Linklaters

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Client Clearing of Derivatives in Europe – a Client's Perspective.

Introduction

What does this guide cover?

This guide introduces the concept of derivatives clearing, the status of mandatory clearing in Europe and points to consider if you are not a clearing member of a central counterparty ("**CCP**") but intend to clear over the counter ("**OTC**") derivatives in Europe. Although this guide briefly touches on exchange traded derivatives ("**ETDs**"), its primary focus is on OTC derivatives clearing.

How will the clearing obligation impact clients?

A number of entities will, in the short to medium term, fall within the scope of the mandatory clearing obligation in Europe in respect of some classes of OTC derivatives. Regardless of whether you become subject to mandatory clearing, you may want to establish the necessary infrastructure to clear some of your OTC derivatives. This will allow you to benefit from the advantages that clearing may offer (such as pricing and capital cost reductions). This guide introduces the key concepts associated with OTC derivatives clearing and highlights some of the principal issues to consider when establishing your OTC derivatives clearing arrangements.

Why Clear Derivatives?

What is derivatives clearing?

Clearing is the process by which a CCP interposes itself between two parties to what would otherwise be a bilateral derivative contract. The process results in the 'division' of the original contract into two separate limbs, each with the CCP as counterparty.

The parties no longer have exposure to each other but instead are exposed to the CCP. The CCP becomes the buyer to every seller and the seller to every buyer.

Why have mandatory clearing of OTC derivatives?

The G20 agreed a set of reforms in the aftermath of the financial crisis of the OTC derivatives markets. Mandatory clearing of certain OTC derivatives is one of the consequences of those reforms.

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The aim of derivatives clearing is to promote financial stability by reducing counterparty credit risk and operational risk, and by standardising the derivatives default management process in the event of an insolvency of a market participant.

By transforming the parties' exposure to the CCP rather than to each other, derivatives clearing aims to insulate market participants from credit risk on each other. As a result, CCPs have become increasingly systemically important, which has led to increased focus on their ability to manage risk.

How is the clearing obligation imposed in the EU?

In the EU, the G20 commitment on clearing was introduced as part of the Regulation on OTC derivatives, central counterparties and trade repositories ("**EMIR**").

EMIR imposes a new mandatory clearing obligation on some market participants in relation to certain OTC derivatives.

Although EMIR came into force on 16 August 2012, the various obligations under EMIR have been, and continue to be, introduced in stages, with the clearing obligation to be phased in from 2016 onwards.

The Markets in Financial Instruments Regulation ("**MiFIR**") also includes provisions regulating derivatives transactions. This will cover, amongst other things, the regulation of 'indirect clearing' for ETDs, rules on timing of acceptance of transactions for clearing, and potentially a requirement for some classes of derivatives that are subject to mandatory clearing to be traded on a trading venue rather than OTC. Implementing measures are being drafted and will come into effect on 3 January 2017.

How does this compare with the US?

In the US, the mandatory clearing requirements (and other derivatives regulatory reforms) were brought in by the Dodd-Frank Act and came into effect in 2013.

What is Client Clearing?

How is clearing achieved?

Transactions can only be cleared through a CCP via a clearing member ("**CM**"). CCPs set stringent requirements for an entity to become a CM. These cover creditworthiness, operational sophistication, minimum trading activity in covered derivatives, contributions to the CCP's default fund and participation in the default management process. The costs and infrastructure requirements to be a CM are significant and are, in practice, only justifiable for entities with a substantial derivatives business.

What is client clearing?

Most entities that wish to clear derivative transactions will therefore not become CMs but, instead, are likely to enter into a relationship with one or more CMs to clear their transactions. Client clearing involves a market participant becoming a client of a CM in order to access a CCP to clear its derivative transactions.

What are the main client clearing models?

Two main models exist to support client clearing: the agency model and the principal model.

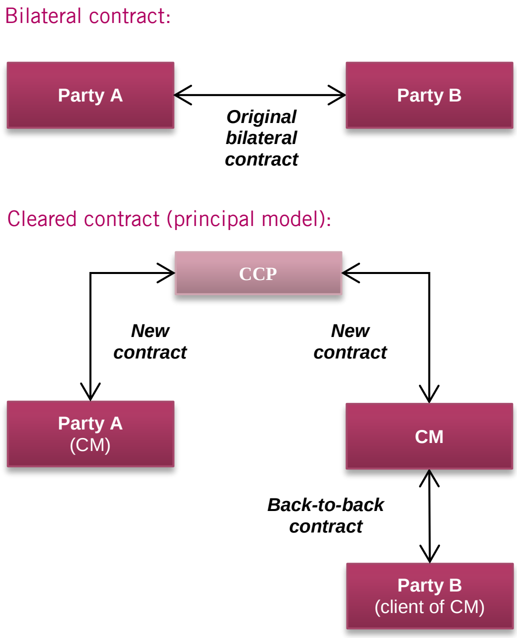
Agency Model

The agency model is predominant in the US. It involves the CM (known as a futures commission merchant or "**FCM**") acting as agent of the client, resulting in the client and the CCP being the two principals of the cleared trade, although the FCM will be liable to the CCP for the client's liabilities.

Principal Model

The principal model is predominant in the EU. It involves the CM having one contract as principal with the CCP and a corresponding back-to-back contract as principal with the client.

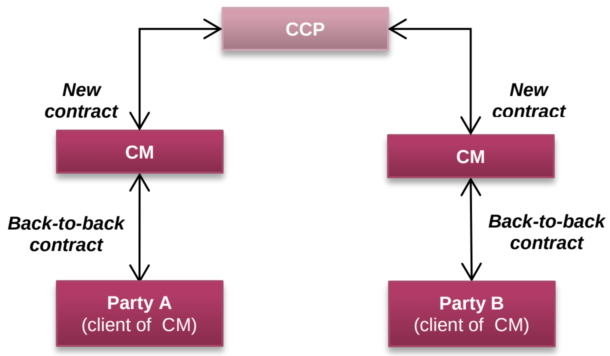
Although the legal relationships and the contractual framework underpinning the agency and principal models are different, both models are, in practice, broadly similar in terms of the relevant participants' rights and obligations. This guide focuses on the principal model.



Does your counterparty have to be a CM?

No. If you execute a transaction that will be cleared with a counterparty that is not a CM, both you and your counterparty will need to have a clearing arrangement in place with a CM of the CCP through which you agree to clear your derivative contract. You will also need (or have an arrangement with a dealer who has) access to an electronic platform which matches the trade data submitted by you and your execution counterparty and then communicates that data to the relevant CCP.

Cleared contract – neither party is a CM:



What is indirect clearing?

Indirect clearing is where a market participant becomes the CM's client in order to clear transactions of underlying clients of that market participant. It was formally introduced into EMIR (somewhat late in the legislative process) in order to ensure that entities who may not have direct access to a CM could still have indirect access to clearing of OTC derivatives.

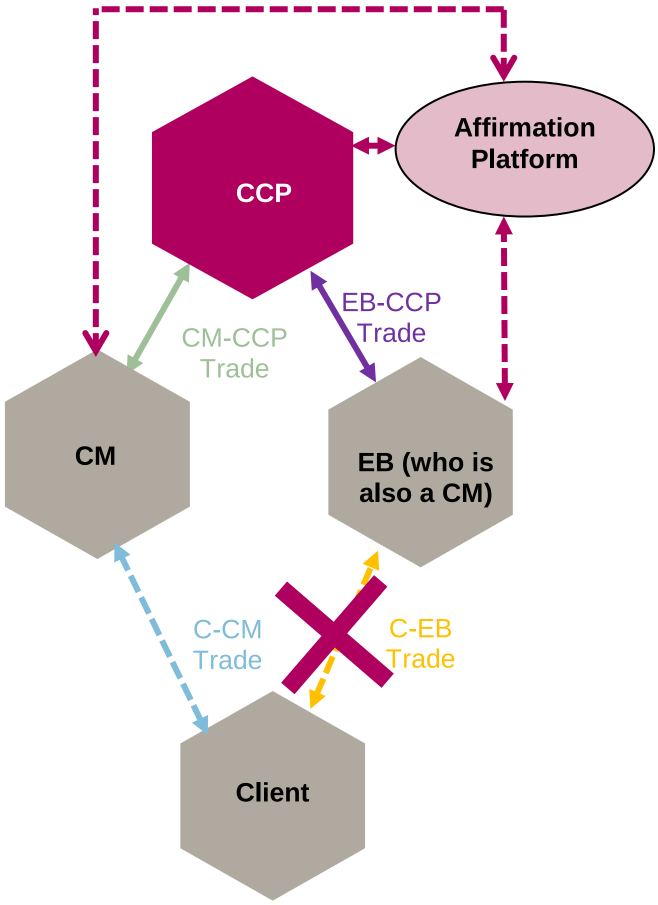
However, the practicalities remain uncertain and no market solution for indirect clearing is yet in place. The need, in practice, for indirect clearing for parties that want to clear, or will become subject to mandatory clearing, will increase. To become a direct client of a CM causes challenges and there are only a relatively small number of CMs that are offering client clearing services for OTC derivatives (and this is often as an add-on to ETD clearing rather than a stand-alone service).

Currently in the ETDs market it is common for client transactions to be indirectly cleared, with no specific regulatory controls to protect the underlying client in the event of default of the service provider that is the direct client of the CM. Such indirect clearing arrangements are due to be regulated under MiFIR. As with indirect clearing under EMIR, there is a concern as to how practical this will be.

How is a cleared transaction established?

What is the first step to having a cleared transaction?

In the same way as you enter into an uncleared OTC derivative you would enter into a transaction (C-EB Trade on the diagram) with an executing broker ("**EB**"). As part of the C-EB Trade, you would need to agree the matching facility through which both parties will be submitting the trade details (the "Affirmation Platform" on the diagram) and the CCP through which the transaction will be cleared. Where transactions are intended to be cleared, you would probably enter into an ISDA/FIA Europe Cleared Derivatives Execution Agreement with your EB before the transaction is entered into.



How does a C-EB Trade then become cleared?

A number of steps must be taken before a cleared transaction is established:

> once the C-EB Trade is entered into, its details must be submitted by both parties and checked via the Affirmation Platform (either manually, or automatically if the C-EB Trade is executed on an Affirmation Platform which automatically matches and submits the trade details to the relevant CCP);

> you will also need to submit the identity of your CM so that it can be checked and confirmed by the CCP;

> the CCP and the CM for each party need to accept the trade for clearing. If each accepts, then the following cleared transactions are automatically put in place:

- a transaction between your CM and the CCP on terms identical[1] to the C-EB Trade but with the CM taking your position and the CCP taking the EB's position (CM-CCP Trade),

[1] Note that the terms of transactions may be modified in accordance with the CCP rules and procedures.

a transaction between you and your CM on terms mirroring the terms of the CM-CCP Trade (C-CM Trade);

- a transaction between the EB (assuming it is also a CM) and the CCP on terms identical[1] to the C-EB Trade but with the CCP taking your position (EB-CCP Trade).

What happens to the C-EB Trade if it is accepted for clearing?

As soon as both the CM and the CCP accept the terms of the C-EB Trade for clearing, the C-EB Trade is, pursuant to the standard ISDA/FIA Europe Cleared Derivatives Execution Agreement, automatically cancelled.

What happens to the C-EB Trade if it is not accepted for clearing?

If the C-EB Trade is not registered with the CCP, then it will depend on the terms of the execution agreement that you have in place with the relevant EB. Under the standard ISDA/FIA Europe Cleared Derivatives Execution Agreement, the C-EB Trade may either:

> continue as a bilateral transaction (unless the transaction is subject to a mandatory clearing obligation); or

> be terminated.

Why might the C-EB Trade not be registered with the CCP?

There are a number of circumstances in which a transaction may not be registered with the CCP, notably:

> the CCP rejects it;

> the CM either rejects it or does not accept it for clearing within the prescribed period; or

> the trade data does not match.

Who is obliged to clear?

Will you be subject to the clearing obligation?

Whether or not you are subject to the clearing obligation depends on the categorisation of you and your counterparty under EMIR. Entities are divided into four categories under EMIR: (i) a financial counterparty ("**FC**"), (ii) a non-financial counterparty above the clearing threshold ("**NFC+**"), (iii) a non-financial counterparty below the clearing threshold ("**NFC-**"), and (iv) a third country entity ("**TCE**").

What is an FC?

EU established banks, insurance/assurance/reinsurance undertakings, alternative investment funds managed by alternative investment fund managers, investment firms, UCITS and pension funds are, broadly speaking, FCs under EMIR.

EU pension funds benefit from a temporary exemption from the clearing obligation (see 11 for more detail).

What is an NFC?

Any undertaking established in the EU that enters into derivatives and is not an FC will, by default, be an NFC.

What is an NFC+?

An NFC is an NFC+ when the rolling average over 30 working days of notional positions in non-hedging OTC derivatives of that NFC and any other NFC in its group exceeds any of the following thresholds:

> EUR 1 billion for credit derivatives;

> EUR 1 billion for equity derivatives;

> EUR 3 billion for interest rate derivatives;

> EUR 3 billion for FX derivatives; or

> EUR 3 billion for commodity and other derivatives.

When is a derivative used for hedging purposes?

Derivatives entered into for hedging purposes do not count towards the clearing thresholds. A derivative is entered into for hedging purposes if it is objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the NFC or of its group. The most objective way of assessing this is if it qualifies as a hedging contract under International Financial Reporting Standards. Intra-group transactions that are not entered into for hedging purposes are counted towards the threshold (although intra-group transactions are exempt from clearing). As the test is applied at group level, those intra-group transactions will be counted twice, ie once for each entity.

What is an NFC-?

An NFC that is not an NFC+.

What about TCEs?

A transaction between an FC or NFC+ and a TCE that would be an FC or NFC+ if it were established in the EU is within the scope of mandatory clearing.

Will the clearing obligation apply to you?

The table below sets out when the clearing obligation may apply to a derivative contract that is not entered into intra-group:

You \ Your counterparty	FC	NFC+	NFC-	TCE (FC/NFC+)*	TCE (NFC-)**
FC	✓	✓	X	✓	X
NFC+	✓	✓	X	✓	X
NFC-	X	X	X	X	X
TCE(FC/NFC+)*	✓	✓	X	✓/X***	X
TCE(NFC-)**	X	X	X	X	X

* ie a TCE that would be an FC or a NFC+ if it were incorporated in the EU.

** ie a TCE that would be an NFC- if it were incorporated in the EU.

*** A contract between two TCEs will only be subject to the clearing obligation if it has a direct, substantial and foreseeable effect within the EU or where it is necessary or appropriate to prevent the evasion of EMIR. A contract would have a direct, substantial and foreseeable effect in the EU if the parties are located in a third country where arrangements have not been declared equivalent by the Commission and:

- one of the TCEs benefits from a guarantee issued by an FC established in the EU, which covers at least EUR 8 bn gross notional amount and is equal to at least 5% of total OTC derivatives exposure of the FC; or
- both TCEs are EU branches of entities established in non-equivalent third countries that would be FCs if they were established in the EU.

What will you have to clear and when?

What will you have to clear?

Mandatory clearing is expected to apply to the following classes of interest rate and credit derivatives:

> basis swaps denominated in four major currencies (EUR, GBP, USD and JPY, the "**G4 Currencies**");[2]

> interest rate swaps ("**IRS**") denominated in the G4 Currencies[2] and CZK, DKK, HUF, NOK, PLN and SEK (the "**EEA Currencies**");[3]

> forward rate agreements ("**FRA**") denominated in EUR, GBP and USD;[2]

> overnight interest swaps ("**OIS**") denominated in EUR, GBP, USD[2], NOK, PLN, SEK;[3]

> iTraxx Europe Main and iTraxx Europe Crossover credit default swaps with five year maturity.[4]

It is likely that the European Securities and Markets Authority ("**ESMA**") will conduct further public consultations in due course on introducing mandatory clearing for other asset classes and for a broader range of products within these asset classes. This means that several mandatory clearing timetables will be running in parallel.

What is the current status of the implementation of the clearing obligation?

The clearing obligation implementation procedure started in Q1 2014 following the first authorisations of CCPs under EMIR. Following this, ESMA has analysed several classes of OTC derivatives and proposed in draft

2 The Commission's final draft delegated regulation (published on 6 August 2015)
3 ESMA's Consultation Paper on the clearing obligation (no. 4) (published on 11 May 2015)
4 ESMA's Consultation Paper on the clearing obligation (no. 2) with respect to credit derivatives (published on 11 July 2014)

regulatory technical standards that some of them be subject to the clearing obligation.

The table below provides an overview of the current status of the clearing obligation process for those classes.

Asset Class	Classes	Consultation Paper and other documents	Status of RTS	Last Update
Interest Rates in respect of the G4 Currencies	Basis swaps and IRS each in EUR, GBP, JPY, USD, FRA and OIS each in EUR, GBP, USD	6 August 2015 the Commission adopted the final draft of the regulatory technical standard	Council and Parliament have 3 months (extendable by 3 months) to object, otherwise it will be published in the Official Journal and come into effect 20 days later	6 August 2015
Interest Rates in respect of the EEA Currencies	IRS in CZK, DKK, HUF, NOK, PLN, SEK and OIS in NOK, PLN, SEK	11 May 2015 Consultation Paper (no. 4)	Consultation period closed July 2015	11 May 2015
Equity	Lookalike contracts, flexible contracts, equity derivatives and contracts for difference	1 October 2014 Final Report (no. 1)	No RTS proposed at this stage	1 October 2014
Credit	Index Credit Default Swaps	11 July 2014 Consultation Paper (no. 2); 20 November 2014 Letter to the Commission	Draft RTS to be delivered to the Commission following finalisation of Interest Rate RTS	20 November 2014
Foreign Exchange	Non-deliverable Forwards	1 October 2014 Consultation Paper (no. 3); 4 February 2015 ESMA Feedback statement	No RTS proposed at this stage	4 February 2015

What is the expected timetable?

After the consultation period in relation to a particular regulatory technical standard (“**RTS**”), ESMA must submit a final draft to the Commission. The Commission then has three months in which to endorse or reject the proposed draft RTS. Once endorsed, the Parliament and Council have one month, where the Commission endorses the RTS without any changes, or three months where the Commission makes changes, to approve the RTS. In either case, the periods are extendable by a period of one or three months respectively at the initiative of either the Council or the Parliament. The RTS generally become effective 20 days after publication in the Official Journal.

When will the clearing obligation come into force?

As indicated above, the first clearing RTS that will come into force will be in respect of interest rate products in the G4 currencies. The Commission, in its final draft RTS for such products (the "**Interest Rate RTS**")[5], divides entities that will become subject to the clearing obligation into four categories.

The categorisation determines the date on which the clearing obligation with respect to a particular asset class becomes effective:

> Category 1 entities: 6 months after the Interest Rate RTS come into force;

> Category 2 entities: 12 months after the Interest Rate RTS come into force;

> Category 3 entities: 18 months after the Interest Rate RTS come into force;

> Category 4 entities: 3 years after the Interest Rate RTS come into force.

It is expected that these categorisations will also apply to the other asset classes when the RTS for these are published.

Who is in Category 1?

Entities that are, on the date of entry into force of the relevant clearing RTS, CMs of at least one CCP that has been authorised or recognised (before the entry into force of such RTS) to clear at least one of those classes subject to the clearing obligation under such RTS.

Who is in Category 2?

FCs and alternative investment funds ("**AIFs**") that are NFC+s:

> that are either not CMs or are CMs that do not clear any of the transaction types subject to the clearing obligation under the relevant RTS, at the time of the relevant clearing RTS coming into force; and

> whose group's aggregate month-end average outstanding gross notional amount of uncleared derivatives for the three months after (and not including the month of publication) the relevant RTS coming into force is above EUR 8 billion.

Who is in Category 3?

FCs and NFC+ AIFs that are not in Category 1 or Category 2.

Who is in Category 4?

NFC+s that are not in Category 1, 2 or 3.

[5] The Commission's final draft delegated regulation (published on 6 August 2015)

What is the rationale for a phased application of the clearing obligation?

Entities that are already CMs of relevant CCPs should become subject to the clearing obligation before those that are not, as non-CMs may not have any current means of having their transactions cleared.

Will an entity always belong to the same category, regardless of the class of the derivatives?

No. Categorisation is on a per asset class basis.

When do transactions entered into between entitles from different categories have to be cleared?

Transactions entered into between two entities that fall in different categories need only be mandatorily cleared on the later of the two relevant dates. For example, if a Category 1 entity enters into a transaction with a Category 4 entity, such transaction will only need to be mandatorily cleared on the date on which the Category 4 entity would need to clear such transaction.

When will pension funds be subject to the clearing obligation?

Transactions entered into by EU pension funds that are objectively measurable as reducing investment risks directly relating to their financial solvency benefit from a temporary exemption from the clearing obligation until 16 August 2017[6]. This exemption period can be further extended for one year by the Commission. Non-EU pension funds do not benefit from this temporary exemption.

The rationale for this exemption is to avoid pension funds divesting a significant proportion of their assets for cash in order to meet CCPs' ongoing margin requirements, thereby reducing the return for policy holders. The Commission has encouraged CCPs to find suitable solutions for the use of non-cash collateral by pension funds to meet such margin requirements. Some EU pension funds are already clearing or do intend to clear in advance of the mandatory clearing obligation. Factors they consider when deciding whether to clear include the pricing differential between cleared and non-cleared transactions, the type and amount of collateral required, set-up and ongoing costs of the relationships required in order to clear, the fact that there will be separate collateral pools for cleared and uncleared transactions (ie no natural off-set) and credit considerations of facing a central clearing counterparty as opposed to a counterparty directly.

Are intra-group transactions subject to the clearing obligation?

Intra-group transactions are, broadly speaking, transactions between two counterparties that are members of the same group and that are consolidated on a full basis. "Group" is defined in EMIR as the group of undertakings consisting of a parent undertaking and its subsidiaries within the meaning of Articles 1 and 2 of the Company Law Directive or the group of undertakings

[6] The relevant legislation has been published in draft form but it is not yet in force. However, it is expected to be in force prior to the mandatory clearing obligation coming into effect.

referred to in Article 3(1) and Article 80(7) and (8) of the Bank Consolidation Directive.

The two counterparties must also be subject to appropriate centralised risk evaluation, measurement and control procedures (and, where one of the counterparties is established outside the EU, the Commission must have adopted an ‘equivalence’ decision in respect of the country where it is established (ie declared that third country ‘equivalent’ in terms of the legal, supervisory and enforcement arrangements)). The Commission has adopted ‘equivalence’ decisions for the regulatory regimes in Australia, Hong Kong, Japan and Singapore. The Interest Rate RTS also grants transitional relief for intra-group transactions with entities in non-EU countries for three years from the date of entry into force of the Interest Rate RTS or (if earlier) until after an equivalence determination has been made.

Additional requirements such as the parties being subject to appropriate prudential requirements or part of the same institutional protection scheme apply where one of the parties is a financial counterparty.

Are any other exemptions available?

The Interest Rate RTS introduces an exemption from the clearing obligation for certain transactions with covered bond issuers or covered pools for covered bonds.

Will you be affected by frontloading?

What is frontloading?

Frontloading is the obligation under EMIR to clear contracts that (i) fall within a class of OTC derivatives that has been declared subject to mandatory clearing and (ii) were entered into prior to the date on which the relevant class of contract becomes subject to the mandatory clearing obligation. In certain cases, as discussed below, these will need to be ‘retrospectively’ cleared, ie subsequently converted into cleared contracts. Frontloading has been, and continues to be, a contentious topic.

What are the issues with frontloading?

Potential issues with derivatives being ‘retrospectively’ cleared are that it may leave parties to a derivative in an uncertain position.

The terms of the collateral arrangements (if any) between the parties are factored into the pricing of any uncleared contracts and are bespoke to those parties. The way in which the same transaction, when cleared, will be margined will invariably be different. This means that, at the time the transaction is frontloaded, it is likely that it will need to be repriced.

How will frontloading be addressed?

Under EMIR only transactions with a minimum remaining outstanding maturity at the time the relevant clearing obligation becomes effective will be subject to frontloading. This minimum maturity has been set for the purposes of the Interest Rate RTS such that transactions entered into before the Interest Rate RTS comes into force will not need to be frontloaded.

The Interest Rate RTS also exempts transactions involving Category 3 and 4 entities from frontloading, and they include a delay for transactions involving Category 1 and Category 2 counterparties to the frontloading start date by a few months after the entry into force of the RTS on the clearing obligation.

The result is that in practice there will be no frontloading for (i) in the case of Category 1 entities, transactions entered into within two months of the Interest Rate RTS coming into force and (ii) in the case of Category 2 entities, within five months of the Interest Rate RTS coming into force. Transactions entered into in the 'frontloading window' between then and the clearing obligation coming into force (ie for Category 1 entities, the next four months, or for Category 2 entities, the next seven months) may be subject to frontloading if the transaction still has a maturity of at least six months when the clearing obligation starts to apply. For transactions entered into between Category 1 and Category 2 entities, the frontloading window opens five months after the clearing obligation comes into force.

What is the practical impact of frontloading applying?

Category 2 entities are most likely to be directly affected by frontloading as they may not have established clearing arrangements with each relevant CCP. A number of Category 2 entities are expected not to want to enter into OTC derivatives that will need to be frontloaded. So, notwithstanding the phased implementation of the clearing obligation, they may look to start clearing voluntarily in advance of the frontloading window commencing. Alternatively, they may use the ISDA frontloading amendment agreement, which enables transactions to be terminated if they become subject to frontloading and the parties cannot agree terms for clearing them.

Clearing through non EU CCPs

If you are subject to EMIR, can you only clear through EU CCPs?

Under EMIR, FCs and NFC+'s have to clear through CCPs that have been 'authorised' or 'recognised' under EMIR.

EMIR sets out the conditions necessary for ESMA to recognise a CCP, namely:

> the Commission has adopted an implementing act;

> the CCP is authorised in the relevant third country and is subject to effective supervision and enforcement ensuring full compliance with the prudential requirements applicable in that third country;

> co-operation arrangements have been established between ESMA and third country authority; and

> the CCP is established or authorised in a third country that has equivalent systems for anti-money laundering and combating financial terrorism.

A third country CCP has to apply to ESMA to receive such recognition. Currently, there have only been implementing acts in respect of Australia, Hong Kong, Japan and Singapore. Cooperation arrangements or memoranda of understanding with third country authorities have also only been entered into with Australia, Hong Kong, Japan and Singapore. This means that, currently, only CCPs located in Australia, Hong Kong, Japan or Singapore can actually be recognised under EMIR. A notable absence from this list is the United States although ESMA has recently consulted upon aligning the margin period of risk with that for US CCPs[7], which would assist with achieving 'equivalence' .

How does this interact with the Capital Requirements Regulation?

Under the Capital Requirements Regulation ("**CRR**"), EU firms are required to hold significant amounts of capital for direct or indirect exposures to third country CCPs which are not Qualifying CCPs ("**QCCPs**").

A third country CCP will only be considered a QCCP if it has been recognised under EMIR.

The deadline for being recognised currently expires on 15 December 2015 (this has been extended three times by the Commission).

[7] Discussion Paper: Review of Article 26 of RTS No 153/2013 with respect to client accounts, published on 26 August 2015.

What does EMIR II mean?

What is EMIR II?

Under EMIR the Commission was obliged to prepare a general report on EMIR by 17 August 2015 (the "**EMIR Review**"). This has not yet been published, but the Commission has sought advice from ESMA and carried out a public consultation exercise. While it is not expected that the EMIR Review will lead to fundamental change to EMIR, it is likely that some reforms will stem from the review (such changes, "**EMIR II**").

Will EMIR II impact on the obligation to clear?

Although it is uncertain what EMIR II will contain, it is intended that the EMIR Review will include some focus on the requirements for CCPs and the clearing requirements.

On 13 August ESMA published four reports[8] that focused on how EMIR has been functioning, and providing input and recommendations to the European Commission's EMIR Review.

The four reports cover a very wide range of issues and highlight potential for further significant changes affecting those trading in derivatives, as well as CCPs and TRs. While a number of changes, if made, will be welcomed in the market, there is a concern that any changes to matters such as classification of counterparties could be administratively onerous. This may be particularly problematic at a time when the market is still grappling with a huge volume of on-going regulatory change.

Some points of particular note are as follows:

> In Report No. 1 ESMA notes that some quasi-financial counterparties (in particular, hedge funds not managed by an EU-regulated fund manager) are NFCs but that it may be more appropriate to treat them as equivalent to FCs (so that, for example, mandatory clearing would apply to them even if their volume of OTC business is below the NFC+ clearing threshold). Additionally ESMA questions whether all transactions (not just non-hedging transactions) should be considered when determining if an entity is an NFC+ or NFC-, which may bring within scope some entities currently outside the scope of the clearing obligation.

> ESMA proposes in Report No. 2 that more detail is included in EMIR and the supporting legislation on the different account structures for client clearing at CCPs, in particular so that the requirements for segregation and default porting clearly correlate to the account structure chosen. One aim of this seems to be to encourage greater use of individually segregated accounts.

[8] Report No. 1 – Review on the use of OTC derivatives by non financial counterparties, Report No. 2 – Review on the efficiency of margining requirements to limit procyclicality, Report No. 3 – Review on the segregation and portability requirements and Report No. 4 – ESMA input as part of the Commission consultation on the EMIR Review.

> In Report No. 4 ESMA recognises that there needs to be greater flexibility around the procedure and timing requirements for introduction of mandatory clearing obligations. Further, it agrees with market concerns that the procedure for suspending or removing a clearing obligation is cumbersome and where it is no longer feasible to clear the relevant class of derivatives, it is essential that the clearing obligation can be suspended as a matter of urgency. ESMA also suggests that EMIR be amended to align the provisions on frontloading with the compromises currently made in the Interest Rate RTS and for the Commission to consider whether frontloading should be removed altogether.

> ESMA, also in Report No. 4, proposes some significant changes in the process for recognition of third country CCPs and trade repositories. The proposal to abolish the need for an international agreement between the EU and a third country in which the third country trade repository is located, before such entity can become recognised, would be particularly welcome given the time likely to be taken to reach such an agreement.

How do you document a clearing arrangement?

What arrangements do you need to have in place before you can clear derivatives?

Whether you are establishing a new relationship or building on an existing one, you will need to ensure that you have in place:

> new legal documentation with each prospective EB and each prospective CM; and

> the necessary operational processes (eg IT systems, payments, accounts etc).

What documentation will you need to have in place?

You will need the following documentation:

> an execution agreement between you and each EB;

> a master agreement between you and each CM (eg an ISDA Master Agreement or FIA Europe Professional Client Agreement);

> a clearing agreement based on the ISDA/FIA Europe Client Cleared OTC Derivatives Addendum or the FIA Europe Clearing Module between you and each CM;

> a collateral arrangement with respect to cleared transactions between you and each CM; and

> documentation supporting all operational processes.

Different jurisdictions may have domestic agreements that can be used instead, for example, the Clearing-Rahmenvereinbarung ("**CRV**") in Germany.

What are the CCP Rules and how do they affect my clearing arrangements?

Each CCP operates in accordance with its rules and procedures ("**CCP Rules**"). Where a CCP clears multiple products it may do so using more than one sub-set of rules and procedures, each relating to different products or groups of products (services).

To ensure an effective default management process, certain provisions of the relevant CCP Rules will apply to (and, to the extent of any inconsistency, override) the contractual terms between you and your CMs.

How do you know which set of clearing documents would better suit your requirements?

There are two sets of clearing documents that are commonly seen in the European cross-border market:

> the ISDA/FIA Europe Client Cleared OTC Derivatives Addendum;

> the FIA Europe Clearing Module.

The table below illustrates key differences in transaction coverage:

Derivatives master agreement and clearing documentation / Which transactions will you clear through the CM?	ISDA Master Agreement with ISDA/FIA Europe Client Cleared OTC Derivatives Addendum	FIA Europe Professional Client Agreement with ISDA/FIA Europe Client Cleared OTC Derivatives Addendum	FIA Europe Professional Client Agreement with FIA Europe Clearing Module
Only ETDs	x	✓	✓
Only OTC derivatives (and it is important to you that any non-cleared OTC derivatives are governed by the same master agreement)	✓	x	x
Only OTC derivatives (and it is not important to you that any non-cleared OTC derivatives are governed by the same master agreement)	✓	✓	✓
All cleared transactions ie a mixture of OTC derivatives and ETDs	x	✓	✓

What is the frontloading amendment agreement?

On 15 June 2015, ISDA published the final version of the frontloading amendment agreement.

The amendment agreement is intended to address the risk that parties, which are subject to the frontloading, enter into a relevant derivative contract during the frontloading window but then are not able to clear the derivative by the relevant deadline. In order to avoid breach (or continuing breach) of the clearing obligation there is an additional termination event ("**ATE**") which permits parties to terminate the relevant derivative.

It is a bilateral agreement to amend the Schedule to specified ISDA Master Agreements. As such, there is no associated ISDA protocol.

How involved is the documentation process?

Given the complexity of clearing documentation and the differing capacity of CMs, it can take months rather than weeks to negotiate and agree documentation.

Therefore, it is important to start the process in good time in order to be ready when the clearing obligation comes into effect.

If you are subject to frontloading, having the documents in place before the frontloading window opens will allow you to clear affected transactions from the outset and so avoid having to frontload.

What account structures are on offer?

What does EMIR require CMs to offer you?

Under EMIR, the CCP and the CM must operate separate accounts for the proprietary assets and positions of the CM and for its clients' positions. In respect of the clients' positions, CCPs and CMs must at least offer a choice between omnibus and individual segregation.

What is an omnibus segregation account?

Under EMIR, an omnibus segregation account (or "**OSA**") is an account where the CCP and the CM operate a single account for more than one of that CM's clients. There are some variants within this account structure, such as (most notably) net omnibus and gross omnibus accounts.

What is the difference between net and gross omnibus accounts?

The main difference between the net and gross omnibus account structures is the way in which margin is determined and called by the CCP.

Net omnibus

For net omnibus structures, all positions of different clients are pooled in order to determine the required amount of margin. This means that any offsetting positions of different clients reduce the overall amount of margin and therefore, in a CM default, not all of the assets posted by a client will necessarily be returned. This is the usual account structure in the ETDs market.

Gross omnibus

By contrast, margin for gross omnibus account clients is determined on a gross basis – there is no offsetting of positions if those positions belong to different clients. The CCP does not, however, record the assets posted for each client, but simply the value of the assets posted as attributed to the CM. The CCP does not necessarily know which assets have been posted by which client.

This means that, in a CM default, the CCP can only return value to clients rather than the very same assets that have been posted.

What is an individual segregation account?

Under EMIR, an individual segregation account (or "**ISA**") is one where the CCP and the CM operate a separate account for positions held for a client, distinct from positions held for the account of other clients and from those of the CM.

Any excess margin needs to be passed on by the CM to the CCP and cannot be held by the CM. This means that the only margin not allocated to a client will be collateral awaiting allocation by the CM and CM buffer posted by the CM to cover future margin requirements.

What are the key drivers in choosing the account?

Before choosing an account structure, you should consider:

> whether you are required under law/regulation to choose a particular type of account;

> how much protection the account structure will give you in a default scenario (eg are you exposed to other clients if your CM defaults?);

> how much you will be charged for the relevant account;

> how much margin you will have to provide;

> whether you want your positions to be ported if your CM defaults, or would prefer for them to be liquidated by the CCP (ie what is your appetite to take on the risk of having to re-hedge your positions?); and

> the likelihood of porting taking place given your choice of account.

What do you need to do about your choice of account?

You will have to confirm your account choice to your CM.

What are the key concepts?

What is the riskless principal concept?

CMs view their function in cleared transactions as being similar to that of an intermediary rather than that of a true OTC derivative counterparty. The CM seeks not to assume any market risk in relation to cleared transactions – its role is simply to facilitate the client's access to the CCP. For this reason, the clearing documentation includes provisions aimed at eliminating the CM's exposure to market risk, preserving its status as 'riskless principal'.

What happens if a CM does not accept a transaction for clearing?

The standard industry documents do not contain any commitment on the part of a CM to accept a transaction for clearing. If a CM does not accept a transaction for clearing (whether because the CM has not given any commitment to clear or because the transaction falls outside any clearing commitment parameters), the parties can seek to clear it again through a different CM, keep it as a bilateral uncleared trade (provided it is not required to be mandatorily cleared) or they can terminate it.

Can you transfer cleared transactions to another CM?

Porting is the transfer of cleared transactions and the associated collateral assets from one CM to another.

Porting can happen at your request on a 'business as usual' basis (that is, absent a CM default) or upon a CM being formally declared to be in default of a CCP's rules by the relevant CCP (known as 'default porting'). 'Business as usual' porting is not relevant in the ETDs market, as transactions would be closed and re-opened with the new CM.

If your CM defaults, you will have a window of time during which you may ask the CCP through which your derivatives are cleared to port the positions with that CCP through your defaulting CM to another CM. For this reason, you will need to have already established a clearing arrangement with another CM.

In light of your expected volume and types of cleared derivatives, you will need to consider the number of CMs to appoint and the volumes you may clear through each of them. This will necessarily involve a tension between, on the one hand, diversification of CMs in order for there to be adequate back up if you wish to port and, on the other hand, reducing netting efficiencies and costs.

The type of account you choose and the level of segregation will have an impact on your ability to port transactions and assets. For example, it is more difficult to transfer associated collateral assets if you have a net omnibus account (see page 18).

How can you terminate your cleared transaction?

Termination of a cleared transaction involves the CM determining the termination amount in accordance with the underlying master agreement. A client may prefer to obtain a price from a dealer in the market for an economically equal and opposite transaction. That new transaction is known as an 'offsetting transaction'. That offsetting transaction (subject to conditions) can be cleared through the same CM.

The existing cleared transaction and the new offsetting transaction (once it is cleared) are then cancelled (or 'compressed') leaving only a single net transaction where the notional amounts of the opposing transactions were not the same. In order to enter into an offsetting transaction and have it accepted by the relevant CM, there must be adequate collateral available to the CM to cover the margin requirement for the residual portfolio of cleared transactions after the offset.

How is margining effected?

Each CCP will require CMs to provide margin in respect of the transactions between the CM and the CCP. Each CM will, in turn, ask for margin from its clients.

In general, there are two types of margin for which a CCP can call:

> Initial Margin ("**IM**") is provided at the outset of a transaction. IM is designed to cover potential losses of the CCP in the event of a default

if the Variation Margin is not sufficient to cover its exposure and is calculated to take into account the time to liquidate or replace the contract. IM can be provided in cash or highly liquid securities which satisfy the eligibility criteria of the CCP.

> Variation Margin ("**VM**") seeks to address any changes in the mark-to-market value of the transactions and posted margin since the previous margin call. If the transaction is out-of-the money to the client, the client will post VM to the CM, which will be transferred to the CCP. If the transaction is in-the-money to the client, the CCP will in most cases pay VM to the CM for the account of the client. VM must be provided in cash.

CCPs retain the right to call margin from CMs multiple times a day. This differs from the typical position for non-cleared OTC derivatives, where margin is usually posted no more frequently than daily. If the CCP calls for margin from the CM intra-day, the CM may seek to make a matching margin call on the client. Some CMs may be willing to reduce the number of margin calls they can make on any day, but may:

> seek to have a sufficient 'buffer' in place to enable them to meet the CCP's requirements without using their own funds; and/or

> apply a funding charge if they meet the margin requirements on your behalf.

How long is margin with the CM during transit?

In most cases, margin will pass through the CM whenever it is posted by the client or by the CCP. Whilst the assets are with the CM, there is a risk that, should the CM become insolvent during this time, the assets may form part of its insolvent estate. This risk is known as 'transit risk' and the extent of the risk depends on the length of time margin is with a CM and the relevant insolvency law in the jurisdiction of that CM.

What are the key CCP issues to consider?

Which CCPs can clear classes of OTC derivatives that are subject to a mandatory clearing obligation?

Under EMIR, a CCP can provide clearing services if it is either authorised by a national competent authority within the EU or (if it is established outside the EU) recognised by the Commission.

With regard to CCPs established outside the EU, the Commission has adopted 'equivalence' decisions for the regulatory regimes in Australia, Hong Kong, Japan and Singapore. As a result, CCPs in these jurisdictions will be able to obtain recognition in the EU and can therefore be used by EU market participants to satisfy the mandatory clearing obligation, whilst remaining subject solely to the regulation and supervision of their home jurisdiction. No third-country CCP has, however, yet been recognised by ESMA.

ESMA maintains a public register which sets out a list of the CCPs that have been authorised and recognised.

Do all CCPs operate in the same way?

No. CCPs can operate in different ways. They may be subject to different insolvency and regulatory regimes, the CCP Rules differ and are not all in English. Other key differences stem from the other questions on this page.

What factors may influence the CCP through which you clear?

> Which products does the CCP clear?

> What liquidity in the relevant product is provided by the CCP?

> What is the relevant service at the CCP (if the CM has different services for different products)?

In relation to the relevant CCP Service:

> What account structures does the CCP offer?

> What are the costs related to using the different account structures?

> What segregation protections apply to the different account structures and the collateral in such accounts?

> How does the CCP calculate margin requirements?

> What types of collateral does the CCP accept and what haircuts does it apply?

What protections for clients are there following a CM default?

Protection afforded by CCPs differ, and the following issues will be important to consider:

> How is margin provided? Is it by way of security or outright transfer?

> How does the CCP allocate losses following a CM default?

> Can the CCP require any amounts to be posted in addition to regular margin following a CM default and, if so, is there a cap on the amounts that can be required?

> Can the CCP use margin provided for one service to pay for losses in respect of another service?

> Does the CCP contribute to the default fund?

> How long is the CCP's post-default porting window and are there any pre-conditions to post-default porting?

> Do all positions and collateral have to be ported or is partial porting possible?

> What happens to the collateral as part of the porting process?

What protections for clients are there following a default by the CCP?

> How do the recovery and resolution rules in the CCP's jurisdiction operate?

> Will client segregation continue to be respected or will there be set-off across all of the accounts of the CM and/or its clients?

> How and when do you get your assets back?

How can you more fully understand CCP risk?

It is worth discussing CCP risks with your CMs to get their views and insight.

In addition, FIA Global, in cooperation with Linklaters and Milbank, Tweed, Hadley & McCloy, has produced a guide to the rules of CCPs. The CCP Risk Review is a subscription service that provides a standardised, comprehensive overview and analysis of the rules and procedures governing certain CCPs, as well as timely updates on changes to the rules and regulatory framework. It highlights the issues most relevant to CMs and end-users who wish to gain a deep understanding of the effect of the rules and procedures of CCPs and, in particular, the account structures and types of segregation available in respect of client clearing at each CCP. This allows market participants to more fully analyse the risks and compare the rules and procedures of CCPs worldwide.

See: https://fia.org/ccp-risk-review and https://www.ccpriskreview.org/ccp/Home for more information.

Glossary

AIF – alternative investment fund

ATE – additional termination event

basis swaps – floating rate to floating rate swaps

business as usual porting – porting absent a CM default

Category 1, 2, 3 and 4 – the categorisation introduced by ESMA in the final draft RTS for clearing of interest rate OTC derivatives relating to the mandatory clearing obligation, which determines the timetable for the phasing of the clearing obligation and whether or not frontloading will apply

CCP – central counterparty

CCP Risk Review – a comprehensive overview and analysis of certain CCP Rules available from FIA Global in cooperation with Linklaters and Milbank, Tweed, Hadley & McCloy

CCP Rules – the rules and procedures applicable to a CCP

CCP Services – a subset of the CCP Rules relating to a specific product or group of products

clearing RTS – regulatory technical standards on the obligation to clear a certain class of OTC derivatives

client – an entity that is not a direct member of a CCP and who can clear by virtue of being a client of a CM

CM – clearing member

Commission – the European Commission

compression – the process by which an existing transaction and an offsetting transaction are fully or partially cancelled

Council – the Council of the European Union

CRR – Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

CRV – the Clearing-Rahmenvereinbarung, the domestic agreement used in Germany for cleared transactions

default porting – porting in circumstances where the CM is formally declared in default of the applicable CCP Rules

EB – executing broker

EEA Currencies – CZK, DKK, HUF, NOK, PLN and SEK

EMIR – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories

EMIR II – possible reforms could stem from the EMIR Review

EMIR Review – the general report that the Commission is obliged to prepare on EMIR by 17 August 2015

ESMA – European Securities and Markets Authority

ETDs – exchange traded derivatives

FC – financial counterparty

FCM – futures commission merchant, the member of a CCP that acts as agent for the client in an agency clearing model

flexible contract – a contract that mirrors an ETD while adding a possibility to customise some of the standard characteristics of a listed product to adequately fit the needs of the customers, and which is traded OTC

FRA – forward rate agreements

frontloading – the potential obligation to convert uncleared OTC derivatives entered into after a particular CCP becomes authorised into cleared OTC derivatives once the related clearing obligation comes into effect

G4 Currencies - EUR, GBP, JPY and USD

IM – initial margin

Interest Rate RTS – the final draft regulatory technical standard for interest rate products in respect of the G4 currencies adopted by the Commission

IRS – fixed interest rate to floating interest rate swaps

ISA – individual segregation account

lookalike contract – an OTC contract which has the same characteristics as a particular exchange-traded contract, so that once cleared the two contracts may become fungible

MiFIR – Regulation (EU) 600/2014 of the European Parliament and Council on markets in financial instruments and amending Regulation (EU) No 648/2012

NFC – non-financial counterparty

NFC+ – an NFC where the rolling average over 30 working days of notional positions in non-hedging OTC derivatives of that NFC and any other NFC in its group exceeds the clearing threshold

NFC- – an NFC that is not an NFC+

offsetting transaction – in relation to an existing transaction, a transaction that is equal (partially or entirely) and opposite to that existing transaction

OIS – Overnight Index Swaps

OSA – omnibus segregation account

OTC – over the counter

Parliament – the European Parliament

porting – the ability to move positions cleared through one CM to another CM

QCCPs – Qualifying CCPs

riskless principal – the position a CM seeks to take in its relationship with a client to avoid the CM's exposure to market risk of the cleared transactions

RTS – a regulatory technical standard

TCE – third country entity

transit risk – the risk that the CM becomes insolvent while margin passes through it from the client to the CCP or from the CCP to the client

VM – variation margin

Contacts

Linklaters Clearing experience

> We have acted, and continue to act, for a number of CCPs advising on their establishment, rules and regulations.

> We have been involved in the negotiation of the industry standard form of ISDA/FIA Europe Client Cleared OTC Derivative Addendum.

> We act for a range of entities that are clients of clearing members advising on all aspects of derivatives clearing and associated documentation.

> We are assisting FIA Global in the preparation of the CCP Risk Review surveys, which provide comprehensive guidance to the rules of central clearing counterparties, including those governing client clearing.

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