

Client Clearing of derivatives in Europe - a client's perspective.

December 2014



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 but intend to clear over the counter (or 'OTC') derivatives in Europe.

How will the clearing obligation impact clients?

A number of entities will, in the medium term, fall within the scope of the mandatory clearing obligation in Europe.

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. Exchange traded derivatives ('ETDs', i.e. bilateral contracts on standard terms that are subject to the rules of the relevant exchange) are not covered in this guide.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the authors.

Authors: Deepak Sitlani / Alyona Smith

Doc: A18389537

Date of publication: 8 December 2014

© Linklaters LLP. All Rights reserved 2014

Linklaters LLP is a limited liability partnership registered in England and Wales with registered number OC326345. It is a law firm authorised and regulated by the Solicitors Regulation Authority. The term partner in relation to Linklaters LLP is used to refer to a member of Linklaters LLP or an employee or consultant of Linklaters LLP or any of its affiliated firms or entities with equivalent standing and qualifications. A list of the names of the members of Linklaters LLP together with a list of those non-members who are designated as partners and their professional qualifications is open to inspection at its registered office, One Silk Street, London EC2Y 8HQ or on www.linklaters.com and such persons are either solicitors, registered foreign lawyers or European lawyers.

Please refer to www.linklaters.com/regulation for important information on our regulatory position.

We currently hold your contact details, which we use to send you guides such as this and for other marketing and business communications.

We use your contact details for our own internal purposes only. This information is available to our offices worldwide and to those of our associated firms.

If any of your details are incorrect or have recently changed, or if you no longer wish to receive marketing communications, please let us know by emailing us at marketing_database@linklaters.com.



Contents.

In this guide we will cover the following frequently asked questions:

Why clear derivatives?	4
What is client clearing?	5
How is a cleared transaction established?	6
Who is obliged to clear?	7
How will the clearing obligation be phased in?	8
What will you have to clear and when?	9
Will you be affected by frontloading?	10
How do you document a clearing arrangement?	11
What account structures are on offer?	12
What are the key concepts?	13
What are the key CCP issues to consider?	14



Why clear derivatives?

What is derivatives clearing?

Clearing is the process by which a central counterparty ('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 OTC derivatives is one of the consequences of those reforms.

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').

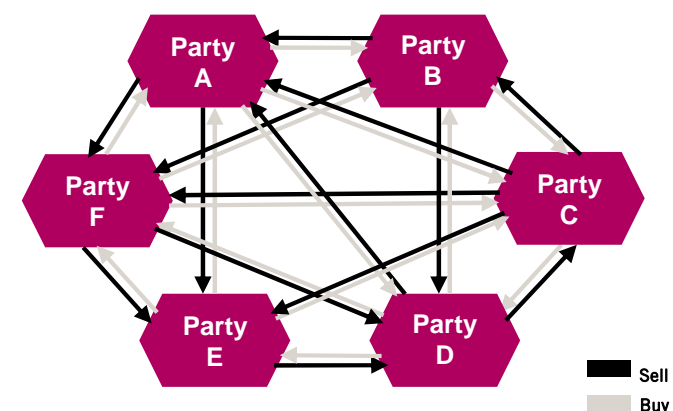
EMIR imposes a new mandatory clearing obligation on some market participants in relation to certain OTC derivatives.

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 2015 onwards.

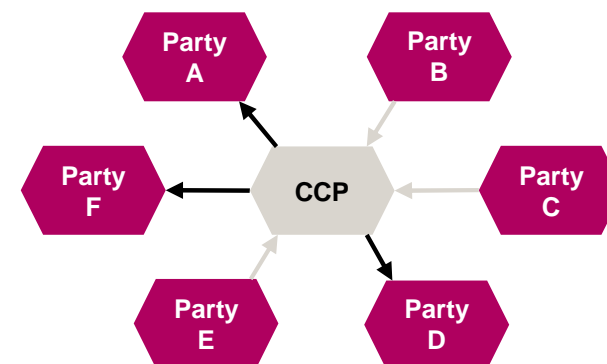
How does this compare with the US?

In the US, the mandatory clearing requirements were brought in by the Dodd-Frank Act and came into effect in 2013.

Bilateral contracts with market counterparties:



Cleared contracts with CCP counterparty:



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.

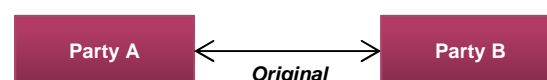
Agency Model

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.

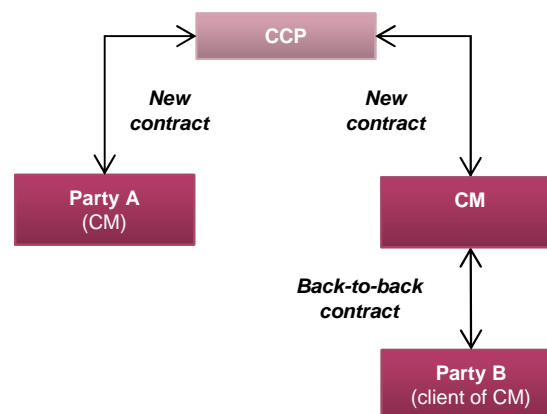
Principal Model

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.

Bilateral contract:



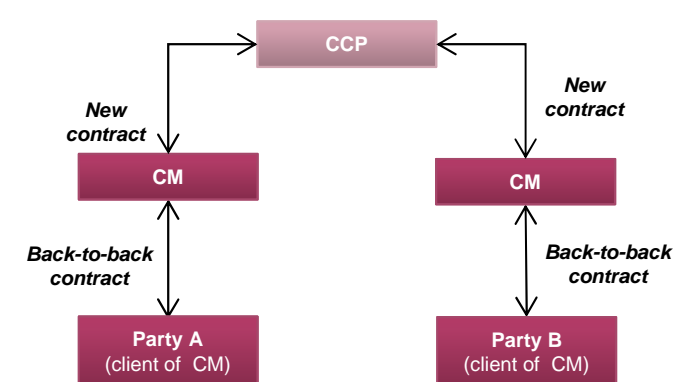
Cleared contract (principal model):



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.

However, the practicalities remain uncertain and there is no widely accepted market solution for indirect clearing in place yet.

What happens if a party defaults?

If a market participant defaults:

- > the contract will be transferred to another CM, or
- > the contract will be unwound.

How is a cleared transaction established?

What is the first step to having a cleared transaction?

In much 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.

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* to the C-EB Trade but with the CM taking your position and the CCP taking the EB's position (CM-CCP Trade),
 - > 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* to the C-EB Trade but with the CCP taking your position (EB-CCP Trade).

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

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?

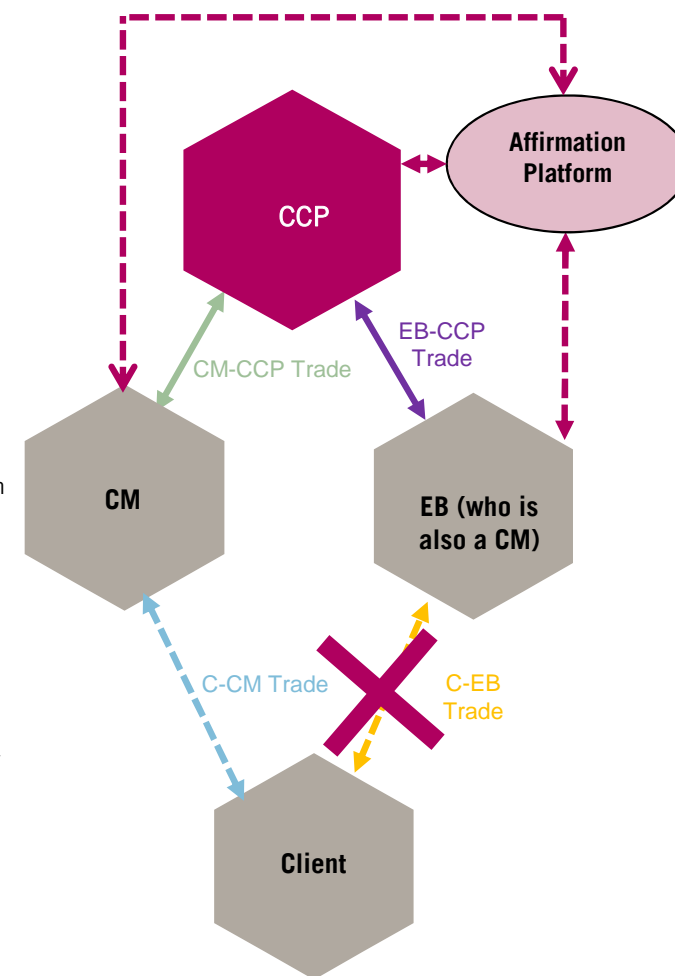
If the C-EB Trade is not registered with the CCP, then it will depend on the terms of the execution agreement that you have in place with the relevant EB. Under the standard ISDA/FIA Europe Cleared Derivatives Execution Agreement, the C-EB Trade may either:

- > 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 4 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 next page 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, i.e. once for each entity.

What is an NFC-?

An NFC that is not an NFC+.

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	✓	✓	✗	✓	✗
NFC+	✓	✓	✗	✓	✗
NFC-	✗	✗	✗	✗	✗
TCE(FC/NFC+)*	✓	✓	✗	✓/✗***	✗
TCE(NFC-)**	✗	✗	✗	✗	✗

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

How will the clearing obligation be phased in?

When will the clearing obligation come into force?

The European Securities and Markets Authority ('ESMA') has proposed in its draft regulatory technical standards (the 'clearing RTS')* that entities subject to the clearing obligation be divided 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 RTS come into force
- > **Category 2** entities: **12 months** after the RTS come into force
- > **Category 3** entities: **18 months** after the RTS come into force
- > **Category 4** entities: **3 years** (for interest rate and credit asset classes) or **33 months** (for non-deliverable FX forwards) after the RTS come into force**

* ESMA's Final Report on draft technical standards on the clearing obligation with respect to interest rate OTC derivatives (published on 1 October 2014)

** ESMA's Consultation Paper on the clearing obligation (no. 3) with respect to non-deliverable forwards (dated 1 October 2014 and amended on 10 October 2014)

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 (before the entry into force of such RTS) to clear any of the classes subject to a clearing obligation.

Who is in Category 2?

FCs and alternative investment funds ('AIFs') that are NFC+s that are either not CMs or are CMs of CCPs that do not clear any of the transaction types that are required to be mandatorily cleared at the time of the relevant clearing RTS coming into force and whose group's aggregate month-end average notional of uncleared derivatives for the 3 months preceding the first clearing 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.

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

ESMA's rationale is that 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 the clearing obligation apply on the same date with respect to all OTC derivatives being declared subject to the clearing obligation?

No. The obligation to clear derivatives of a certain class will follow the publication of a clearing RTS for such class and will commence for the entities belonging to each category once the phase-in period for such category has elapsed. This means that several mandatory clearing timetables will be running in parallel.

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

Yes. Categorisation is not on a per asset class basis.

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 2015. It is expected that this exemption period will be further extended 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.

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 derivatives, credit default swaps and non-deliverable forwards:

- > basis and fixed to floating swaps denominated in four major currencies (EUR, GBP, USD and JPY),*
- > forward rate agreements and overnight interest swaps denominated in EUR, GBP and USD, *
- > iTraxx Europe Main and iTraxx Europe Crossover credit default swaps with 5 year maturity,**
- > Non-deliverable forwards - cash settled foreign exchange forward contracts, with the settlement currency being USD and the other currency in the currency pair being any of the following currencies: BRL, CLP, CNY, COP, IDR, INR, KRW, MYR, PHP, RUB or TWD.***

* ESMA's Final Report on draft technical standards on the clearing obligation with respect to interest rate OTC derivatives (published on 1 October 2014)

** ESMA's Consultation Paper on the clearing obligation (no. 2) with respect to credit derivatives (published on 11 July 2014)

*** ESMA's Consultation Paper on the clearing obligation (no. 3) with respect to non-deliverable forwards (dated 1 October 2014 and amended on 10 October 2014)

It is likely that ESMA will conduct further public consultations on other asset classes and on a broader range of products within the interest rate, credit and FX asset classes.

What is the expected clearing timetable?

After the consultation period in relation to a particular 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 to approve the RTS. The RTS become effective 21 days after publication in the Official Journal.

Step	Transaction Type	Interest Rate*	Credit**	Non Deliverable FX Forwards***
ESMA Consultation Paper Published		11 July 2014	11 July 2014	1 October 2014
Final Draft RTS published by ESMA		1 October 2014	Due on 22 November 2014****	Due on 12 December 2014
Comment and endorsement by Commission, Council and Parliament		Q 1 2015	Q 1 2015	Q 2 2015
First Clearing Obligation for contracts between two Category 1 entities		Q 3 2015	Q 3 2015	Q 4 2015
First Clearing Obligation for contracts between two Category 2 entities or a Category 1 and a Category 2 entity		Q 1 2016	Q 1 2016	Q 2 2016
First Clearing Obligation for contracts between two Category 3 entities or a Category 1 or 2 and a Category 3 entity		Q 3 2016	Q 3 2016	Q 4 2016
First Clearing Obligation for contracts where one of the parties is a Category 4 entity		Q 1 2018	Q 1 2018	Q 1 2018

**** In a letter dated 20 November 2014, ESMA communicated its intention not to deliver the final draft RTS pending the Commission's assessment of certain aspects of the final draft interest rate clearing RTS

Will you be affected by frontloading?

What is frontloading?

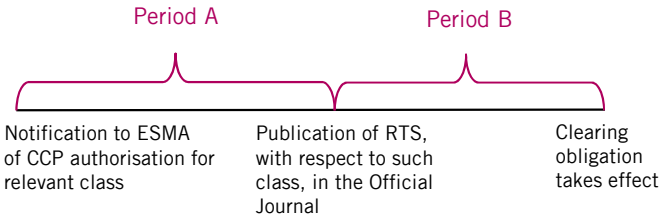
Frontloading is the requirement under EMIR that certain OTC derivatives entered into after the date on which ESMA is notified of a CCP being authorised but before the date on which the related clearing obligation comes into force be ‘retrospectively’ cleared, i.e. subsequently converted into cleared contracts.

Frontloading has been, and continues to be, a contentious topic. The issues vary depending on whether the OTC derivative is entered into during Period A or Period B.

What are Periods A and B?

In relation to a clearing obligation with respect to a class of OTC derivatives:

- > Period A is the period between (i) the notification to ESMA that a CCP has been authorised to clear that class of OTC derivatives and (ii) the publication of the clearing RTS, with respect to such class, in the Official Journal.
- > Period B is (i) the period from the publication of the clearing RTS in the Official Journal and (ii) the date on which the clearing obligation takes effect.



What are the issues with frontloading?

During Period A, the parties to a derivative are left in an uncertain position. At the time of transacting, they do not know:

- > whether their transaction will be subject to the clearing obligation
- > if it does become subject to the clearing obligation, when the transaction will be required to be cleared
- > which CCPs will be available to clear the transaction.

If, however, the parties enter into a transaction during Period B, all of these unknowns are now known. However, this does not mean that uncleared contracts entered into during Period B can be converted into cleared contracts (or ‘frontloaded’) without difficulty.

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. As the uncleared trade can be frontloaded at any time during Period B, the difference in collateral terms cannot readily be factored into the price of the uncleared transaction. This means that, at the time the transaction is frontloaded, it is likely that it will need to be repriced.

How does ESMA propose to address frontloading?

Under EMIR only transactions with a minimum remaining outstanding maturity at the time the relevant clearing obligation becomes effective will be subject to frontloading.

ESMA intends to set the minimum remaining outstanding maturity such that frontloading does not apply during Period A.

However, based on the current drafts of the clearing RTS, ESMA intends to set the minimum remaining outstanding maturity such that frontloading does apply to Category 1 and Category 2 entities during Period B when the counterparty to the transaction is also a Category 1 or Category 2 entity.

	Period A	Period B
Category 1	X	✓
Category 2	X	✓
Category 3	X	X
Category 4	X	X

What is the practical impact of frontloading applying?

As Category 1 entities are likely to have established clearing arrangements with each relevant CCP at the time Period B starts, Category 2 entities are most likely to be directly affected by frontloading. A number of Category 2 entities are expected not to want to expose their contracts to the risk of being repriced. So, notwithstanding the phased implementation of the clearing obligation, they may look to establish the infrastructure to clear in advance of Period B commencing.

Has the application of frontloading been finalised?

A number of entities and industry bodies have been lobbying the Commission to disapply frontloading entirely. On 20 November 2014, ESMA explained in an open letter to the Commission that, because the Commission is still assessing certain aspects of the interest rate clearing RTS, ESMA would delay delivery of the forthcoming final draft of the credit derivatives clearing RTS until the Commission has finalised that assessment process. This is a sensible reaction given the intended similarity in approach across the three clearing RTS and one can hope that the Commission is using the opportunity to reconsider the requirement for frontloading.

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 (e.g. 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 (e.g. an ISDA Master Agreement or FOA Professional Client Agreement),
- > a clearing agreement based on the ISDA/FOA Client Cleared OTC Derivatives Addendum or the FOA 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/FOA Client Cleared OTC Derivatives Addendum
- > the FOA Clearing Module.

The table below illustrates key differences in transaction coverage:

Derivatives master agreement and clearing documentation	ISDA Master Agreement with ISDA/FOA Client Cleared OTC Derivatives Addendum	FOA Professional Client Agreement with ISDA/FOA Client Cleared OTC Derivatives Addendum	FOA Professional Client Agreement with FOA Clearing Module
Which transactions will you clear through the CM?			
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 i.e. a mixture of OTC derivatives and ETDs	X	✓	✓

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 publication of the relevant clearing RTS 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.

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 (e.g. 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 (i.e. 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 I 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').

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 as a **back up clearing member**.

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.

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 12).

How can I terminate my 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, 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. 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 is the relevant service at the CCP (if the CM has different services for different products)?

In relation to the relevant 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 announced a guide to the rules of CCPs. The [CCP Risk Review](#) is a subscription service that will provide 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 will highlight the issues most relevant to CMs and end-users as they evaluate evolving regulatory obligations relating to CCPs on a real-time basis.

Glossary.

AIF - alternative investment fund

back up clearing member - a CM with whom you have established a clearing arrangement who can accept transactions from another CM

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

CM - clearing member

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

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

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

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

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

frontloading - the potential obligation to convert uncleared OTC derivatives entered into after ESMA is notified of a particular CCP being authorised into cleared OTC derivatives once the related clearing obligation comes into effect

IM - initial margin

ISA - individual segregation account

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

OSA - omnibus segregation account

OTC - over the counter

Parliament - the European Parliament

Period A - in relation to a class of derivative, the period between ESMA being notified of a CCP being authorised and the publication of the related clearing RTS

Period B - in relation to a class of derivative, the period between the end of Period A and the related clearing obligation coming into effect

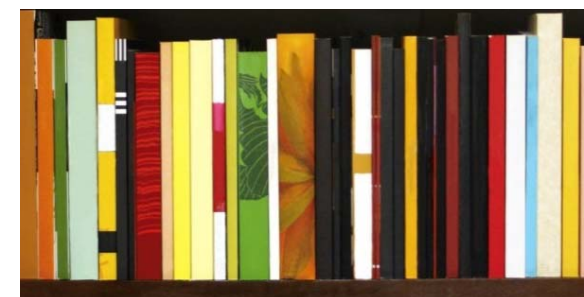
porting - the ability to move positions cleared through one CM to another CM

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

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/FOA 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.

For further information please contact:

London:

Deepak Sitlani, Partner
(+44) 20 7456 2612
deepak.sitlani@linklaters.com

Pauline Ashall, Partner
(+44) 20 7456 4036
pauline.ashall@linklaters.com

Matthew Monahan, Partner
(+44) 20 7456 4629
matthew.monahan@linklaters.com

Rhian Roberts, Counsel
(+44) 20 7456 4815
rhian.roberts@linklaters.com

Ursula Williamson, Counsel
(+44) 20 7456 3757
ursula.williamson@linklaters.com

Alyona Smith, Managing Associate
(+44) 20 7456 4558
alyona.smith@linklaters.com

Suzanna Brunton, Managing Associate
(+44) 20 7456 5382
suzanna.brunton@linklaters.com

Paris:

Bertrand Andriani, Partner
(+33) 15643 5780
bertrand.andriani@linklaters.com

Marc Perrone, Partner
(+33) 15643 5867
marc.perrone@linklaters.com

Frankfurt:
Kurt Dittrich, Partner
(+49) 6971003 585
kurt.dittrich@linklaters.com

Christian Storck, Partner
(+49) 6971003 531
christian.storck@linklaters.com

Berlin:
Jörg Fried, Counsel
(+49) 3021496 331
joerg.fried@linklaters.com

Milan:
Dario Longo, Partner
(+39) 0288393 5219
dario.longo@linklaters.com

Brussels:

David Ballegeer, Partner
(+32) 2501 9069
david.ballegeer@linklaters.com

Charles-Antoine Leunen, Partner
(+32) 2501 9120
charles-antoine.leunen@linklaters.com

Etienne Dessy, Counsel
(+32) 2501 9069
etienne.dessy@linklaters.com

Luxembourg:
Nicki Kayser, Partner
(+35) 22608 8235
nicki.kayser@linklaters.com

Madrid:
Iñigo Berricano, Partner
(+34) 91399 6010
inigo.berricano@linklaters.com

Paloma Fierro, Partner
(+34) 91399 6054
paloma.fierro@linklaters.com

Lisbon:
António Soares, Partner
(+351) 21864 0013
antonio.soares@linklaters.com

Hong Kong:

Chin Chong Liew, Partner
(+85) 22842 4857
chin-chong.liew@linklaters.com

Karen Lam, Counsel
(+85) 22842 4871
karen.lam@linklaters.com

Stephen Song, Managing Associate
(+85) 22901 5440
stephen.song@linklaters.com

New York:
Caird Forbes-Cockell, Partner
+1212903 [9040]
caird.forbes-cockell@linklaters.com

Noah Melnick, Counsel
+1212903 9203
noah.melnick@linklaters.com

Edward Ivey, Associate
+1212903 9118
edward.ivey@linklaters.com