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Timing and Scope of EU Clearing Obligation for Derivatives

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The European Securities and Markets Authority is consulting on the mandatory clearing obligation for certain derivatives. Draft regulatory technical standards have been published for the mandatory clearing of certain interest rate swaps and credit default swaps. This note considers the proposals and the corresponding US rules and sets out the timing for implementation of the first EU clearing obligations.

Classes of IRS and CDS Proposed for the Clearing Obligation

The European Markets Infrastructure Regulation (EMIR) introduced the concept of an obligation to clear certain classes of over-the-counter (OTC) derivatives through central counterparties (CCPs)¹. ESMA is required to prepare draft Regulatory Technical Standard (RTS) on the clearing obligation within six months of the authorisation or recognition of the relevant CCPs.

Based on the OTC derivatives classes cleared by CCPs who have applied for (re-) authorisation under EMIR², the European Securities and Markets Authority (ESMA) has determined that certain interest rate swaps (IRSs) and credit default swaps (CDSs) classes fulfil the criteria of standardisation, having sufficient volume, liquidity and pricing information, and so should be subject to mandatory clearing.

¹ Article 4(1) EMIR requires mandatory clearing of certain OTC derivatives (as determined by ESMA) which are entered into between parties who are EU authorised counterparties, relevant non-financial counterparties and certain non-EU entities. For further information, you may refer to Client Note OTC Derivatives Regulation and Extraterritoriality III (8 February 2013): <http://www.shearman.com/-/media/Files/NewsInsights/Publications/2013/02/OTC-Derivatives-Regulation-and-ExtraterritorialityIII/Files/View-full-memo-OTC-Derivatives-Regulation-and-ExtraterritorialityIII.pdf>.

² The present clearing obligation determination is made as part of the "bottom-up" process under Article 5(2) EMIR in response to the CCP notifications as opposed to the "top down" process under Article 5(3) EMIR where ESMA takes its own initiative to identify classes of OTC derivatives to be subject to clearing obligation.

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IRS (with no optionality and with a single settlement currency – EUR, GBP and USD)

- Fixed-to-float IRS, as well as float-to-float “basis” swaps, referencing either EURIBOR or LIBOR, with a maturity of 28 days to 50 years (this includes instruments which settle in JPY);
- Forward Rate Agreements, referencing either EURIBOR or LIBOR, with a maturity of 3 days to 3 years; and
- Overnight Index Swaps, referencing EONIA, FedFunds or SONIA, with a maturity of 7 days to 3 years.

Eurex Clearing AG and LCH.Clearnet Ltd are authorised to clear all three types of in-scope IRS. Nasdaq OMX Clearing AB clears all types of in-scope IRS except “basis” swaps.

This list is largely the same as the classes of IRS specified by the Commodity Futures Trading Commission (CFTC) in its final rules (CFTC Regulation 50.4) issued on 28 November 2012 implementing the first mandatory clearing determination under the Dodd–Frank Wall Street Reform and Consumer Protection Act. However, the CFTC provides an additional condition that an IRS that has a “conditional notional amount” (i.e., notional amounts that can change over the term of the swap) is not required to be cleared. Furthermore, unlike the ESMA’s list, the CFTC’s list includes JPY for Forward Rate Agreements and the coverage of Overnight Index Swaps has a narrower maturity.

CDS (traded in Europe and settled in EUR only)

- Index CDS (untranching index), referencing iTraxx Europe Main or iTraxx Europe Crossover indices, with a series of 11 onwards and a maturity period of five years.

Both LCH. Clearnet SA and ICE Clear Europe clear these CDS products.

In comparison, the CFTC’s clearing determination also covers iTraxx Europe HiVol and the obligation applies to European untranching indices with a broader range of applicable series. In addition, it also covers USD-denominated North American untranching indices being traded in North America.

ESMA is currently of the view that mandatory clearing for equity interest rate classes and options (IRS CP) and other iTraxx CDS and single name CDS (CDS CP) is not necessary in this first wave of mandatory clearing but this will be monitored. The present consultations may be followed by others relating to additional derivatives classes.

Proposed Phased-In Implementation

To encourage a timely and orderly application of the clearing obligation, ESMA currently favours a phased-in approach to implementation for different categories of counterparties. The currently preferred option is to apply a three-level classification (with reference to existing definitions under EMIR):

- Category 1 – Clearing Members of at least one EMIR authorised CCP that

clears the specified IRS or CDS products subject to clearing obligation.

- Category 2 – Non-Clearing Members that are financial counterparties or alternative investment funds (AIFs) (as defined under the Alternative Investment Fund Managers Directive) which qualify as non-financial counterparties above the clearing threshold.
- Category 3 – Non-Clearing Members that are non-financial counterparties above the clearing threshold (except AIFs).

Frontloading

The consultation paper also deals with a technical problem under EMIR known as “frontloading”. Under EMIR, some derivatives might have been required to be cleared if executed into prior to the clearing obligation being imposed. This is considered undesirable because cleared derivatives are priced differently to non-cleared derivatives. The draft RTS and accompanying consultation paper effectively eliminate this as an issue (i) for derivatives which have at least one NFC as a party; (ii) for any transactions entered into prior to the publication in the Official Journal of the European Union of an RTS specifying an asset class subject to the clearing obligation; (iii) for instruments of less than six months maturity as at the time of publication in the Official Journal of the relevant RTS. On the latter point, the consultation further explains that “the minimum remaining maturity” only needs to be assessed on the date of application of the clearing obligation for the contract and the counterparty, which may be six months or 18 months after the entry into force of the RTS, depending on whether the counterparties fall within Category 1 or Category 2. As a result and for example, a circa two year contract entered into by two clearing members after publication of the RTS with circa 18 months to run upon the clearing obligation taking effect would have to be cleared. However, a circa nine month contract entered into by the same parties on the same date with circa three months to run on the date of the clearing obligation taking effect would not.

Timetable

Due to the differences in the timing of the CCP authorisations, the IRS and CDS classes are covered in two separate consultations and will follow different timetables set out below.

Expected Implementation Timeline	2014					2015		2016		2017					
	July	18 August	18 September	Around November	December	May	June	May	June	November	December				
*IRS	•	•	A few months →		•	6 months →		•	18 months →			•	3 years →		•
*CDS	•	•	A few months →		•	6 months →		•	18 months →			•	3 years →		•
	Publication of CPs	End of Consultation Period		RTS Likely to Come into Force		Category 1 (Clearing Member)		Category 2 (Non-Clearing Member – Financial Counterparties / AIFs)		Category 3 (Non-Clearing Member – Non-Financial Counterparties Above the Clearing Threshold)					
	CONSULTATION			RTS ON CLEARING OBLIGATIONS		PROPOSED DATES OF APPLICATION OF CLEARING OBLIGATIONS **									

* This only covers the product classes covered by the CCPs referred to in the CPs. If other CCPs are authorised at a later stage, several clearing obligation procedures may run in parallel.

** Market Participants will be able to fulfil the clearing obligation for IRS and CDS included in all CCP's authorisation (not only those CCPs listed in this note) as long as the relevant CCPs are authorised before the relevant clearing obligation commences.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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