

EMIR: Amended draft RTS on the clearing obligation

January 2015

C L I F F O R D
C H A N C E

Contents

| | |
|---|----|
| Introduction | 3 |
| EMIR: illustrative implementation timeline | 4 |
| Amended draft RTS: how has the Commission responded to industry concerns? | 5 |
| IRS clearing obligation: scope | 7 |
| Categories, phase-in periods and application of the frontloading obligation | 9 |
| Application of the clearing obligation to different counterparty combinations | 10 |
| Exemption for covered bond derivatives | 11 |
| Treatment of third-country entities | 12 |
| Implementation issues for IRS | 13 |
| Consultation Paper No. 2 (CDS) | 16 |
| Consultation Paper No. 3 (FX NDF) | 17 |
| Glossary | 19 |
| Clifford Chance contacts | 20 |

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The European Commission has proposed amendments to the final draft regulatory technical standards (RTS) on the clearing obligation for OTC interest rate derivatives (IRS) delivered by the European Securities and Markets Authority (ESMA).

The Commission has written to ESMA expressing its intention to endorse with amendments the final draft RTS submitted by ESMA on 1 October 2014 after a public consultation. The Commission's proposed amendments include postponing the start date of the frontloading requirement, clarifying the calculation of the Category 2 threshold for investment funds* and providing a transitional exemption for intragroup transactions involving non-EU entities.

ESMA now has until the end of January 2015 to amend the draft RTS on the basis of the Commission's proposed amendments and resubmit in the form of a formal opinion to the Commission.

Assuming ESMA resubmits the RTS in substantially the form suggested by the Commission, it is expected that the Commission will act quickly to endorse the resubmitted RTS and send them to the Parliament and the Council for their review. On that basis, assuming the Parliament and Council quickly confirm that they have no objection, it is possible that the RTS could be published in the Official Journal (OJ) and enter into force as early as March 2015, but this timetable could slip.

This document assumes that the RTS on IRS are adopted in substantially the same form as the Commission's amended draft RTS.

OTC credit derivatives (CDS) and OTC foreign exchange non-deliverable forwards (FX NDF)

ESMA has also conducted public consultations on the clearing obligations for CDS and FX NDFs. ESMA was due to publish its final report on CDS by 22 November 2014 and its final report on FX NDF by 12 December 2014. The publication of these reports and the delivery of final draft RTS to the Commission have been delayed whilst the Commission concluded its review of the final draft RTS on IRS.

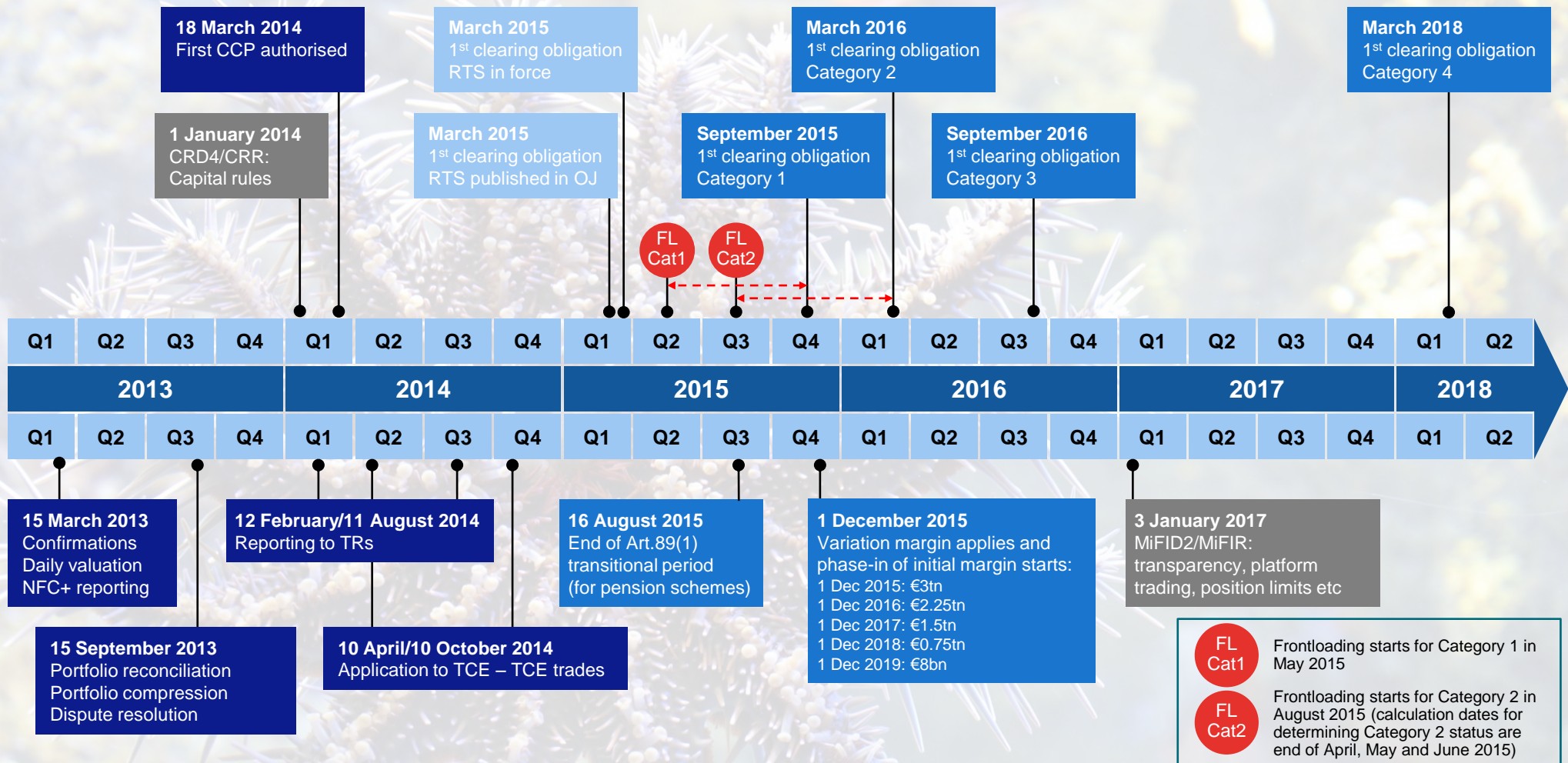
There are also other issues in respect of CDS and FX NDF which may have contributed to ESMA's delay delivering final draft RTS to the Commission. ESMA has expressed an expectation that one other CCP would be authorised to clear CDS before the entry into force of the RTS on CDS and that at least one other EU CCP would be authorised to clear FX NDFs before the clearing obligation for FX NDF comes into effect. These CCPs have yet to be authorised**.

In respect of the FX NDF asset class, there have been additional concerns regarding international convergence, particularly because the CFTC has not yet indicated which classes of FX NDF it expects to subject to the US clearing mandate.

* Whilst the Commission has stated an intention to include a recital clarifying this point, it has (perhaps inadvertently) not proposed suggested wording for this recital in the amended draft RTS.

** ESMA expects that ICE Clear Europe will be authorised before the entry into force of the RTS on CDS and that at least one other European CCP will be available to clear FX NDF before the clearing obligation for FX NDF comes into effect. ESMA is aware that CME Clearing Europe and Nasdaq OMX Clearing are developing FX NDF clearing offerings and it expects ICE Clear Europe (which currently offers a FX NDF clearing service) to be authorised in the near future. There are also a number of third-country CCPs offering FX NDF clearing services.

EMIR: illustrative implementation timeline



Note: Assumes: (i) ESMA submits revised draft 1st clearing obligation RTS consistent with the Commission's amended draft RTS, the Commission adopts the revised draft RTS without further amendment in February 2015, the Parliament and the Council confirm that they do not object and the RTS are published in the OJ and come into force in March 2015; (ii) the Commission does not extend the Article 89(1) EMIR transitional period for pension schemes (the Commission may extend this for two years and then a further year); and (iii) the margin RTS are adopted in the form originally proposed by the ESAs for consultation.

Amended draft RTS: how has the Commission responded to industry concerns?

| | Key Asks | Changes made? | Commentary |
|-------------------------|--|---------------|--|
| “Two-step” test | Amendment to recitals to avoid the risk that the RTS create a trading ban on contracts accepted for clearing by authorised CCPs at the date of their authorisation but which is subsequently not accepted for clearing by any authorised CCPs. | No | The RTS are now silent on the “two-step” test i.e. the RTS do not reference the need for a contract to have been accepted for clearing by a CCP on the date it was authorised in order for it to be subject to the clearing obligation. |
| Changing status | The date on which a contract is entered into or novated is the relevant date for determining whether the frontloading obligation applies to a contract and the categorisation of the counterparties to a contract for the purposes of the RTS. | No | Issue not addressed by the Commission. |
| Category 2 calculation | The 3 month calculation period for the Category 2 threshold should start after the RTS enter into force. | Yes | The Commission has amended the RTS so that the 3 month calculation period for the Category 2 threshold starts the month after the RTS are published in the OJ (see Article 2(1)(b) of the amended draft RTS). |
| | Transactions between members of a group should not be included in the calculation of the Category 2 threshold. | No | Issue not addressed by the Commission. |
| | The Category 2 threshold for funds should be calculated on a fund-by-fund basis. | Unclear | The Commission expresses an intention in its letter to ESMA to include a recital to this effect, but it has not made this change in the amended draft RTS. |
| Frontloading obligation | The start of the frontloading obligation should be delayed so that no contracts entered into before the date the RTS enter into force are subject to frontloading. | Yes | The frontloading period is now set by reference to the date the RTS enter into force rather than the date the RTS are published in the OJ (see Article 4 of the amended draft RTS). The list of Category 1 counterparties is still set by reference to the date the RTS enter into force rather than the date the RTS are published in the OJ (see Article 2(1)(a) of the amended draft RTS). |
| | The start of the frontloading obligation for Category 2 counterparties should be delayed until 6 months after the RTS enter into force in order to give counterparties time to determine which category they and their counterparties belong. | Yes | The frontloading period for FCs in Category 2 begins 5 months after the RTS enter into force (see Article 4(2) of the amended draft RTS). Additionally, the Commission has amended the RTS so that the frontloading period for FCs in Category 1 begins 2 months after the RTS enter into force (see Article 4(1) of the amended draft RTS). |

Amended draft RTS: how has the Commission responded to industry concerns?

(continued)

| | Key Asks | Changes made? | Commentary |
|-------------------------|--|---------------|--|
| Frontloading obligation | Transactions between members of the same group should not be subject to the frontloading obligation. | Partially | <p>The Commission has amended the RTS to provide for a 3 year period during which transactions between an EU FC and a third country entity which would be an FC if established in the EU can benefit from the intragroup exemption in Article 4(2)(b) of EMIR without the need for an equivalence decision under Article 13(2) of EMIR in respect of the third country provided that all the other conditions of the exemption are met (including prior authorisation by the competent authority). The 3 year period is cut short if the Commission makes an equivalence decision for the relevant third country before the end of the 3 year period. See Recital 12 and Article 3(3) of the amended draft RTS.</p> <p>The Commission does not need to extend the relief to NFC+s that are not AIFs as transactions with those NFC+s benefit from a 3 year phase-in period and are not subject to the frontloading obligation. The frontloading obligation also does not apply to NFC+s that are AIFs and, in any event, AIFs are unlikely to need to rely on the exemption (as most AIFs do not form part of a group).</p> <p>The Commission does not propose any relief from frontloading in respect of intragroup transactions between two EU counterparties in Category 1 or 2 (which are FCs). These transactions would need to meet all the conditions for the exemption, including no objection by the competent authorities before the end of the frontloading period.</p> |

Other changes made by the Commission

- Changes to covered bond exemption (but no material changes)
- Substantial changes to recitals
- Article 2 – refers to the classes "set out in Annex 1" rather than "subject to the clearing obligation". This could suggest that the Commission favours the asset-class by asset-class basis for the categorisation of counterparties

IRS clearing obligation: scope

Scope of IRS clearing obligation

The Commission has not amended the classes of IRS proposed by ESMA to be subject to the clearing obligation.

The amended draft RTS cover certain classes of IRS cleared by Nasdaq OMX Clearing AB, Eurex Clearing AG, LCH.Clearnet Limited and/or CME Clearing Europe Limited. ESMA ruled out applying a clearing obligation to the equity OTC derivatives and interest rate future and option classes cleared by Nasdaq and LCH.Clearnet Limited.

ESMA left open the possibility that further classes will be added to the clearing obligation in due course. In particular, ESMA proposes to conduct further analysis of IRS denominated in the Nordic currencies and the Polish Zloty. ESMA expects to publish a consultation paper covering these classes shortly after the Commission has approved the first RTS on IRS.

“Two-step” test

ESMA had added a reference to a “two-step” test in the recitals of the final draft RTS to address concerns that some contracts may fall into a “dead-zone” whereby they meet the specified characteristics in Annex 1 of the RTS but cannot in practice be cleared.

“...the set of classes covered by this Regulation has been based on a selection of the classes which the CCPs had been authorised to clear at the time of their authorisation. The selection covered only contracts that the authorised CCPs have accepted for clearing at the time of authorisation.” (Recital 2 of the final draft RTS on IRS)

This recital was also intended to address concerns that the scope of the clearing obligation could be extended by CCPs alone (by introducing a new clearable feature) rather than through the regulatory process. The recital above indicates that only contracts which were accepted by CCPs at the date of their authorisation will be within the scope of the clearing obligation.

This wording did, however, leave open the possibility that an authorised CCP could stop clearing a class of contracts which meets the seven characteristics specified in the RTS and which would have been accepted by that CCP for clearing at the time of their authorisation. If no other CCPs accept that class of contract for clearing, would the CCP’s actions, in effect, impose a trading ban on that class of contracts?

The Commission does not address these concerns in the amended draft RTS. The recital included by ESMA has been deleted and the amended draft RTS are silent on whether there is in fact a “two-step” test and, if there is, the point in time a particular contract must have been accepted for clearing by an authorised CCP i.e. point of trade or the date on which the CCP was authorised.

IRS Clearing Obligation: scope

(continued)

The amended draft RTS on IRS propose to subject the following classes to the clearing obligation:

| Type | Reference Index | Settlement Currency | Maturity | Settlement Currency Type | Optionality | Notional Type* | Authorised CCPs | | | | |
|----------------|-----------------|---------------------|----------|--------------------------|-------------|----------------------|-----------------|---------|--------|------|-----|
| | | | | | | | Eurex | LCH Ltd | Nasdaq | KDPW | CME |
| Basis | Euribor | EUR | 28D-50Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| | Libor | GBP | 28D-50Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| | Libor | JPY | 28D-30Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| | Libor | USD | 28D-50Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| Fixed-to-float | Euribor | EUR | 28D-50Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✓ | ✗ | ✓ |
| | Libor | GBP | 28D-50Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| | Libor | JPY | 28D-30Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| | Libor | USD | 28D-50Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| FRA | Euribor | EUR | 3D-3Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✓ | ✗ | ✓ |
| | Libor | GBP | 3D-3Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| | Libor | USD | 3D-3Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| OIS | EONIA | EUR | 7D-3Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✓ | ✗ | ✓ |
| | FedFunds | USD | 7D-3Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |
| | SONIA | GBP | 7D-3Y | Single currency | No | Constant or Variable | ✓ | ✓ | ✗ | ✗ | ✓ |

* Recital 2 of the amended draft RTS indicates that contracts with conditional notional amounts will not be subject to the clearing obligation. In particular, the recital acknowledges that a distinction exists between variable notionals (notionals which vary over the life of the contract in a predictable way) and conditional notionals (notionals which vary over the life of the contract in an unpredictable way).

Categories, phase-in periods and application of the frontloading obligation

| Category | Counterparties covered | Phase-in period (from entry into force) | Frontloading |
|----------|--|---|---|
| 1 | Counterparties which, on the date of entry into force of the RTS, are clearing members for at least one of the classes of OTC derivatives subject to the clearing obligation of at least one of the CCPs authorised or recognised before that date to clear at least one of those classes | 6 months | Yes* From 2 months after the entry into force of the RTS |
| 2 | FCs and NFC+ AIFs which are not included in Category 1 which belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for [3 months following the publication of the RTS in the OJ, excluding the month of publication] is above EUR 8 billion | 12 months | Yes* From 5 months after the entry into force of the RTS |
| 3 | FCs and NFC+ AIFs which are not included in Categories 1 or 2 | 18 months | No** |
| 4 | NFC+ which are not included in Categories 1, 2 or 3 | 3 years | No* |

Category 2 threshold

- **Alignment with Margin RTS:** “For the purpose of calculating the group aggregate month-end average notional amount, all of the group's non-centrally cleared derivatives, including foreign exchange forwards, swaps and currency swaps, shall be included”.
- **Snap-shot:** ESMA intended to use the same three month period (now the three month period following the month in which the RTS on IRS are published in the OJ) in all subsequent RTS, such that a counterparty cannot move between Categories 2 and 3.

Frontloading

- **No frontloading for NFC+:** contracts where at least one counterparty is an NFC+ (in any Category) are not subject to frontloading.
- **No frontloading for Category 3:** the maximum remaining maturity (MRM) for contracts entered into with Category 3 counterparties has been set at the maximum maturity of each class subject to the clearing obligation.
- **Frontloading applies for Category 1 and Category 2:**
 - The frontloading period for Category 1 counterparties begins 2 months after the RTS enter into force and begins for Category 2 counterparties 5 months after the RTS enter into force.
 - Contracts entered into or novated after the relevant start date and before the end of the relevant phase-in period will be subject to frontloading if they have MRM higher than 6 months.

* Transactions with NFC+ (regardless of which category they fall into) are not subject to frontloading

** The MRM for contracts entered into with Category 3 counterparties is set such that no contracts will be in scope for frontloading

Application of the clearing obligation to different counterparty combinations

| | Category 1 | Category 2 | Category 3 | Category 4 |
|------------|--|--|---|---|
| Category 1 | <p>6 month phase-in period.</p> <p>4 month frontloading period, which begins 2 months after the RTS enter into force, unless:</p> <ul style="list-style-type: none"> ➤ one or both counterparties are NFC+; or ➤ the contract has a MRM of 6 months or less, <p>in which case, there is no frontloading obligation.</p> | <p>12 month phase-in period.</p> <p>7 month frontloading period, which begins 5 months after the RTS enter into force, unless:</p> <ul style="list-style-type: none"> ➤ one or both counterparties are NFC+; or ➤ the contract has a MRM of 6 months or less, <p>in which case, there is no frontloading obligation.</p> | <p>18 month phase-in period.</p> <p>No frontloading obligation.</p> | <p>3 year phase-in period.</p> <p>No frontloading obligation.</p> |
| Category 2 | <p>12 month phase-in period.</p> <p>7 month frontloading period, which begins 5 months after the RTS enter into force, unless:</p> <ul style="list-style-type: none"> ➤ one or both counterparties are NFC+; or ➤ the contract has a MRM of 6 months or less, <p>in which case, there is no frontloading obligation.</p> | <p>12 month phase-in period.</p> <p>7 month frontloading period, which begins 5 months after the RTS enter into force, unless:</p> <ul style="list-style-type: none"> ➤ one or both counterparties are NFC+; or ➤ the contract has a MRM of 6 months or less, <p>in which case, there is no frontloading obligation.</p> | <p>18 month phase-in period.</p> <p>No frontloading obligation.</p> | <p>3 year phase-in period.</p> <p>No frontloading obligation.</p> |
| Category 3 | <p>18 month phase-in period.</p> <p>No frontloading obligation.</p> | <p>18 month phase-in period.</p> <p>No frontloading obligation.</p> | <p>18 month phase-in period.</p> <p>No frontloading obligation.</p> | <p>3 year phase-in period.</p> <p>No frontloading obligation.</p> |
| Category 4 | <p>3 year phase-in period.</p> <p>No frontloading obligation.</p> | <p>3 year phase-in period.</p> <p>No frontloading obligation.</p> | <p>3 year phase-in period.</p> <p>No frontloading obligation.</p> | <p>3 year phase-in period.</p> <p>No frontloading obligation.</p> |

Exemption for covered bond derivatives

EMIR envisages special treatment for covered bond derivatives:

Recital 16 of EMIR states that, in determining which classes of OTC derivative contracts are to be subject to the clearing obligation, "ESMA should take into account the specific nature of OTC derivative contracts which are concluded with covered bond issuers or with cover pools for covered bonds".

The amended draft RTS contain an exemption for covered bond derivatives.

The classes of OTC derivatives subject to the clearing obligation would not include contracts associated with covered bonds when such contracts satisfy all of the following conditions:

- they are used only to hedge the interest rate or currency mismatches of the cover pool in relation with the covered bond;
- they are registered or recorded in the cover pool of the covered bond in accordance with national covered bond legislation;
- they are not terminated in case of resolution or insolvency of the covered bond;
- the counterparty to the OTC derivative concluded with covered bond issuers or with covered pools for covered bonds ranks at least *pari-passu* with the covered bond holders except where the counterparty to the OTC derivative concluded with covered bond issuers or with covered pools for covered bonds is the defaulting or the affected party, or waives the *pari-passu* rank;
- the covered bond meets the requirements of Article 129 of the Capital Requirements Regulation (Regulation (EU) No 575/2013);
- the covered bond is subject to a regulatory collateralisation requirement of at least 102%.

It is expected that a similarly worded exemption will be included in the final draft RTS on the margin requirements for non-centrally cleared OTC derivatives.

ESMA rejected calls for a corresponding exemption for securitisations swaps.

ESMA did not consider itself empowered to introduce an exemption for securitisation swaps and the Commission has not introduced an exemption in the amended draft RTS.

Whilst EMIR has specific references to covered bonds, this is not the case for securitisation swaps. Securitisation swaps will therefore be subject to the clearing obligation if they meet the seven characteristics in Annex 1 of the RTS and they are accepted for clearing by CCPs.

However, ESMA considered that in practice most securitisation swaps will likely fall outside the scope of the clearing obligation because either they fail to meet the seven characteristics in Annex 1 (e.g. by containing conditional notional amounts) or they contain bespoke terms which a CCP will not accept for clearing (e.g. limited recourse provisions). See discussion above on the application of the "two-step" test.

Whilst the clearing obligation affects transactions with and between third-country entities, the amended draft RTS do not specifically address the application of the clearing obligation to third-country entities, although consideration is given to intragroup transactions involving third-country entities.

In its final report, however, ESMA made a number of statements relating to contracts concluded between one EU counterparty and one third-country counterparty:

- The obligation to clear lies with the counterparty established in the EU.
- In order for the EU counterparty to determine: (i) the clearing application date (i.e. what the relevant phase-in period is); and (ii) whether frontloading applies, the EU counterparty will need to know which category its third-country counterparty falls into. On this point, ESMA has stated that third-country entities belong to the category of counterparty to which they would belong if they were established in the EU.

Special treatment for intra-group contracts with third-country entities.

Whilst ESMA rejected calls to provide longer phase-in periods for transactions entered into with third-country entities and/or intragroup transactions involving a third-country entity, the Commission has accepted that intra-group contracts should be given special treatment when one counterparty is established in a third country for which the Commission has not yet made an equivalence decision under Article 13(2) of EMIR.

Article 3(3) of the amended draft RTS provides that

“for 3 years after the date of entry into force of this Regulation or until a decision is made pursuant to Article 13(2) of [EMIR] on the equivalence of the third country referred to in point (i) of Article 3(2)(a) of [EMIR], whichever date is earlier, that third country shall be deemed equivalent within the meaning of Article 13(2) of [EMIR] for the sole purpose of point (i) of Article 3(2)(a) of [EMIR].”

Transactions between third country entities may be subject to clearing.

The clearing obligation will apply if the counterparties would have been subject to the clearing obligation if established in the EU and if the transaction has a direct, substantial and foreseeable effect in the EU or it is appropriate for the rules to prevent avoidance of EMIR – as specified in the relevant RTS on third country entities, which are now fully in effect.

Identifying in-scope contracts

It is unclear whether the Commission has accepted that the identification of an in-scope contract is a “two-step” process i.e. a contract must meet the seven characteristics listed in Annex 1 of the RTS and be clearable by an authorised or recognised CCP.

- If there is not a “two-step” process for the identification of contracts subject to the clearing obligation, will firms be forced to stop trading contracts which meet the seven characteristics listed in Annex 1 of the RTS but which no authorised or recognised CCP will accept for clearing?
- If there is a “two-step” test, at which date will firms need to assess whether a contract will be accepted for clearing – the trade date or the date the CCP was authorised/recognised?
- If the relevant date for the “two-step” test is the CCP authorisation/recognition date, firms will need to know what contracts and terms CCPs were clearing at the date of their authorisation / recognition. Will this information be made available to all market participants?
- If a CCP cleared a particular type of contract at the time it was authorised, but subsequently stops clearing it, will the contract still be subject to the clearing obligation? If so, this will cause particular difficulties during the frontloading period where contracts are traded on a delayed clearing basis in the expectation that they will be cleared before the end of the applicable phase-in period.
- How will future developments in contractual terms affect the scope of the clearing obligation (e.g. as new versions of ISDA definitions are used)?
- Unlike the US regime, EMIR does not contain a general anti-avoidance mechanism. Will greater focus be given to non-standard terms in contracts (such as break clauses) to ensure there is a real justification for their inclusion?

Classification of own group entities and counterparties for phase-in and frontloading purposes

Firms are likely to need to conduct another round of categorisation (and will likely need further client representations). Firms will need to determine which group entities and counterparties are:

- clearing members of relevant CCPs at the relevant time (this information may not be readily available);
- AIFs that are NFC+; and
- for FCs and NFC+ AIFs which are not clearing members, whether they exceed the EUR 8 billion threshold .

Dealing with counterparties which will not confirm counterparty status or provide an incorrect status

- How should firms treat counterparties in the absence of a representation? Do they need to assume a higher categorisation?
- Where a firm relies on a representation made by a counterparty which subsequently amends its representation (e.g. a counterparty which incorrectly provides a Category 3 representation when it actually is a Category 2 counterparty) how should such transactions be treated?

Implementation issues for IRS

(continued)

Changing counterparty status

- Where a firm trades with an NFC which subsequently becomes an FC (e.g. when an AIF's manager becomes authorised under the Alternative Investment Fund Managers Directive), how should transactions entered into prior to the change be treated?

Calculating the Category 2 threshold

FCs and NFC+ AIFs will need to address a number of preliminary questions before they can calculate their “group” aggregate month-end average notional amount:

- Will intra-group transactions be included in the calculation of the group aggregate month-end average notional amount? If so, far more counterparties are likely to end up in Category 2 as a result.
- How will the Category 2 threshold be applied to counterparties which are established after the three month period used for calculating the group aggregate month-end average notional amount? This may depend on whether the new entity falls within a group or not.
- Will the threshold need to be reassessed when there are changes to the “group” e.g. acquisitions, disposals or reorganisations which may change the composition of the group?

Documentation/pricing for frontloading

Contracts between Category 1 and Category 2 counterparties will be subject to the frontloading obligation if entered into during the applicable frontloading period, which begins 2 months after the RTS enter into force for Category 1 counterparties and 5 months after the RTS enter into force for Category 2 counterparties.

- From that time parties will either have to clear affected contracts voluntarily or agree pricing/terms with counterparties to address the future frontloading obligation, e.g. termination rights if the parties fail to agree on clearing (or assume that clearing can be agreed when the clearing obligation is effective).
- Currently, there is no agreed market standard documentation to address frontloading and it may be difficult to agree pricing for contracts cleared at a future time.

Clearing contracts during the frontloading period with CCPs which are not yet authorised or recognised

- If firms clear in-scope contracts traded during the frontloading period at CCPs which have not been authorised or recognised by the time the clearing obligation enters into effect, those firms will have to de-clear their positions and move them to authorised/recognised CCPs. This may cause market disruption (especially as some firms may not have clearing arrangements in place with other CCPs) and, in some cases, it may not be possible to de-clear the position because firms will be unable to trade an offsetting position at the unauthorised/unrecognised CCP without those trades being a breach of the EMIR clearing obligation.

Implementation issues for IRS

(continued)

Transactions with third-country entities

ESMA has said that third-country entities are not directly subject to the clearing obligation when they trade with EU firms.

- EU firms may therefore have difficulties persuading their third-country counterparties to establish clearing arrangements. Whilst this issue will be mitigated in respect of some third-country counterparties by equivalence determinations under Article 13(2) of EMIR (or recognition of third country CCPs under Article 25 of EMIR), it may be some time before there are equivalence determinations or recognition decisions for all major third countries.
- Further difficulties will arise where there are conflicting clearing obligations (e.g. where an EU counterparty is subject to the EMIR clearing obligation and its US counterparty is subject to the CFTC clearing mandate). This may, in practice, prevent firms from trading with certain third-country entities.
- Third-country entities trading with other third-country entities within the scope of the RTS on transactions between third-country entities will need to consider whether they are subject to the clearing obligation (e.g. where a counterparty benefits from a guarantee from an EU FC).

Intra-group exemptions

- Firms will need to identify which entities might benefit from the exemption for intragroup transactions.
- In particular, firms need to determine which group entities are subject to “appropriate centralised risk evaluation, measurement and control procedures” in order to qualify for the exemption.
- Firms will need to notify/apply to relevant competent authorities to apply the exemption in good time before the clearing obligation starts.

Treatment of “lifecycle” events

- Will the clearing obligation be triggered by lifecycle events such as:
 - New trades resulting from risk reducing processes (such as compression services); and
 - Exercises of physically settled swaptions?
- For novated contracts, from which date will the maturity be calculated in order to determine whether the contract meets the specified characteristics?

Onboarding for clearing

Firms and clients need to address possible process and clearing capacity constraints, as there is likely to be bunching of clients seeking clearing arrangements near to deadlines, including prior to the start of the frontloading period (if the solution to frontloading is voluntary clearing).

Consultation Paper No. 2 (CDS)

ESMA indicated that it would hold off delivering the final draft RTS on CDS until the RTS on IRS has been endorsed by the Commission.

In Consultation Paper No. 2, ESMA proposed to subject the following classes of CDS to the clearing obligation:

| Type | Sub-Type | Geographical Zone | Reference Index | Settlement Currency | Series | Maturity | Authorised CCPs | |
|-----------|-------------------|-------------------|-------------------------|---------------------|------------|----------|-----------------|------------|
| | | | | | | | LCH SA | ICE Clear* |
| Index CDS | Untranching Index | Europe | iTraxx Europe Main | EUR | 11 onwards | 5Y | ✓ | ✓ |
| | Untranching Index | Europe | iTraxx Europe Crossover | EUR | 11 onwards | 5Y | ✓ | ✓ |

* ESMA stated that it expected that ICE Clear Europe will be authorised before the entry into force of the RTS on CDS.

Consultation Paper No. 3 (FX NDF)

Consultation Paper No. 3 set out ESMA’s proposed draft RTS establishing a clearing obligation for certain FX NDFs.

ESMA will treat cash settled and physically settled contracts as belonging to distinct classes for the purposes of the clearing obligation. Consultation Paper No. 3 only addressed cash-settled (i.e. non-deliverable) contracts.

- Cash settled are non-deliverable contracts i.e. contracts that cannot result in physical delivery of currency (exchange of principal) under any circumstances.
- Physically settled are deliverable contracts i.e. contracts that can result in physical delivery of currency (exchange of principal) if participants wish, whether by intention at inception or by subsequent election.

ESMA proposed to subject the following classes of FX NDF to the clearing obligation:

| Type | Currency Pair | Settlement Currency | Settlement Type | Maturity | Authorised CCPs* |
|-----------|---------------|---------------------|-----------------|----------|------------------|
| | | | | | LCH Ltd |
| NDF | BRL / USD | USD | Cash settlement | 3D-2Y | ✓ |
| | CLP / USD | USD | Cash settlement | 3D-2Y | ✓ |
| | CNY / USD | USD | Cash settlement | 3D-2Y | ✓ |
| | COP / USD | USD | Cash settlement | 3D-2Y | ✓ |
| | IDR / USD | USD | Cash settlement | 3D-2Y | ✓ |
| | INR / USD | USD | Cash settlement | 3D-2Y | ✓ |
| | KRW / USD | USD | Cash settlement | 3D-2Y | ✓ |
| | MYR / USD | USD | Cash settlement | 3D-2Y | ✓ |
| | PHP / USD | USD | Cash settlement | 3D-2Y | ✓ |
| | RUB / USD | USD | Cash settlement | 3D-2Y | ✓ |
| TWD / USD | USD | Cash settlement | 3D-2Y | ✓ | |

* ESMA stated that it expected at least one other European CCP to be available to clear these classes before the clearing obligation for FX NDF comes into effect. ESMA was aware that CME Clearing Europe and Nasdaq OMX Clearing were developing FX NDF clearing offerings and it expected ICE Clear Europe (which currently offers an FX NDF clearing service) to be authorised in the near future. There are also a number of third-country CCPs offering FX NDF clearing services.

Consultation Paper No. 3 (FX NDF)

(continued)

ESMA generally followed the same approach to counterparty classification, phase-in periods and frontloading as adopted in the final draft RTS on IRS, with the following modifications:

Cumulative classification for clearing members.

ESMA was of the view that the sophistication of counterparties is appropriately assessed at a global level rather than at the level of the asset class. ESMA therefore proposed a cumulative classification for clearing members, whereby any counterparty already included in Category 1 for the IRS or CDS classes is automatically included in Category 1 for the FX NDF classes, even if it is not a clearing member for FX NDF.

If this approach is taken in all RTS, it will have the effect that once a counterparty becomes Category 1 for one asset class, it will be treated as Category 1 for all subsequent asset classes (unless it ceases to be a clearing member, in which case it will be categorised differently going forwards but it will remain Category 1 for any asset classes already declared subject to the clearing obligation).

Shorter phase-in period for Category 4.

For FX NDF, ESMA proposed a 33 month phase-in period for Category 4 counterparties (the three month difference reflected the expected time-lapse between delivery to the Commission of the final draft RTS on IRS and the delivery to the Commission of the final draft RTS on FX NDF). ESMA indicated that it will progressively shorten the phase-in period for Category 4 counterparties in subsequent RTS.

ESMA has not yet indicated how it will adjust subsequent draft RTS in response to the Commission's amendments to its final draft RTS on IRS.

-
- **AIF:** alternative investment fund as defined in the alternative investment fund managers directive
 - **CCP:** central counterparty
 - **CDS:** credit derivatives
 - **Clearing obligation:** requirement to clear at a CCP all OTC derivative contracts pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation in accordance with the procedure in Art.5(2) EMIR
 - **Commission:** the European Commission
 - **Council:** the Council of the European Union
 - **CRD4/CRR:** the capital requirements directive and regulation implementing Basel III in the EU
 - **Derivative:** as defined in EMIR, i.e. a financial instrument as set out in points (4) to (10) Section C, Annex 1, MiFID, as implemented by the MiFID implementing regulation
 - **EMIR:** the EU regulation on OTC derivatives, central counterparties and trade repositories
 - **ESA:** European Supervisory Authority (i.e. EBA, EIOPA or ESMA)
 - **ESMA:** European Securities and Markets Authority
 - **EU:** European Union
 - **FC:** financial counterparty as defined in EMIR, i.e. an investment firm, credit institution, insurance/reinsurance undertaking, UCITS, pension scheme and alternative investment fund managed by an alternative investment fund manager, in each case where authorised or registered in accordance with the relevant EU directive
 - **Frontloading:** the requirement in Art.4(1)(b)(ii) EMIR to clear OTC derivatives (pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation) that are entered into after the notification referred to in Art.5(1) EMIR and before the date of application of the clearing obligation
 - **FX NDF:** foreign exchange non-deliverable forwards
 - **IM:** initial margin
 - **IRS:** interest-rate derivatives
 - **MiFID:** the EU markets in financial instruments directive
 - **MiFID2 and MiFIR:** the EU directive and regulation repealing and replacing MiFID
 - **MRM:** minimum remaining maturity as referred to in Art.4(1)(b)(ii) EMIR
 - **NFC:** non-financial counterparty as defined in EMIR, i.e. an undertaking established in the EU which is not a financial counterparty or a CCP
 - **NFC+:** a non-financial counterparty whose positions in OTC derivatives (excluding positions reducing risks directly relating to commercial or treasury financing activity) exceed the clearing threshold
 - **OJ:** Official Journal
 - **OTC derivative:** over-the-counter derivative as defined in EMIR, i.e. a derivative executed outside a regulated market or equivalent non-EU market
 - **Parliament:** the European Parliament
 - **RTS:** regulatory technical standards proposed by an ESA and adopted by the Commission under powers conferred by an EU regulation or directive
 - **TCE:** third country entity
 - **TR:** trade repository
 - **VM:** variation margin

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