ESMA Plans Phased-in Approach to EMIR OTC Derivatives Clearing

The European Regulation on Derivative Transactions, Central Counterparties and Trade Repositories (known as the European Market Infrastructure Regulation ("EMIR")) requires counterparties to clear over-the-counter ("OTC") derivative transactions if the transaction is in a class of trades subject to the clearing obligation. Clearing is the process by which an OTC derivative trade is executed in the ordinary course and then novated to a clearing house, which is substituted as the counterparty to each party to the trade.

Which entities are subject to the clearing obligation?

EU established financial counterparties[1] ("FCs") and non-financial counterparties that exceed the clearing threshold[2] ("NFC+s") are subject to the clearing obligation. US and other non-EU managers frequently execute OTC transactions with EU dealers on behalf of their funds. By virtue of facing an EU dealer, EMIR's intent appears to be to make such funds subject to the clearing obligation, although it is presently unclear whether it achieves that objective. Depending on interpretation (on which industry views differ), the clearing obligation will apply to counterparties established outside the EU that would be subject to the clearing obligation if established in the EU (such as a US mutual fund or US managed Cayman hedge fund) and that face an EU FC (such as an EU dealer) or an NFC+. Regulatory guidance and the approach taken by EU dealers will inform the position in due course.

Which products are subject to the clearing obligation?

The European Securities and Markets Authority ("ESMA") has released two consultations on the EMIR clearing obligation and proposed a list of product types as subject to clearing. ESMA is presently only proposing the most standardised interest rate swaps and index credit default swaps as subject to clearing. These are substantially (but not identically) the same as the products subject to clearing in the US under Dodd-Frank. We set out in the Annex all the classes of derivatives that must be cleared in the EU (based on current proposals) and the US, and point out the differences between the two regimes. It is expected that ESMA will propose additional products for clearing in the future.

When does the obligation come into effect?

ESMA proposes a long phase-in period for mandatory clearing. Once the rules are approved by the European Commission and Parliament (which is expected at some point in the first half of 2015), the industry will have varying amounts of time to comply, ranging from six months for firms that are clearing members, to 18 months for non-clearing financial firms (including proprietary traders and investment funds that are not clearing members) and three years for NFC+s (i.e., non-financial firms whose derivatives exceed the threshold noted above). On the assumption that the rules will not be finalized before the first half of 2015, clearing will not apply to most EU-established or managed investment funds (including UCITS and alternative investment funds) before late 2016. As noted above, it is not entirely clear at this time how entities established outside of the EU will be treated for this purpose when facing an EU dealer.

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[1] Financial counterparties include banks, brokers, pension funds, UCITS funds and investment funds managed by EU managers.
[2] Non-financial counterparties are EU undertakings other than financial counterparties. An NFC will exceed the clearing threshold if it executes uncleared OTC derivatives (other than hedging derivatives) above a threshold.

What is the frontloading obligation?

Frontloading is the application of the clearing obligation to OTC derivatives that have already been entered into before the date the rules apply. Frontloading creates uncertainty because it leaves parties in the position of having entered into an OTC derivatives trade that may be subject to clearing at a later date. Following a communication from the European Commission to ESMA, it seems likely that the frontloading obligation will apply to trades entered into between the date of publication of rules in the EU Official Journal (i.e., the date when the rules come into effect) and the future date on which clearing actually applies (i.e., the end of the phase in period). This is designed to give participants some certainty that, when executing their trade, it will or will not be subject to clearing.

There are also minimum remaining maturity periods for contracts to be subject to clearing. Trades entered into after the date of publication of the rules must have at least six months remaining maturity to be subject to clearing. However, as many OTC contracts have a term of more than six months, many OTC contracts entered into during the phase-in period will be subject to clearing. As many clients will therefore be executing OTC contracts during the phase-in period that will need to be cleared immediately at the end of the phase-in period, clients will need to have clearing arrangements in place as at the end of the 18-month phase-in period. Clients will also need to consider the complexities of moving existing trades from an uncleared to cleared environment at the end of the phase-in period.

How can participants satisfy the clearing obligation?

Managers will need to arrange for their funds and other accounts that trade OTC derivatives to put in place clearing arrangements with dealers or other financial institutions that will act as their clearing member. The clearing member is the intermediary that stands between the fund and the clearing house.

Many funds will already have clearing arrangements with US clearing members. If the product that is subject to EMIR clearing is also subject to clearing under Dodd-Frank, the fund should be able to satisfy the EMIR obligation to clear the product by clearing the trade with a US dealer under a US OTC clearing agreement under Dodd-Frank. Final rules to allow this have not yet been published, but ESMA has performed initial work (called technical advice on third country equivalence) in which it indicates that the US clearing obligations are equivalent to their European counterparts. The European Commission has not yet adopted ESMA's technical advice in making formal decisions on "equivalence" – the delay may lie in the unwillingness of the US CFTC to give full reciprocal recognition to non-US clearing houses.

EMIR "equivalence" allows both counterparties to fulfil the EMIR clearing obligation by clearing under the rules of a "third country" – where one of the counterparties is established in that third country. It is not currently clear how equivalence will apply to funds that are not established in the US but are subject to Dodd-Frank by virtue of being "US persons", such as a Cayman Islands fund that is majority-owned by US persons or has its principal place of business in the US.

If the product is a European product that is not covered by Dodd-Frank clearing, funds will need to agree clearing terms that reflect EMIR's requirements and that arrange for clearing with an EU clearing house. Funds will need to open clearing accounts with EU dealers and consider the level of collateral segregation they require. It may be possible to execute clearing terms with a US dealer, which in turn will pass the trade to its EU clearing member affiliate for clearing – known as "indirect clearing" under EMIR.

EMIR foresees a long phase-in period for all participants other than clearing members. Clearing members will first need to clear trades executed with other clearing members. Most buy-side participants will have until 2016 to consider the impact of clearing on their portfolio, select clearing members and put in place clearing terms.

Annex

Part 1 - Types of OTC derivatives that must be cleared in both the EU and the US

Interest rate OTC derivatives

Basis swaps class

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
Basis	EURIBOR	EUR	28D-50Y	Single currency	No	Constant or Variable
Basis	LIBOR	GBP	28D-50Y	Single currency	No	Constant or Variable
Basis	LIBOR	JPY	28D-30Y	Single currency	No	Constant or Variable
Basis	LIBOR	USD	28D-50Y	Single currency	No	Constant or Variable

Fixed-to-float interest rate swaps class

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
Fixed-to-Float	EURIBOR	EUR	28D-50Y	Single currency	No	Constant or Variable
Fixed-to-Float	LIBOR	GBP	28D-50Y	Single currency	No	Constant or Variable
Fixed-to-Float	LIBOR	JPY	28D-30Y	Single currency	No	Constant or Variable
Fixed-to-Float	LIBOR	USD	28D-50Y	Single currency	No	Constant or Variable

Forward rate agreement class

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
FRA	EURIBOR	EUR	3D-3Y	Single currency	No	Constant or Variable
FRA	LIBOR	GBP	3D-3Y	Single currency	No	Constant or Variable
FRA	LIBOR	USD	3D-3Y	Single currency	No	Constant or Variable

Overnight index swaps class

Type	Reference Index	Settlement Currency	Maturity[1]	Settlement Currency Type	Optionality	Notional Type
OIS	EONIA	EUR	7D-3Y	Single currency	No	Constant or Variable
OIS	Fed Funds	USD	7D-3Y	Single currency	No	Constant or Variable
OIS	SONIA	GBP	7D-3Y	Single currency	No	Constant or Variable

Credit OTC derivatives

European untranched index CDS class

Type	Sub-Type	Geographical Zone	Reference Index	Settlement Currency Type	Series[2]	Maturity
Index CDS	Untranched Index	Europe	iTraxx Europe Main	EUR	11 onwards	5Y
Index CDS	Untranched Index	Europe	iTraxx Europe Crossover	EUR	11 onwards	5Y

Part 2 - Types of OTC derivatives that must be cleared only in the US

Interest rate OTC derivatives

Forward rate agreement class

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
FRA	LIBOR	JPY	3D-3Y	Single currency	No	Constant or Variable

Credit OTC derivatives

North American untranched index CDS class

Type	Sub-Type	Geographical Zone	Reference Index	Settlement Currency Type	Series	Maturity
Index CDS	Untranched Index	North America	CDX.NA.IG	USD	3Y: 15 onwards 5Y: 11 onwards 7Y: 8 onwards 10Y: 8 onwards	3Y, 5Y, 7Y, 10Y
Index CDS	Untranched Index	North America	CDX.NA.HY	USD	11 onwards	5Y

European untranched index CDS class

Type	Sub-Type	Geographical Zone	Reference Index	Settlement Currency Type	Series	Maturity
Index CDS	Untranched Index	Europe	iTraxx Europe Main	EUR	7 onwards	10Y
Index CDS	Untranched Index	Europe	iTraxx Europe HiVol	EUR	10 onwards	5Y

[1] The maturity of trades that have to be cleared in the US is from seven days to **two years**. In the EU, it is from seven days to **three years**.
[2] For both iTraxx Europe and iTraxx Europe Crossover, **Series 10** and after have to be cleared in the US. In the EU, it is **Series 11** and after.