EUROPEAN UNION

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 (‘‘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.

The Final Report focuses 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 (‘‘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;
ESMA also confirms that proxy hedging, portfolio hedging and OTC derivative contracts that offset other hedging and OTC derivative contracts may qualify as "hedging contracts".

**Risk Mitigation for Non-Cleared OTC Derivative Contracts**

The impact of EMIR does not stop at the clearing obligation. ESMA outlines risk-mitigation requirements that apply to all OTC derivative contracts, including those that are not subject to the clearing obligation. Compliance will be monitored to ensure that there are appropriate procedures and arrangements in place to measure, monitor, and control the 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 not conducting a portfolio compression exercise in an appropriate manner.

**Dispute Resolution**

When concluding OTC derivative contracts with each other, FCs and NFCs must have agreed standard procedures and processes in relation to the identification, correction, and resolution of disputes. These include the relevant competent authority for resolving the dispute and the timeframe for resolving the dispute.

**Next Steps**

The Final Report has been submitted to the European Commission for approval. The Commission has three months from 14 and 8 September 2012 to decide on the approval of the Final Report. The industry awaits final details of the Commission's statements relating to certain issues with implementation.
Techniques (including collateral and segregation arrangements), the international application of EMIR, and central counterparty interoperability.

NOTES
2 ‘Non-financial counterparties’ include EU undertakings that are not authorized investment firms, credit institutions, insurance companies or undertakings for collective investment in transferable securities (‘UCITS’) or alternative investment funds (‘AIF’s) 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.
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