



Legal Alert: ESMA Issues Final Draft Standards for the Central Clearing of Certain Interest Rate Swaps under EMIR

October 14, 2014

On October 1, the European Securities and Markets Authority (ESMA) issued final draft regulatory technical standards (RTS) with respect to the central clearing of four classes of interest rate swaps (IRS). The RTS follows ESMA's publication on July 11, 2014 of a [consultation paper](#) on the IRS clearing mandate, and takes into account feedback to the consultation paper that ESMA received from market participants.¹ The RTS represents the first clearing mandate from ESMA developed pursuant to the European Market Infrastructure Regulation (EMIR),² which according to ESMA Chair Steven Maijoor, "will lead to significant improvements in the risk management of EU derivatives markets."³

The following is an overview of the RTS, which specifies: (1) the type of IRS contracts required to be centrally cleared; (2) the type of counterparties⁴ obligated to clear such contracts, and (3) a phased-in compliance schedule based on the counterparty classification.

Entities Authorized to Clear Certain OTC Derivatives

EMIR requires that derivatives contracts be cleared by central counterparties (CCPs). CCPs can be either European CCPs authorized by national competent authorities or third-country CCPs recognized by ESMA. As of September 16, 2014, there are 13 European CCPs authorized to offer services in the EU.⁵ As of August 8, 2014, 38 third-country CCPs have applied for authorization under EMIR, eight of which are U.S. entities.⁶

Classes of IRS Subject to the Clearing Determination

The clearing obligation will apply to four types of swaps:

- Basis swaps denominated in EUR, GBP, JPY, USD;
- Fixed-to-float swaps denominated in EUR, GBP, JPY, USD;
- Forward rate agreements denominated in EUR, GBP, USD; and
- Overnight index swaps denominated in EUR, GBP, USD.

ESMA consulted with regulators in certain jurisdictions regarding the scope of transactions covered by the RTS and did not receive any objections. The charts in Annex A outline the IRS classes subject to ESMA's proposal compared with the IRS classes currently subject to mandatory clearing in the United States.

Generally, the classes of IRS contracts required to be cleared by ESMA and the U.S. Commodity Futures Trading Commission (CFTC) are similar but not

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identical. The differences between the clearing mandates include the following:

- The CFTC requires the clearing of Forward Rate Agreements denominated in JPY but ESMA does not.
- The maximum maturity for the Overnight Index Swap Class is two years under CFTC regulations and three years in ESMA's RTS.

Counterparties Subject to Mandatory Clearing and Compliance Dates

Counterparties that are obligated to clear IRS contracts are divided into four categories and are required to comply with a phased-in compliance schedule based on the effective date of the RTS, as outlined below.

- Category 1 includes clearing members⁷ of CCPs either authorized or recognized for the purpose of the clearing obligation as listed in the Public Register⁸ in accordance with Article 6(2)(b) of EMIR. Category 1 counterparties will have to comply within six months after the final standards become effective.
- Category 2 includes financial counterparties and alternative investment funds (AIFs) that are non-financial counterparties⁹ above the clearing threshold, which are not included in Category 1, and which belong to a group¹⁰ whose aggregate month-end average notional amount¹¹ of non-centrally cleared derivatives for November 2014, December 2014, and January 2015¹² is above EUR 8 billion. Category 2 counterparties will have to comply within 12 months after the final standards become effective.
- Category 3 includes financial counterparties and AIFs that are non-financial counterparties below the clearing threshold, which are not included in Category 1 or Category 2. Category 3 counterparties will have to comply within 18 months after the final standards become effective.
- Category 4 includes non-financial counterparties not included in the other categories. Category 4 counterparties will have to comply within three years after the final standards become effective.

Next Steps and Other Considerations

Next Steps

ESMA submitted the RTS to the European Commission on October 1, 2014. The European Commission has up to three months (until January 2015) to endorse the RTS. The final draft standards will become effective 20 days after being published in the Official Journal. Therefore, the clearing mandate, which will apply first to Category 1 entities, is not expected to become effective until early 2015.

Frontloading

Category 1 and Category 2 counterparties will also be required to clear the IRS contracts entered into between the effective date of the RTS and the respective compliance date of their clearing obligation. This retroactive clearing of transactions is referred to as “frontloading.”

Substitute Compliance

Under EMIR, U.S. entities are considered third-country entities and are not directly subject to EMIR. However, absent a substitute compliance determination, U.S. entities that would be financial counterparties or non-financial counterparties above the clearing threshold under EMIR would be indirectly impacted by the EMIR clearing mandate to the extent that they trade with EU entities that are subject to mandatory clearing. While this would mean that U.S. entities and EU entities could face dual clearing mandates for the same transaction, ESMA and the CFTC have agreed in the [Path Forward](#) to coordinate their regulatory efforts so that market participants will not encounter such operational and practical conflicts in complying with the laws of multiple jurisdictions.¹³

ANNEX A

IRS Contracts Required to be Cleared in both the EU and the U.S.

(1) Basis Swaps Class denominated in EUR, GBP, JPY, and USD

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
Basis	EURIBOR	EUR	28D-50Y	Single currency	No	Constant or Variable
Basis	LIBOR	GBP	28D-50Y	Single currency	No	Constant or Variable
Basis	LIBOR	JPY	28D-30Y	Single currency	No	Constant or Variable
Basis	LIBOR	USD	28D-50Y	Single currency	No	Constant or Variable

(2) Fixed-to-Float Interest Rate Swaps Class denominated in EUR, GBP, JPY, and USD

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
Fixed-to-Float	EURIBOR	EUR	28D-50Y	Single currency	No	Constant or Variable
Fixed-to-Float	LIBOR	GBP	28D-50Y	Single currency	No	Constant or Variable
Fixed-to-Float	LIBOR	JPY	28D-30Y	Single currency	No	Constant or Variable
Fixed-to-Float	LIBOR	USD	28D-50Y	Single currency	No	Constant or Variable

(3) Forward Rate Agreement Class denominated in EUR, GBP, and USD¹⁴

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
FRA	EURIBOR	EUR	3D-3Y	Single currency	No	Constant or Variable
FRA	LIBOR	GBP	3D-3Y	Single currency	No	Constant or Variable
FRA	LIBOR	USD	3D-3Y	Single currency	No	Constant or Variable

(4) Overnight Index Swaps Class denominated in EUR, GBP, and USD¹⁵

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
OIS	EONIA	EUR	7D-3Y	Single currency	No	Constant or Variable
OIS	FedFunds	USD	7D-3Y	Single currency	No	Constant or Variable
OIS	SONIA	GBP	7D-3Y	Single currency	No	Constant or Variable

¹ On July 12, 2013, ESMA published a [discussion paper](#) seeking stakeholders' views about the clearing obligation standards under EMIR. Based on the responses received from the discussion paper, ESMA drafted and published consultation papers on the clearing obligation for three classes of over-the-counter (OTC) derivatives: (1) [interest rate swaps](#); (2) [credit derivative classes](#); and (3) [foreign exchange non-deliverable forwards](#). To date, ESMA has published finalized RTS only for the interest rate swaps.

² EMIR came into force on August 16, 2012, and introduced requirements to improve the transparency of OTC derivatives markets in Europe and to reduce the risks associated with such markets, similar to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

³ [ESMA Press Release](#).

⁴ A "counterparty" under EMIR is any party to a derivatives transaction.

⁵ The list of CCPs authorized under EMIR can be found [here](#).

⁶ A list of third-country CCPs that have applied for authorization under EMIR is available [here](#).

⁷ The term "Clearing Member" is defined in Article 2(14) of EMIR. Clearing member includes authorized EU CCPs or recognized third-country CCPs.

⁸ According to Article 6 of Regulation (EU) No 648/2012 of the European Parliament and of the Council of July 4, 2012, ESMA is required to maintain a Public Register to inform market participants about their clearing obligations.

⁹ Financial counterparties include banks, investment managers, insurance companies, or brokers. Non-financial counterparties include all entities that are not financial counterparties.

¹⁰ "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 Directive 83/349/EEC (the Company Law Directive). Among other things, a parent undertaking involves owning a majority of the shareholders' voting rights in another undertaking (called a subsidiary undertaking), controlling members of a subsidiary undertaking, exercising dominant influence over a subsidiary undertaking, etc. See Articles 1 and 2 of Directive 83/349/EEC.

¹¹ For calculating the group aggregate month-end average notional amount, all of the group's non-centrally cleared derivatives, including foreign exchange forwards, swaps and currency swaps, shall be included. The RTS does not specify whether hedging transactions are included in this calculation. However, EMIR generally does not include hedges in calculating clearing thresholds. See EMIR Regulation No. 648/2012, Article 10(3).

¹² These months were chosen under the assumption that the RTS will enter into force during the month of February 2015. If this assumption is incorrect, these months will be adjusted so that they include the three months preceding the entry into force of the RTS, excluding the month of entry into force.

¹³ On July 11, 2013, the CFTC and the European Commission announced a Path Forward, which outlines their joint

understandings of how to approach cross-border derivatives regulation.

¹⁴ The U.S. also requires the clearing of the Forward Rate Agreement Class denominated in JPY. The EU does not.

¹⁵ The maturity of the Overnight Index Swaps that have to be cleared in the U.S. is from seven days to two years. In the EU, it is from seven days to three years.

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