Russian Ruble (RUB) / U.S. Dollar (USD)
- Taiwan Dollar (TWD) / U.S. Dollar (USD)

Categorisation of Market Participants

Given the details provided with respect to which transactions are likely to become clearable, the next question is when this is likely to happen? Since ESMA recognises that different counterparties are subject to different levels of readiness for central clearing, its preference is to operate a phased-in approach, whereby the largest and most active participants shall be required to centrally clear their derivatives trades first. Accordingly, it has opted to divide market counterparties into four categories as follows:

Category 1 = *Clearing Members*. ESMA regards that Clearing Members are the group of counterparties that should have to clear first, since they are the most active participants and they already have direct access to the CCPs to clear their derivatives.

[6] This is typically USD

Category 2 = *Financial Counterparties* or *Alternative Investment Funds* ("AIFs") *that are also Non-Financial Counterparties above the clearing threshold* ("NFC+")[7], which:

- are not Clearing Members satisfying the Category 1 requirements; and
- have an aggregate month-end average notional amount of non-centrally cleared derivatives equal to or greater than, €8 billion.

Category 3 = *Financial Counterparties* or *AIF's that are also NFC+ entities*, which:

- are not Clearing Members satisfying the Category 1 requirements; and
- do not have an aggregate month-end average notional amount of non-centrally cleared derivatives equal to or greater than, €8 billion.

Category 4 = All *NFC+ entities* which are not covered by Categories 1, 2 or 3.

It should be noted that these categories reflect the position as stated in the IRS Report, following ESMA's analysis of the market's response to its proposals. At present, the CD Consultation makes reference to the application of only three phase-in categories, as per the position in the initial IRS consultation (published in July 2014). We expect, however, that the phase in of credit derivative clearing will follow the approach described above (as is also the case for foreign exchange derivatives).

Considerations for Third-Country Entities

The categorisation of entities established in third-countries is exactly the same as it is for EU counterparties. This is because third-country entities are deemed to belong to the category of counterparty to which they *would* belong, *if they were established in the Union*. Essentially, a non-EU entity that is subject to the clearing obligation shall therefore be required to make the following determinations:

- If the relevant entity were 'hypothetically' established in the EU, would it be either a Financial Counterparty or an NFC+?

A large number of third-country entities, particularly those which trade derivatives with EU counterparties, have already been asked by such EU counterparties to consider their classification under EMIR, for example, in order for the EU counterparty to work out how often portfolios of non-cleared derivatives need to be reconciled. As a consequence, for many entities, this analysis may not be entirely new. However, entities looking at this for the first time will need to consider a variety of factors, including the nature of their business and the volume of derivatives trades that they enter into[8].

- Is the relevant entity a direct Clearing Member of a CCP authorised under EMIR?

[7] The clearing thresholds refer to thresholds above which EMIR requires that a Non-Financial Counterparty shall be subject to the clearing requirement. They are as follows: €1 billion in gross notional value for OTC credit derivative contracts, €1 billion in gross notional value for OTC equity derivatives, €3 billion in gross notional value for OTC interest rate derivatives, €3 billion in gross notional value for OTC foreign exchange derivatives, €3 billion in gross notional value for OTC commodity derivatives and €3 billion in gross notional value for OTC derivative contracts not otherwise specified. Once an entity breaches the clearing threshold for any one class of derivatives, it is required to centrally clear all classes of derivatives subject to the clearing obligation.

[8] Morrison & Foerster has acted for a significant number of third-country entities in performing this analysis and would be happy to assist if this were required.

To fall into Category 1 for *all* classes of derivatives subject to the clearing obligation, an entity only needs to be a Clearing Member (of a CCP that is authorised under EMIR to clear such derivatives) for the purpose of clearing *one* of the classes of derivatives subject to the clearing obligation.

- If the relevant entity were established in the EU, would it be an Alternative Investment Fund (AIF) that qualifies as an NFC+?

An AIF is essentially a collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors. Certain AIFs do not qualify as Financial Counterparties but still trade a high enough volume of OTC derivatives to fall above the clearing threshold for a particular asset class. As a consequence, this may push the relevant counterparty into either Category 2 or 3.

Phase-In of Clearing Obligation

Given the classification of an entity in accordance with the categorisation described above, the phase-in dates for when the clearing obligation comes into effect are as follows:

- Category 1: 6 months after the applicable RTS enters into force;
- Category 2: 12 months after the applicable RTS enters into force;
- Category 3: 18 months after the applicable RTS enters into force; and
- Category 4: 3 years after the IRS RTS enters into force[9].

Counterparties in Two Different Categories

Where a contract is entered into between two counterparties included in different categories, then the clearing obligation takes effect on the latest of the two dates. Therefore, in order to know when the clearing obligation will apply in respect of clearable trades entered into between two counterparties, each counterparty must know its own categorisation, as well as the categorisation of its counterparty.

Frontloading

Article 4(1)(b)(ii) of EMIR provides the primary frontloading obligation. This states that after a CCP has been authorised to clear a particular class of derivative, but before the actual clearing obligation applies to that class of derivatives (the “frontloading period”), all derivatives of that class that are entered into or novated during the frontloading period and have a certain minimum remaining maturity, must be cleared.

The main concern with this obligation from an operational perspective has been that market participants have had no certainty regarding whether or not (or when) a particular derivative that they are about to enter into will become clearable. As a consequence, this has led to enormous pricing difficulties (i.e., should it be priced as a cleared trade or not?). Since a cleared OTC trade has a different collateralisation and liability regime to an uncleared OTC trade, it needs to be priced differently.

ESMA was charged with developing regulatory technical standards in relation to the appropriate minimum

[9] The Category 4 phase-in for interest rate swaps is 3 years (or 36 months) from the date the IRS RTS comes into force. Given that the effectiveness of the NDS RTS will follow that date by around three months, there will be a progressive shortening for each future class of derivative to be cleared going forwards, thereby ensuring that the clearing obligation for all classes of derivatives is likely to be fully implemented within 3 years of the IRS RTS coming into force.

remaining maturity for contracts to be frontloaded, and in a letter from ESMA to the Commission dated May 8, 2014, ESMA explains that the frontloading period can be subdivided into two categories:

Period A: from the time a CCP is authorised by a competent authority to clear a class of derivatives (and such authorisation is notified to ESMA) and the date of publication in the Official Journal of the RTS relating to clearing that class; and

Period B: from the date of publication in the Official Journal of the RTS relating to clearing that class and the date of application of the clearing obligation.

Period A is deemed to be the time of greater concern to market participants, since at that stage, there is no clarity on whether the class of derivatives will be accepted for clearing. In Period B, however, the RTS has been finalised and counterparties will have a date for when the clearing obligation becomes effective (depending on their categorisation).

For Period A therefore, ESMA has recommended setting the minimum remaining maturity requirement very high, to ensure that effectively no trades entered into or novated during that period will need to be cleared. For Period B, however, ESMA has recommended a reasonably low level which ensures that only those trades close to expiry (e.g., within 6 months) when the RTS are published will not have to be cleared.

Next Steps

The IRS Report has now been submitted to the European Commission. The Commission has three months within which to adopt the draft RTS in the form of a Commission Regulation. Assuming that the RTS are adopted by the end of the three month period, this means that the first phase of Category 1 clearing obligations will become applicable in mid- 2015.

The CD Consultation closed for comments on September 18, 2014. We await ESMA's final report in this regard. The FX NDF Consultation remains open for comments until November 6, 2014. Once the consultation process for these asset classes has been completed, the technical standards applicable to credit and foreign exchange derivatives will be published in final form and submitted to the European Commission for endorsement. As above, the European Commission will have three months to make its endorsement.

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