

EMIR – European Commission Responds to Draft RTS on IRS Clearing

The European Commission has publicised its decision to endorse draft regulatory technical standards (“RTS”) submitted to it by the European Securities and Markets Authority (“ESMA”) on the clearing of interest rate OTC derivatives (“IRS”) under EMIR,¹ with certain amendments.² ESMA has until 29 January 2015 (six weeks from the date of the communication from the Commission) to re-submit the draft RTS to the Commission with amendments consistent with those proposed by the Commission or to make a different proposal.³ The European Parliament and the Council will have at least three months from the time when final RTS are adopted by the Commission to raise any objections to them.⁴

The draft RTS:

- Define the classes of IRS that are going to be subject to the clearing obligation in EMIR;
- Divide counterparties into four categories for the purposes of determining when the clearing obligation takes effect and the extent to which outstanding IRS will have to be cleared when the clearing obligation takes effect (“frontloading”);
- Set the effective dates of the clearing obligation for the different categories of counterparty; and
- Set the minimum remaining maturities of IRS in the different classes that will need to be cleared if they were entered into or novated during the frontloading window.

In this Alert, we summarise the provisions of the draft RTS on IRS clearing, as amended by the Commission.⁵ Finally, we provide an update on the status of the RTS for the clearing of certain classes of credit OTC derivatives (“CDS”) and OTC foreign-exchange non-deliverable forwards (“NDFs”) under EMIR.

Classes of IRS Subject to the Clearing Obligation

The classes of IRS subject to the clearing obligation in EMIR are:

- Single currency floating-to-floating or “basis” swaps settled in EUR, GBP, JPY or USD, where the floating reference rate is EURIBOR (for EUR basis swaps) or LIBOR (for GBP, JPY and USD basis swaps), with a maturity of between 28 days and 50 years (for EUR, GBP and USD basis swaps) or between 28 days and 30 years (for JPY basis swaps), with a constant or variable (but not conditional) notional amount and with no embedded optionality.
- Single currency fixed-to-floating or “plain vanilla” interest rate swaps, settled in EUR, GBP, JPY or USD, where the floating reference rate is EURIBOR (for EUR fixed-to-floating swaps) or LIBOR (for GBP, JPY and USD fixed-to-floating swaps), with a maturity of between 28 days and 50 years

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.

² See [letter from the Commission](#) to ESMA dated 18 December 2014 and attached [amended draft RTS](#).

³ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (“Regulation 1095/2010”), Article 10(1), sixth and seventh subparagraphs.

⁴ Regulation 1095/2010, Article 13(1).

⁵ Our previous Alert, [ESMA Plans Phased-in Approach to EMIR OTC Derivatives Clearing](#), discussed the position under ESMA’s consultation paper on the clearing of IRS under EMIR, which contained a first draft of the RTS on IRS clearing. That draft was subsequently updated in a final report published by ESMA, containing the draft RTS that were submitted to the European Commission for endorsement.

(for EUR, GBP and USD fixed-to-floating swaps) or between 28 days and 30 years (for JPY fixed-to-floating swaps), with a constant or variable (but not conditional) notional amount and with no embedded optionality.

- Single currency Forward Rate Agreements (“FRA”), settled in EUR, GBP or USD, where the floating reference rate is EURIBOR (for EUR FRA) or LIBOR (for GBP and USD FRA), with a maturity of between three days and three years, with a constant or variable (but not conditional) notional amount and with no embedded optionality.
- Single currency Overnight Index Swaps (“OIS”), settled in EUR, USD or GBP, where the floating reference rate is EONIA (for EUR OIS), FedFunds (for USD OIS) or SONIA (for GBP OIS), with a maturity of between seven days and three years, with a constant or variable (but not conditional) notional amount and with no embedded optionality.

As long as they meet the conditions set out in the RTS, IRS entered into in connection with covered bonds are excluded from the clearing obligation. IRS entered into by securitisation or structured finance special purpose vehicles do not benefit from this exclusion.

As noted in our previous Alert, [ESMA Plans Phased-in Approach to EMIR OTC Derivatives Clearing](#), the classes of IRS proposed to be subject to mandatory clearing under EMIR are very similar to the IRS classes that are currently required to be cleared under Title VII of the U.S. Dodd-Frank Act, although there are a few differences. Please see our previous [Alert](#) for additional detail.

Categories of Counterparties

The Position under EMIR

In summary, mandatory clearing under EMIR applies to dealings in OTC derivatives where the counterparties fall into the following categories:

- The counterparties are both “financial counterparties”;⁶
- The counterparties are both “non-financial counterparties” that have exceeded the “clearing threshold”;⁷
- One counterparty is a financial counterparty and the other counterparty is a non-financial counterparty that has exceeded the clearing threshold; or
- One counterparty is a financial counterparty or a non-financial counterparty that has exceeded the clearing threshold and the other counterparty is an entity established outside of the European Union (the “EU”) that would be subject to the clearing obligation if it were established in the EU.⁸

⁶ In accordance with Article 2(8) of EMIR, “financial counterparties” include authorised EU investment firms, banks, insurers and undertakings for collective investment in transferable securities (UCITS), EU occupational pension funds regulated by the Institutions for Occupational Retirement Provision Directive and alternative investment funds (whether established in the EU or outside the EU) managed by alternative investment fund managers authorised or registered under the Alternative Investment Fund Managers Directive.

⁷ In accordance with Article 2(9) of EMIR, “non-financial counterparties” include undertakings established in the EU other than financial counterparties. A non-financial counterparty will exceed the “clearing threshold” if it and the other non-financial entities in its group execute OTC derivatives above any of the thresholds set for the different classes of OTC derivatives in the regulations supplementing EMIR. Only OTC derivatives that are not entered into for defined hedging purposes should be counted towards the threshold (see EMIR, Article 10(3)).

⁸ EMIR, Article 4(1)(a).

The Four New Categories of Counterparties Created under the RTS

The draft RTS divide financial counterparties and non-financial counterparties subject to the clearing obligation in EMIR into four further categories:

- *Category 1* comprises counterparties (“Category 1 Counterparties”) that, on the date when the RTS come into force,⁹ are participants in (or “clearing members” of) a clearing house (or “CCP”), as long as they participate in the clearing of at least one of the classes of IRS subject to the clearing obligation (see *Classes of IRS Subject to the Clearing Obligation* earlier) and the CCP of which they are a member has been authorised or recognised under EMIR before that date to clear at least one of those classes of IRS.
- *Category 2* comprises counterparties (“Category 2 Counterparties”) other than Category 1 Counterparties, who belong to a group whose aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives for the three months after the RTS are published in the Official Journal of the EU (the “OJ”), excluding the month of publication, exceeds €8 billion (the “Category 2 Threshold”), as long as they are either:
 - financial counterparties; or
 - “alternative investment funds” (“AIFs”) within the meaning of the Alternative Investment Fund Managers Directive¹⁰ that are classed as non-financial counterparties under EMIR.
- *Category 3* comprises counterparties (“Category 3 Counterparties”) other than Category 1 Counterparties and Category 2 Counterparties, as long as they are either:
 - financial counterparties; or
 - AIFs within the meaning of the Alternative Investment Fund Managers Directive that are classed as non-financial counterparties under EMIR.
- *Category 4* comprises non-financial counterparties (“Category 4 Counterparties”) other than Category 1 Counterparties, Category 2 Counterparties and Category 3 Counterparties.

The Treatment of AIFs under EMIR and the Draft RTS

AIFs are only classified as “financial counterparties” under EMIR if they have a manager who is authorised or registered under the Alternative Investment Fund Managers Directive (see *The Position under EMIR* earlier). Other AIFs established in the EU (i.e., those without a manager authorised or registered under the Alternative Investment Fund Managers Directive) are classified as “non-financial counterparties” under EMIR. However, for the purposes of the draft RTS, AIFs classified as non-financial counterparties under EMIR are treated in the same way as AIFs classified as financial counterparties under EMIR.

Threshold Calculation – Assessment Period

The assessment period for the Category 2 Threshold calculation is made up of the three months following the month during which the RTS are published in the OJ. This represents a change from the draft RTS proposed by ESMA, which would have required counterparties to base the Category 2 Threshold calculation on month-end figures for the three months prior to the month in which the RTS were set to come into force.

⁹ The RTS are set to come into force on the twentieth day after they are published in the Official Journal of the EU.

¹⁰ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

Threshold Calculation – Meaning of “Group” in the Case of Funds

The European Commission stated in its covering letter to ESMA that it considered it necessary to clarify the calculation of the Category 2 Threshold in the case of counterparties who are “investment funds”. The Commission proposed to include a recital in the RTS to the effect that the Category 2 Threshold should be calculated for an individual fund, and not at a group level, as long as the fund is not collateralised, guaranteed or supported by other funds or by the manager of the fund. In the current draft of the RTS, there is no direct confirmation of how a fund should calculate its “group’s” outstanding gross notional amount of non-centrally cleared derivatives. It is hoped that this point will be clarified in a subsequent draft of the RTS, however.

Treatment of “Third-Country Entities” under the RTS

Counterparties who are established outside of the EU (referred to as “third-country entities” in EMIR and its supporting regulations) are not given a distinct classification in the draft RTS. As a result, in line with the treatment of third-country entities for other purposes under EMIR and the views expressed by ESMA during the consultation process leading up to the draft RTS proposed by ESMA, non-EU entities, if they have dealings in OTC derivatives with a counterparty classed as a financial counterparty or a non-financial counterparty that has exceeded the clearing threshold under EMIR, should treat themselves as belonging to the category of counterparty to which they would belong if they were established in the EU.

Dates from which the Clearing Obligation takes effect

The clearing obligation for the classes of IRS described in *Classes of IRS Subject to the Clearing Obligation* earlier will take effect:

- Six months after the date the RTS come into force for Category 1 Counterparties;
- 12 months after the date the RTS come into force for Category 2 Counterparties;
- 18 months after the date the RTS come into force for Category 3 Counterparties; and
- Three years after the date the RTS come into force for Category 4 Counterparties.

Where the counterparties to the IRS belong to different categories, the later of the two effective dates will apply.

Time-Limited Relief for Certain Intra-Group Transactions

Subject to certain conditions, an exemption from the clearing obligation is available under EMIR for intra-group OTC derivatives. If one of the counterparties to the OTC derivative is a third-country entity, the exemption can only be relied on if the European Commission has declared the regulatory regime of the relevant non-EU country to be “equivalent” to EMIR. As yet, no equivalence decisions have been announced by the Commission. In a change to the original RTS proposed by ESMA, the draft RTS include a provision that deems an equivalence decision to have been made in relation to third countries for the purposes of the exemption for intra-group OTC derivatives between certain EU and non-EU financial entities. The deeming provision applies for three years after the date when the RTS come into force or until an equivalence decision is actually made by the Commission in relation to the relevant non-EU country (whichever date is earlier).

Minimum Remaining Maturities

The Frontloading Obligation in EMIR

In accordance with EMIR,¹¹ OTC derivatives with a remaining maturity at the date when the clearing obligation takes effect higher than the “minimum remaining maturity” set in the RTS are subject to the clearing obligation if they were entered into or novated during the period (or “window”) between the notification to ESMA that follows the authorisation of a CCP to clear a class of OTC derivatives and the date when the clearing obligation takes effect. This obligation to clear outstanding OTC derivatives when the clearing obligation takes effect is known as “frontloading”.

The Application of the Frontloading Obligation under the RTS

The minimum remaining maturities set in the original RTS proposed by ESMA would have resulted in the frontloading obligation applying only to financial counterparties that are Category 1 Counterparties or Category 2 Counterparties and only to IRS entered into after the publication of the RTS in the OJ.

The minimum remaining maturities set in the new draft of the RTS have the effect of limiting the frontloading obligation to financial counterparties that are Category 1 Counterparties or Category 2 Counterparties (as before) and postponing further the start date of the frontloading window until two months after the date when the RTS come into force (for financial counterparties that are Category 1 Counterparties) and five months after the date when the RTS come into force (for financial counterparties that are Category 2 Counterparties). The new draft of the RTS also clarifies that, where the counterparties to the IRS belong to different categories, the longer of the two minimum remaining maturities will apply.

In accordance with the draft RTS:

- For financial counterparties that are Category 1 Counterparties and OTC derivatives entered into or novated before two months have elapsed since the date when the RTS come into force, the minimum remaining maturities for the different classes of IRS subject to the clearing obligation are set at such a level that the frontloading obligation does not apply. For financial counterparties that are Category 1 Counterparties and OTC derivatives entered into or novated on or after the date falling two months after the date when the RTS come into force, the minimum remaining maturity for the different classes of IRS subject to the clearing obligation is set at six months (see the summary table that follows).
- For financial counterparties that are Category 2 Counterparties and OTC derivatives entered into or novated before five months have elapsed since the date when the RTS come into force, the minimum remaining maturities for the different classes of IRS subject to the clearing obligation are set at such a level that the frontloading obligation does not apply. For financial counterparties that are Category 2 Counterparties and OTC derivatives entered into or novated on or after the date falling five months after the date when the RTS come into force, the minimum remaining maturity for the different classes of IRS subject to the clearing obligation is set at six months (see the summary table that follows).
- For financial counterparties that are Category 3 Counterparties, the minimum remaining maturities for the different classes of IRS subject to the clearing obligation are set at such a level that the frontloading obligation does not apply (whenever the OTC derivatives were entered into or novated).

¹¹ Article 4(1)(b)(ii).

- Where the counterparties to the IRS belong to different categories, the longer of the two minimum remaining maturities applies.

Minimum Remaining Maturities – Summary Table

Category of Counterparties	Frontloading Window	Minimum Remaining Maturity
Financial counterparties that are Category 1 Counterparties	Two months after the RTS come into force until the clearing obligation takes effect	Six months (for all classes of IRS subject to the clearing obligation)
Financial counterparties that are Category 2 Counterparties	Five months after the RTS come into force until the clearing obligation takes effect	Six months (for all classes of IRS subject to the clearing obligation)

Does the Frontloading Obligation Apply to Non-Financial Counterparties?

As explained by ESMA during the consultation process leading up to the draft RTS proposed by ESMA, the frontloading obligation in EMIR cannot apply to non-financial counterparties who become subject to the clearing obligation because they pass the clearing threshold (see *Categories of Counterparties - The Position under EMIR* earlier). This position is endorsed by the European Commission in the amended draft RTS, with the result that the frontloading obligation does not apply where at least one of the counterparties to the IRS is classed as a non-financial counterparty under EMIR (including an AIF that is a non-financial counterparty classed as a Category 2 Counterparty – see *Categories of Counterparties - The Four New Categories of Counterparties Created under the RTS* and *The Treatment of AIFs under EMIR and the Draft RTS* earlier).

Update on Status of RTS for Clearing of CDS and NDFs

Consultation papers were published by ESMA proposing first drafts of RTS on the clearing of CDS and NDFs under EMIR.¹² However, ESMA announced that it would delay the submission by it to the European Commission of final draft RTS for the clearing of CDS until the RTS for the clearing of IRS have been settled.¹³ Final draft RTS for the clearing of NDFs are also due to be submitted by ESMA to the Commission, but their submission can be expected to be subject to a similar delay.

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¹² ESMA's Consultation Papers – Clearing Obligation under EMIR (no. 2) (published on 11 July 2014) and Clearing Obligation under EMIR (no. 3) (published on 1 October 2014 and amended on 10 October 2014).

¹³ See [ESMA's letter to the European Commission](#) regarding EMIR clearing obligation dated 20 November 2014.