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ESMA Issues Final Report On Clearing Under EU's New OTC Derivatives Rules

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Regulation (EU) No. 648/2012 of the European Parliament and of the Council of July 4, 2012, on OTC Derivatives, Central Counterparties and Trade Repositories, also known as the European Market Infrastructure Regulation ("EMIR"), was introduced to provide a framework to improve the functioning of the over-the-counter ("OTC") derivatives markets in the European Union (*see analysis at WSLR, April 2012, page 24*). EMIR requires the European Securities and Markets Authority ("ESMA") to develop draft regulatory and implementing technical standards in relation to several key provisions of EMIR. On September 27, 2012, ESMA published its final report (the "Final Report") on such standards[1] .

The Final Report focusses on a wide range of topics, including the clearing obligation, intragroup exemptions, indirect clearing arrangements, access to trading venues and requirements relating to central counterparties and trade repositories.

This report highlights the implications of EMIR and related provisions of the Final Report for 1) entities outside the financial sector that use OTC derivatives and 2) OTC derivatives that are not subject to the clearing requirements of EMIR.

Non-Financial Counterparties

The Clearing Obligation

Non-financial counterparties[2] ("NFCs") are subject to the "clearing obligation" only if their positions in eligible OTC derivative contracts exceed certain specified thresholds. OTC derivative contracts that protect the NFC against risks "directly related to its commercial activities or treasury financing activities" (that is, "hedging contracts") can be excluded by an NFC when calculating whether its OTC derivative positions exceed the relevant clearing threshold.

In the Final Report, ESMA confirms that an OTC derivative contract will be treated as a hedging contract when, whether by itself or in combination with other derivative contracts, and whether directly or through closely correlated instruments, it meets *one* of the following conditions:

1) it covers the risks arising from the potential change in the value of assets, services, inputs, products, commodities or liabilities that the NFC or its group owns, produces, manufactures, processes, provides, purchases, leases, sells or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring in the normal course of its business;

2) it covers the risks arising from the potential indirect impact on the value of the things referred to in 1) above resulting from fluctuations of interest rates, inflation rates, foreign exchange rates or credit risk; or

3) it qualifies as a hedging contract pursuant to International Financial Reporting Standards (but not contracts considered to be "hedges" solely under local accounting rules).

ESMA also confirms that proxy hedging, portfolio hedging and OTC derivative contracts that offset other hedging contracts may qualify as "hedging contracts".

The Clearing Threshold

The clearing thresholds used to determine whether an NFC should be subject to the clearing obligation will be set on a per asset class basis. The Final Report divides OTC derivatives into the following asset classes for this purpose: 1) credit derivatives, 2) equity derivatives, 3) interest rate derivatives, 4) foreign exchange derivatives and 5) commodity and other OTC derivatives. The threshold for each of the credit and equity derivative classes will be €1 billion (U.S.$1.3 billion) in gross notional value, and the threshold for each of the interest rate, foreign exchange and commodity and other derivative classes will be €3 billion (U.S.$3.9 billion) in gross notional value.

Despite suggestions from the industry, ESMA has rejected calls to use marked-to-market values instead of gross notional values to determine the thresholds, though ESMA reiterates that these will be subject to ongoing review. When one of the clearing thresholds for an asset class is reached, the NFC will be considered as exceeding the clearing threshold, and therefore will be subject to the clearing obligation for *all* classes of eligible OTC derivative contracts, and not only in respect of the class of OTC derivatives where the clearing threshold is exceeded.

Risk Mitigation for Non-Cleared OTC Derivative Contracts

The impact of EMIR does not stop at the clearing obligation. EMIR contains risk mitigation requirements that apply to all OTC derivative contracts, including those that are not subject to the clearing obligation. Counterparties will need to ensure that there are appropriate procedures and arrangements in place to measure, monitor and mitigate operational counterparty credit risk. The Final Report sets out requirements including in relation to: 1) timely confirmation, 2) portfolio reconciliation, 3) portfolio compression, and 4) dispute resolution.

Timely Confirmation

OTC derivative contracts concluded between financial counterparties ("FCs") or NFCs which are not cleared will have to be confirmed, where available via electronic means, as soon as possible. In the Final Report, ESMA distinguishes between, on the one hand, FCs and NFCs above the clearing threshold and, on the other hand, NFCs below the clearing threshold. Within each of these categories, ESMA further distinguishes between different categories of derivative contracts, setting different requirements and different implementation periods accordingly. Several interim objectives are set for periods ranging from the entry into force of the technical standards to August 2013, February 2014 and August 2014, which will allow interim enhancement of the timeframe before reaching the end-goal timing. The stated end-goal timing is the business day following execution for FCs and NFCs above the clearing threshold and the second business day following execution for NFCs below the clearing threshold.

Portfolio Reconciliation

FCs and NFCs will have to agree in writing, before entering into an OTC derivative contract, on the terms on which portfolios shall be reconciled. For FCs and NFCs above the clearing threshold, the reconciliation has to be 1) each business day when the counterparties have 500 or more OTC derivative contracts outstanding with each other; 2) once per week when the counterparties have between 51 and 499 OTC derivative contracts outstanding with each other at any time during the week; and 3) once per quarter when the counterparties have 50 or fewer OTC derivative contracts outstanding with each other at any time during the quarter. For an NFC below the clearing threshold, the relevant periods are: 1) once per quarter when the counterparties have more than 100 OTC derivative contracts outstanding with each other at any time during the quarter; and 2) once per year when the counterparties have 100 or fewer OTC derivative contracts outstanding with each other[3] .

Portfolio Compression

FCs and NFCs with 500 or more OTC derivative contracts outstanding with a counterparty which are not centrally cleared are required to have procedures to regularly, and at least twice a year, analyse the possibility of conducting a portfolio compression exercise in order to reduce their counterparty credit risk. In the Final Report, ESMA clarifies that portfolio compression is not mandatory, but that counterparties will have to ensure that they are able to provide a reasonable and valid explanation to the relevant competent authority for concluding that a portfolio compression exercise is not appropriate[4] .

Dispute Resolution

When concluding OTC derivative contracts with each other, FCs and NFCs must have agreed detailed procedures and processes in relation to the identification, recording and monitoring of disputes relating to the recognition or valuation of the contracts and to the exchange of collateral between counterparties and in relation to the resolution of disputes in a timely manner. There should be a specific process for disputes that are not resolved within five business days[5] .

Next Steps

The Final Report has been submitted to the European Commission for approval. The Commission has three months from the end of September 2012 to decide whether to endorse ESMA's draft technical standards.

The industry awaits details of further proposed technical standards relating to certain other risk mitigation tech-

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niques (including collateral and segregation arrangements), the extraterritorial application of EMIR, and central counterparty interoperability.

NOTES

[1] Available at http://www.esma.europa.eu/system/files/2012-600_0.pdf.

[2] "Non-financial counterparties" include EU undertakings that are *not* authorised investment firms, credit institutions, insurance companies or undertakings for collective investment in transferable securities ("UCITS") or alternative investment funds ("AIFs") managed by an alternative investment fund manager ("AIFM").

[3] This provision enters into force six months after the entry into force of the regulation endorsing the draft technical standard.

[4] This provision enters into force six months after the entry into force of the regulation endorsing the draft technical standard.

[5] This provision enters into force six months after the entry into force of the regulation endorsing the draft technical standard.

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