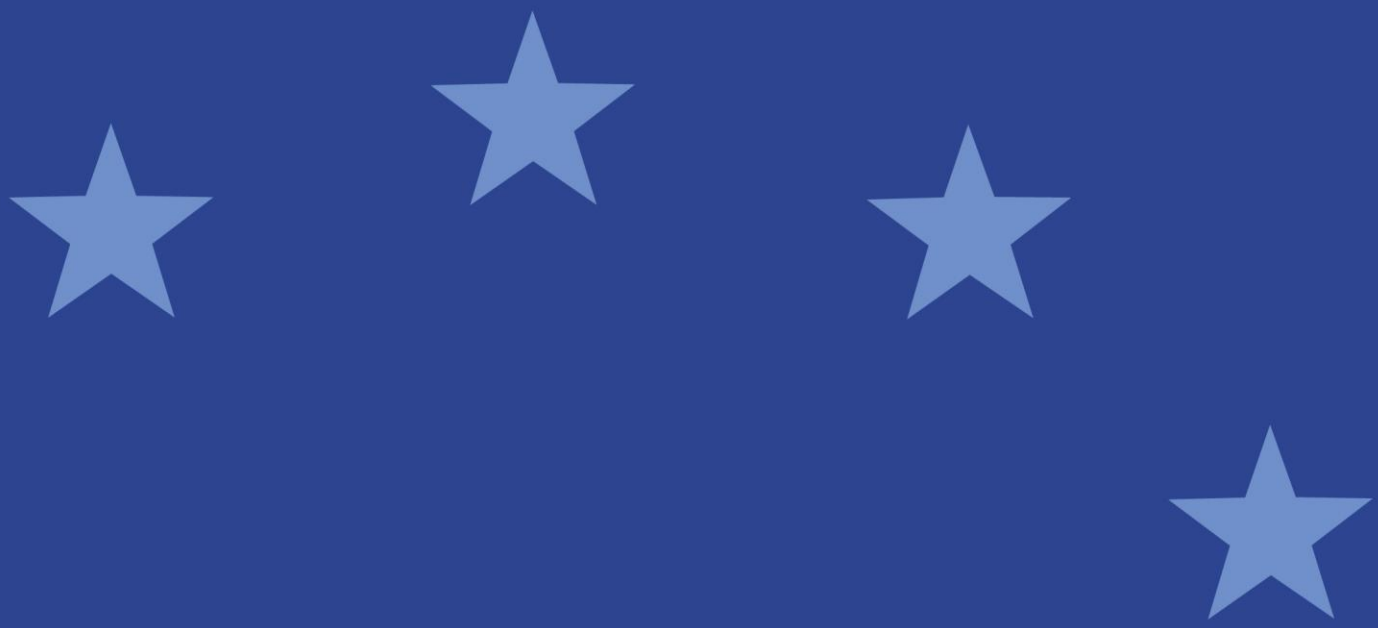
esma European Securities and Markets Authority

Opinion

Draft RTS on the Clearing Obligation on Interest Rate Swaps



29 January 2015 | 2015/ESMA/223

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1 Legal Basis

1. According to Article 5(2) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR), the European Securities and Markets Authority (ESMA) shall develop draft regulatory technical standards specifying the class of OTC derivatives that should be subject to the clearing obligation, the date or dates from which the clearing obligation takes effect, including any phase in and the categories of counterparties to which the obligation applies, and the minimum remaining maturity of the OTC derivative contracts referred to in Article 4(1)(b)(ii) of EMIR.

2 Background and Procedure

2. On 1 October 2014, ESMA submitted a draft regulatory technical standard (RTS) on the clearing obligation to the European Commission pursuant to Article 10(1) of Regulation No (EU) 1095/2010 (the ESMA Regulation) and Article 5(2) of EMIR. This draft RTS covered Interest Rate Swaps.

3. On 18 December 2014, the Commission informed ESMA of its intention to endorse with amendments this draft RTS and submitted to ESMA a modified version of the RTS (the "modified RTS") introducing, among others, (1) amendments to the date on which the frontloading obligation starts to apply and (2) a new provision on the treatment of non-EU intragroup transactions.

4. Pursuant to Article 10(1) of the ESMA Regulation, this notification from the Commission opens a period of six weeks during which ESMA may amend its draft RTS on the clearing obligation on the basis of the Commission's proposed amendments and resubmit it to the Commission in the form of a formal opinion. ESMA has to send a copy of its formal opinion to the European Parliament and to the Council.

5. In accordance with Article 44(1) of the ESMA Regulation the Board of Supervisors has to adopt a formal opinion.

3 Executive summary

6. ESMA agrees with the ultimate objectives of the modifications that the European Commission intends to introduce.

7. However, ESMA considers that the tool proposed by the Commission for the matter related to the non-EU intra group transactions is not appropriate from a legal perspective and, in the case that the Commission intention is to define a later application date for those transactions, ESMA stands ready to explore, in coordination with the Commission, a different manner to incorporate that provision.

8. ESMA backs the modifications on the frontloading section, though has a few observations and improvements with respect to several recitals.

9. ESMA proposes to incorporate the suggestion of the Commission to deal with the application of the 8 billion threshold to investment funds for the definitions of types of counterparties as a specific provision in the text of the RTS.

4 ESMA opinion

10. ESMA is supportive of the policy objectives of the additions introduced by the European Commission and highlighted in the letter from 18 December 2014. However, ESMA has some observations that affect several provisions introduced by the European Commission.

11. The ESMA regulation gives the opportunity to consider the amendments and provide further input where the draft RTS can benefit from the technical input from the Authority. There are some points among the changes that the European Commission (EC or Commission) intends to introduce that ESMA considers should be reviewed or improved and that are discussed below. They have been reflected in the second version of the draft RTS submitted to the Commission with this opinion (Annex I).

4.1 Non-EU Intragroup transactions

Article 3 – Dates from which the clearing obligation takes effect

12. Article 4(1) of EMIR imposes on counterparties to clear all OTC derivative contracts pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation in accordance with Article 5(2) of EMIR if such contracts fulfil a number of conditions in Article 4(1). The first condition determines the counterparties to the OTC derivative contracts. The second condition relates to the contracts themselves and covers also contracts entered into or novated on or after the notification referred to in Article 5(1) of EMIR but before the date from which the clearing obligation takes effect, provided that the contracts have a remaining maturity higher than the minimum remaining maturity determined by an RTS adopted as a delegated act pursuant to Article 5(2)(c) of EMIR.

13. EMIR foresees that under certain conditions, intragroup transactions (IGT) can be exempted from the clearing obligation[1]. Such exemption affects the first condition of Article 4(1) of EMIR and means that the parties to such transactions will not be required to clear those intragroup contracts.

14. As per Article 3 of EMIR, and as clarified in OTC Question 6 of the ESMA Q&A on the implementation of EMIR, one condition for a transaction concluded with a non-EU entity

[1] The conditions and processes for counterparties to apply the IGT exemption are detailed in Article 4(2)(a) of EMIR when the two counterparties are established in the Union and in Article 4(2)(b) of EMIR when one counterparty is established in the Union and the other counterparty is established in a third-country.

to qualify as intragroup transaction is that the non-EU counterparty is established in a third country in respect of which the Commission has adopted an implementing act declaring that the legal, supervisory and enforcement arrangements of that third-country are equivalent to the requirements laid down in EMIR in respect of, inter alia, the clearing obligation (Article 13(2) of EMIR).

15. The adoption of such implementing act is not an unconditional obligation (i.e. the Commission may adopt it if a number of conditions are met) but it is a tool which the Commission may use to achieve the objective referred to in Recital 6 of EMIR, namely, to avoid potential duplication or conflict of requirements. To date, no implementing act on equivalence on legal, supervisory and enforcement framework of a third-country under Article 13(2) of EMIR has been adopted[2].

16. **In the modified RTS, the Commission proposes to introduce a new paragraph in Article 3 indicating that for a period of maximum three years, any third country shall be deemed equivalent within the meaning of Article 13(2) of EMIR**, for the purpose of point (i) of Article 3(2)(a)[3] of EMIR. The outcome of this proposal is that, for a period of three years, financial counterparties would be able to apply for the IGT exemption in respect of their transactions with any third-country entity in the absence of decisions on equivalence.

17. While ESMA understands that in the absence of an equivalence decision no intragroup transaction between an EU and a non-EU counterparty can benefit from the exemption envisaged in EMIR and therefore concurs with the targeted outcome of this provision, in ESMA's view the treatment of non-EU intragroup transactions raises some concerns detailed below.

18. The adoption by the Commission of implementing acts on equivalence under Article 13 is the specific and only procedure that is foreseen by EMIR to establish that third-countries can be considered as having legal, supervisory and enforcement frameworks equivalent to EMIR. Any provision that has an effect equivalent to that of an implementing act on equivalence under Article 13, although limited in time and scope, but without the assessment provided by the examination procedure referred to in Article 13(2), may have unintended consequences with respect to the objectives of EMIR and therefore requires a very careful review.

19. For example, one such unintended consequence in the context of IGT would be that an EU counterparty entering into an intragroup transaction with a non-EU counterparty established in a country in respect of which the Commission does not intend to take an

[2] Implementing acts on equivalence under Articles 13(2) and 25(6) cover different scopes. On the one hand, Article 13(2) addresses whether the legal, supervisory and enforcement arrangements of a third country are equivalent with regards to the requirements applicable to counterparties as laid down in Articles 4 (Clearing Obligation), 9 (Reporting Obligation), 10 (Non-financial counterparties) and 11 (Risk-mitigation techniques for non-cleared OTC derivatives) of EMIR. On the other hand, Article 25(6) addresses whether the legal, supervisory and enforcement arrangements of a third country are equivalent with regards to the requirements applicable to CCPs as laid down in Title IV of EMIR. To date, no implementing act under Article 13(2) has been adopted, whereas the first implementing acts under Article 25(6) were adopted on 30 October 2014.

[3] Point (i) of Article 3(2)(a) defines intragroup transactions between one EU financial counterparty and one third-country entity.

equivalence decision (e.g. because the regulatory framework of this country does not address in any way the G20 objectives related to OTC derivatives) will have the possibility to apply for the intragroup exemption for a limited period of time.

20. Before elaborating on the concerns, ESMA understands that the scope of the provision that the European Commission intends to introduce is limited only to the clearing obligation on interest rate derivatives, which is the scope of the draft RTS. Other interpretations, for instance that it would also apply to any future classes of derivatives that could become subject to the clearing obligation, or that it would apply to the effects of Article 3(2)(a) more generally, would raise other type of concerns, addressed separately at the end of this section.

21. First, ESMA has doubts as to whether the legal basis for the development of the RTS caters for the amendment proposed by the Commission regarding non-EU intragroup transactions.

22. Indeed, the empowerment for ESMA under Article 5(2) of EMIR is to define in a draft RTS:

    - the classes of OTC derivatives that should be subject to the clearing obligation;
    - the dates of application of the obligation, including any phase-in and the categories of counterparties to which the obligation applies; and
    - the minimum remaining maturity of the contracts subject to frontloading.

    It is not evident that these points contain express powers to define or specify the elements of the first condition of Article 4(1) in respect of the counterparties to the OTC derivative contracts (or the jurisdictions/countries in which they operate) or in respect of the exemption provided for in Article 4(2) of EMIR; nor does there appear to be a basis for implying such a power.

23. Second, as mentioned above, the intended introduction of the new provision could be understood as creating a transitional amendment to the conditions which need to be met in order for the exemption provided for in Article 4(2) of EMIR to apply.

24. Indeed, sub-paragraph (b) of Article 4(2) states that where two counterparties belong to the same group but one of them is established in a third country the exemption shall apply only if the counterparty established in the Union has been authorised by its competent authority to apply the exemption, provided that the conditions under Article 3 of EMIR are met. One of the conditions in Article 3 is that the Commission has adopted an implementing act under Article 13(2) in respect of a particular third country.

25. In accordance with ECJ case-law, exceptions to legal rules have to be interpreted narrowly. The underlying reason is that exemptions should not undermine the main objectives pursued by a legislative act. Exemptions to main rules imply policy choice and any amendment thereof should be considered as an amendment of essential elements of a legislative act. In the present case, the exemption in question bears significant

importance as it is an exemption to one of the core rules of EMIR – compliance with the clearing obligation.

26. It follows that amendments in respect to the application or the scope of the exemption provided for in Article 4(2) of EMIR, and in particular, to the conditions which should be met cannot be introduced through a delegated act such as an RTS because a delegated act can amend or supplement only non-essential elements of a legislative act.[4]

27. Third, a side effect that, though less relevant than the points identified above, has not been expressly mentioned in the justification by the European Commission of the inclusion of the new provision will be that the volume of notifications to be sent to, and processed by, the relevant competent authorities is expected to increase in a reduced amount of time as the change to the conditions for applying the exemption will facilitate the use of the exemption. Indeed, counterparties can be expected to send notifications to their competent authorities to be exempted from the clearing obligation for their IGT with counterparties established in any third-country, as opposed to a limited number of equivalent countries if the equivalence decisions had been taken.

28. In addition, under the assumption that the scope of the proposed provision on equivalence is limited to the RTS on interest rate derivatives, counterparties should apply for the IGT exemption in respect of their activity in the IRS classes only. Therefore, when a new RTS proposing a clearing obligation for other classes comes into force (e.g. CDS, NDF), they should apply again for the IGT exemption in respect of their activity in those additional classes. The whole process of notifications by counterparties and assessments by NCAs should be repeated for each new RTS, which could be burdensome for counterparties as well as for the NCAs making the assessment to grant or refuse the exemption.

29. Fourth, it is also unclear that there is a legal basis for ESMA to submit a draft RTS (under Article 10 of the ESMA Regulation based on Article 290 of the TFEU) with a provision that has the same effect as an equivalence decision to be adopted as implementing act under Article 291 of the TFEU, although limited in time and scope. Such process would be inconsistent with Article 13 of EMIR which envisages also a different procedure applicable to the adoption of implementing acts.

30. Fifth, under the assumption that the provision that the European Commission intends to introduce would affect only the derivatives covered by the draft RTS (interest rate derivatives), ESMA wonders how it would be possible to address this matter in upcoming RTS on clearing obligation for other classes of derivatives, which are currently under development (e.g. CDS, NDF).

31. Considering that ESMA understands it is not empowered to regulate third country equivalence in any manner, since it is an exclusive competence of the Commission, through an implementing act and under very specific conditions, ESMA would be legally

[4] See Article 290 of the TFEU

unable (even if it concurs with the policy objectives) to introduce a similar provision in future draft RTS, since it would be outside its empowerment.

32. Therefore, in the absence of a modification of the drafting proposed by the Commission for non-EU intragroup transactions, the only way to extend to other classes of derivatives subject to the clearing obligation the same provision would be for the Commission to amend again the draft RTS and send them back to ESMA, like on this occasion. ESMA would like to point out that such a technique (incorporating amendments and using the RTS as a regulatory tool for purposes not envisaged in their initial scope) is operationally cumbersome and also affects the timeframe of the adoption of the clearing obligation.

33. It should be noted that the introduction of amendments by the Commission, which the ESMA Regulation envisages as an exceptional circumstance (see Article 10 of the ESMA Regulation and its Recital 23 thereof) automatically adds 6 weeks to the regulatory process and extends the objection period of the Council and the European Parliament from one month to three months, extendible by another 3 months. Taking into account that the total time allowed to ESMA to analyse, consult, draft and deliver the RTS is set at 6 months and that it seems a policy objective to bring effective clearing mandates to the EU as soon as possible, the legal technique chosen (even if it were to be considered legally robust, which is not ESMA's view) would significantly impact the effective timing of the implementation of the clearing obligation.

34. Finally, the proposed duration of the temporary equivalence decision introduced via the RTS (3 years) does not seem to be sufficiently justified.

35. The letter of 18 December addressed to ESMA does not deal with the above concerns and ESMA did not have an opportunity to discuss these elements with the Commission before it submitted its notification of the intention to incorporate this amendment. The letter only indicates that the equivalence decisions cannot be adopted before the RTS on the clearing obligation enters into force. The reasoning for such statement is not further developed and it is not repeated in the relevant recital of the modified RTS. Instead, Recital 12 of the modified RTS provides two explanations for the modification related to Intra Group Transactions: (1) to allow sufficient time for the adoption of implementing acts pursuant to Article 13(2) of EMIR regarding the third country concerned; and (2) to allow counterparties to apply for the exemption from clearing intragroup transactions. No other reasons (of legal nature) for the proposed modification were provided.

36. Regarding the statement mentioned in the letter to ESMA, it should be noted that ESMA delivered its technical advice on third country regulatory equivalence in October 2013.

37. However, if the scope of the intended modification was not limited to the clearing obligation of interest rate derivatives (as explained in paragraph 20 above), but would cover all EMIR provisions related to Article 3(2)(a)(i), at least the following additional elements of concern would arise:

    - it would seem even less justified and outside the mandate of ESMA to introduce, in an RTS limited to the clearing obligation for IRS, a temporary equivalence provision with a broader scope;

- an additional relevant side effect of the new provision would be to impact the upcoming obligation of exchange of collateral for non-cleared trades. Indeed, if all the countries are deemed equivalent for the purpose of point (i) of Article 3(2)(a), then any transaction meeting all the other conditions of Article 3 would qualify as an intragroup transaction, and hence be eligible not only to the exemption from the clearing obligation, but also to the exemption from the exchange of collateral. Therefore, the effect of the modification would go beyond the issue that it originally intended to cover.

38. For the reasons stated above, ESMA is of the opinion that the introduction of the new provision in Article 3 of the draft RTS does not constitute an appropriate way of solving the issue described from a legal perspective and, therefore, considers that, in the absence of equivalence decisions under Article 13(2) of EMIR, other ways to address the problem could be explored by the Commission to achieve the same result.

39. In particular, if the objective of the provision was to delay the date of application of the clearing obligation for certain intragroup transactions rather than introducing a temporary equivalence determination for all third countries, ESMA stands ready to explore, in coordination with the Commission, a different manner to address the issue.

4.2 Frontloading

Article 4 – Minimum remaining maturity

(a) Overall approach

40. ESMA is supportive of the Commission's intention to extend the initial approach with the objective of postponing the start date of the frontloading obligation further than previously agreed.

41. As background information, it is reminded that a framework on frontloading had been arranged via an exchange of letters between ESMA and the Commission[5], excluding frontloading until legal certainty is reached on the exact set of classes subject to the clearing obligation and the CCPs authorised to clear them.

42. Under this framework, which the Commission did not dispute at the time the draft RTS were developed and submitted by ESMA, it was agreed that the certainty would be reached no later than on the date of publication of the RTS in the Official Journal of the Union[6] hence that the frontloading obligation could not be delayed beyond that date.

43. The amendments introduced by the Commission in the modified RTS now allow for an increased flexibility and enable a more pragmatic implementation by postponing the start date of the frontloading obligation.

[5] Letter from ESMA (ESMA/2014/483) dated 8 May 2014 and reply from the European Commission dated 8 July 2014
[6] This is explained in paragraph 140 of the Final Report on the clearing obligation for IRS ESMA/2014/1184 published on 1 October 2014

44. ESMA thus concurs with the modifications to Article 5 of the draft RTS, which are designed to:

    (1) provide counterparties in Category 2 or 3 with an appropriate period of time to determine the category to which they belong before they become subject to the frontloading obligation; and

    (2) provide counterparties in Category 1 with an appropriate period of time to apply for the intragroup exemption before they become subject to the frontloading obligation.

45. Given that the justification for the second point above is provided in the letter from the Commission addressed to ESMA on 18 December 2014 and not in the relevant recital, **ESMA suggests to add some language in a recital to explain it, as presented in the second submission of the RTS included in Annex I.**

    (b) Recitals

46. Although ESMA acknowledges that the modifications introduced by the Commission in Article 5 required some redrafting of the corresponding recitals, ESMA is of the view that the modified Recitals 13 to 16 would benefit from the proposals listed below.

Recital 13 of the EC amended RTS (Recital 12 of the draft RTS in Annex I)

47. The first recital on frontloading (Recital 13) as redrafted by the Commission starts with an introduction of the concept of frontloading and clarifies, within the same sentence, the Level 1 requirement according to which the frontloading obligation only applies to financial counterparties, as opposed to non-financial counterparties. In ESMA's view the sentence would benefit from redrafting with the objective of clarifying, in a separate sentence, that the frontloading obligation only applies to financial counterparties. **The second version of the draft RTS in Annex I is modified accordingly.**

Recital 14 of the EC amended RTS (Recital 13 of the draft RTS in Annex I)

48. Recital 14 in the proposed amended RTS by the Commission provides the justification for why the frontloading obligation should not apply immediately after the notification of the classes to ESMA. One new argument that has been introduced is that frontloading can "create additional systemic risk which can be caused by the counterparties of such contracts adapting them in order to take into account the clearing obligation", i.e. the pricing complexities related to the uncertainty of a possible forward clearing requirement.

49. In line with the ESRB's response to the consultation, in particular the part stating that "the overall effect of a mispricing on the trade date can be expected to be negligible", **ESMA has not kept the additional argument and has chosen instead to base the justification on the more direct impact on the orderly functioning and stability of the market, as per the initial drafting.**

50. In addition, the second sentence of Recital 14 of the EC amended RTS states that the uncertainty on whether contracts would become subject to the clearing obligation

"remains until counterparties know whether the contracts they conclude pertain to the classes of OTC derivatives that are subject to the clearing obligation". However, this is incomplete; there are other conditions in addition to the one related to the classes in scope before certainty is reached. Indeed, all the conditions are explained in one of the following sentences of Recital 14, including in particular the time for counterparties to establish to which category they belong.

51. **Therefore, ESMA has removed this part of the sentence.**

Recital 15 of the EC amended RTS (Recital 14 of the draft RTS in Annex I)

52. The first sentence of Recital 15 states that contracts should not be subject to the clearing obligation before counterparties "can implement the necessary arrangements to clear them". The time counterparties need to prepare for the clearing obligation has been taken into account to determine the phase-in for each category. Therefore the sentence could be interpreted as an exemption of contracts concluded before the counterparties have implemented the necessary arrangements to clear them, i.e. possibly the end of their respective phase-in. This would negate frontloading, which cannot be the intent as it is contrary to the outcome of the RTS.

53. With regards to the second part of the sentence, Recital 15 lists two conditions (introduced by the words "should be cleared unless") that apply to "contracts that are subject to the clearing obligation", which could be interpreted incorrectly. When contracts are subject to the clearing obligation, they necessarily meet the criteria of EMIR and the overarching objective of the reduction of systemic risk. Indeed, there are no additional conditions when contracts are subject to the clearing obligation.

54. **ESMA believes this first sentence of Recital 15 needs to be redrafted as proposed in the new version on the draft RTS** (see Recital 14 in Annex I)**.**

55. Finally on Recital 15 of the EC amended RTS, with the objective to justify the determination of the appropriate minimum remaining maturity, one new argument was introduced to explain that contracts with longer maturities "pose higher risks to the market". ESMA considers that it is a too simplistic representation and that the risks posed by derivative contracts are a combination of many more characteristics. However, contracts with longer maturities carry risk for obviously longer.

56. **Consequently, ESMA is of the view that the new justification of Recital 15 should be removed.**

Recital 16 of the EC amended RTS (Recital 15 of the draft RTS in Annex I)

57. In ESMA's view, it is essential to modify the last sentence of Recital 16 of the modified RTS i.e. "Therefore, contracts concluded by counterparties in the third category before the date on which the clearing obligation takes effect should not be cleared."

58. Certainly the intention of the Commission was not to prevent nor disincentivise counterparties in Category 3 to clear their OTC derivative contracts on a voluntary basis, but rather to explain that frontloading is not appropriate for them.

59. Accordingly, ESMA is proposing to replace the wording “should not be cleared” with the wording “should not be subject to the clearing obligation.”

4.3 Clarifying the calculation of the threshold for investment funds

Article 2 – Categories of counterparties

60. The letter from the Commission addressed to ESMA on 18 December 2014 mentions in point 2 the need for a clarification regarding the calculation of the threshold for investment funds to be included in a recital to the draft RTS.

61. ESMA agrees that this clarification is necessary and is in line with the text agreed at international level in the context of bilateral margins for non-cleared derivatives[7]. However, ESMA has not found any reference in the modified RTS incorporating such clarification.

62. **Therefore ESMA has added a provision in Article 2 to indicate that the 8bn threshold applies at fund level when the counterparties are UCITS or AIFs. A recital with the justification was also added.**

4.4 Additional items

Article 1 – Classes of OTC derivatives subject to the clearing obligation

Recital 2 – Conditional amounts

63. In the modified RTS, the content of Recital 2 related to derivatives with conditional amounts was modified by the addition of a justification based on the access to pricing information for derivatives with conditional amounts.

64. A class of derivatives is a defined term in Article 2(6) of EMIR. It is a ‘subset of derivatives sharing common and essential characteristics’. As explained in Recital 2, the type of notional amount is one such characteristic for the interest rate derivatives on which this draft RTS is based. Indeed, interest rate derivatives can have three types of notional amounts:

— constant notional amount;

[7] See page 9 of the BCBS IOSCO paper on “Margin requirements for non-centrally cleared derivatives” published in September 2013

— notional amount that vary over time in a predictable way (i.e. 'variable notional amount');

— notional amount that vary over time in an unpredictable way (i.e. 'conditional notional amount').

65. The conditionality feature mentioned above makes derivatives with conditional notional amount more complex in nature, making consequently their pricing and risk management also more complex. As a result, as of today, CCPs only accept for clearing the first two types of notional amount (constant and variable).

66. Hence, the classes proposed for the clearing obligation do not include contracts with conditional notional amount because they are not accepted for clearing, and not because of insufficient access to pricing information.

67. Therefore, ESMA is of the view that **the following sentence in the proposed amendments by the Commission to the RTS: "fair, reliable and generally accepted pricing information is therefore not available for interest rate OTC derivative contracts which have a conditional amount" should be removed.**

Article 3 – Categories of counterparties

Recital 8 – NFC and experience with OTC derivatives

68. Recital 4 explains the approach to split the counterparties that need to comply with the clearing obligation into different categories and Recital 8 explains which counterparties would belong to the fourth category. The modified RTS introduces an additional argument stating that counterparties of this fourth category have limited experience and operational capacity with OTC derivatives.

69. The fourth category is composed of the NFCs above the clearing threshold that are not in the other three categories, i.e. NFCs above the clearing threshold that are neither clearing members nor AIFs. In addition, the threshold has been determined according to Article 10(4) of EMIR, in particular "taking into account the systemic relevance of the sum of net positions and exposures per counterparty and per class" outside hedging transactions.

70. ESMA thus considers that the definition of the clearing threshold ensures that non-financial counterparties above it do have a significant experience with OTC derivatives and thus should have an appropriate level of operational capacity to process them. As a result, although they would likely have limited experience with the central clearing of OTC derivatives, counterparties from the fourth category should still be considered to have a meaningful experience with OTC derivatives.

71. **Therefore, ESMA is proposing to delete this addition from Recital 8.**

Recital 9 – Composition and appropriate phase-in for the first category

72. ESMA is supportive of structuring the recitals by decoupling the rationale for the composition of the categories (Recitals 5 to 8) from the rationale for the appropriate dates of application of the clearing obligation for each of these categories (Recitals 9 to 11).

73. However, ESMA has some reservations regarding the additional justification for the appropriate phase-in for clearing members in Recital 9: "*In addition, counterparties in this category constitute the access point to clearing for counterparties that are not clearing members (indirect clearing), indirect clearing being expected to increase substantially as a consequence of the entry into force of the clearing obligation."*

74. ESMA understands that the wording 'indirect clearing' was used by the Commission in opposition to 'direct clearing' by clearing members. This would mean that 'indirect clearing' in this modified recital encompasses (1) indirect clearing as per the meaning of Article 4 of EMIR and the RTS on OTC derivatives[8] (i.e. the client of the client of a clearing member) but also, and primarily, (2) client clearing (i.e. the client of a clearing member).

75. ESMA believes that it may create confusion to use the same expression ('indirect clearing') with respect to two different concepts in EMIR. **Hence, ESMA has clarified this in the second version of the draft RTS.**

76. Finally, in the second version of the draft RTS in Annex I, ESMA has re-incorporated the tables with the classes to be subject to the clearing obligation, which ESMA understands were excluded by mistake in the modified RTS.

[8] Regulation (EU) 149/2013

Annex I – Second version of the draft RTS on the clearing obligation

COMMISSION DELEGATED REGULATION (EU) No …/..

of XXX

[…]

supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on the clearing obligation
of [ ]
(text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories[9], and in particular Article 5(2) thereof,

Whereas:

(1) The European Securities and Markets Authority (ESMA) has been notified of the classes of interest rate OTC derivatives that certain central counterparties (CCPs) have been authorised to clear. For each of those classes ESMA has assessed the criteria that are essential for subjecting them to the clearing obligation, including the level of standardisation, the volume and liquidity, and the availability of pricing information. With the overarching objective of reducing systemic risk, ESMA has determined the classes of interest rate OTC derivatives that should be subject to the clearing obligation in accordance with the procedure set out in Regulation (EU) No 648/2012.

(2) Interest rate OTC derivative contracts can have a constant notional amount, a variable notional amount or a conditional notional amount. Contracts with a constant notional amount have a notional amount which does not vary over the life of the contract. Contracts with a variable notional amount have a notional amount that varies over the life of the contract in a predictable way. Contracts with a conditional notional amount have a notional amount which varies over the life of the contract in an unpredictable way. Conditional notional amounts add complexity to the pricing and risk management associated to interest rate OTC derivative contracts and thus to the ability of CCPs to clear them. This feature should be taken into account when defining the classes of interest rate OTC derivatives to be subject to the clearing obligation.

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9 OJ L 201, 27.7.2012, p. 1.

(3) In determining which classes of OTC derivative contracts should be subject to the clearing obligation, the specific nature of OTC derivative contracts which are concluded with covered bond issuers or with cover pools for covered bonds should be taken into account. In this respect, the classes of interest rate OTC derivatives subject to the clearing obligation under this Regulation should not encompass contracts concluded with covered bond issuers or cover pools for covered bonds, provided they meet certain conditions.

(4) Different counterparties need different periods of time for putting in place the necessary arrangements to clear the interest rate OTC derivatives subject to the clearing obligation. In order to ensure an orderly and timely implementation of that obligation, counterparties should be classified into categories in which sufficiently similar counterparties become subject to the clearing obligation from the same date.

(5) A first category should include both financial and non-financial counterparties which, at the date of entry into force of this Regulation, are clearing members of at least one of the relevant CCPs and for at least one of the classes of interest rate OTC derivatives subject to the clearing obligation, as those counterparties already have experience with voluntary clearing and have already established the connections with those CCPs to clear at least one of those classes. Non-financial counterparties that are clearing members should also be included in this first category as their experience and preparation towards central clearing is comparable with that of financial counterparties included in it.

(6) A second and third category should comprise financial counterparties not included in the first category, grouped according to their levels of legal and operational capacity regarding OTC derivatives. The level of activity in OTC derivatives should serve as a basis to differentiate the degree of legal and operational capacity of financial counterparties, and a quantitative threshold should therefore be defined for division between the second and third categories on the basis of the aggregate month-end average notional amount of non-centrally cleared derivatives. That threshold should be set out at an appropriate level to differentiate smaller market participants, while still capturing a significant level of risk under the second category. The threshold should also be aligned with the threshold agreed at international level related to margin requirements for non-centrally cleared derivatives in order to enhance regulatory convergence and limit the compliance costs for counterparties. As in those international standards, whereas the threshold applies at group level, for investment funds this threshold should be applied separately to each fund. However, this should only apply as long as, in the event of fund insolvency or bankruptcy, the investment funds are distinct legal entities that are not collateralised, guaranteed or supported by other investment funds or the investment manager itself.

(7) Certain alternative investment funds ("AIFs") are not captured by the definition of financial counterparties under Regulation (EU) No 648/2012 although they have a degree of operational capacity regarding OTC derivative contracts similar to that of AIFs captured by that definition. Therefore AIFs classified as non-financial counterparties should be included in the same categories of counterparties as AIFs classified as financial counterparties.

(8) A fourth category should include non-financial counterparties not included in the other categories, given their limited experience and operational capacity with central clearing.

(9) The date on which the clearing obligation takes effect for counterparties in the first category should take into account the fact that they do not necessarily have the necessary pre-existing connections with CCPs for all the classes subject to the clearing obligation. In addition, counterparties in this category constitute the access point to clearing for counterparties that are not clearing members, client clearing and indirect client clearing being expected to increase substantially as a consequence of the entry into force of the clearing obligation. Finally, this first category of counterparties account for a significant portion of the volume of interest rate OTC derivatives already cleared, and the volume of transactions to be cleared will significantly increase after the date on which the clearing obligation set out in this Regulation will take effect. Therefore, a reasonable timeframe for counterparties in the first category to prepare for clearing additional classes, to deal with the increase of client clearing and indirect client clearing, and to adapt to increasing volumes of transactions to be cleared should be set at 6 months.

(10) The date on which the clearing obligation takes effect for counterparties in the second and third categories should take into account the fact that most of them will get access to a CCP by becoming a client or an indirect client of a clearing member. This process may require between 12 and 18 months depending on the legal and operational capacity of counterparties and their level of preparation regarding the establishment of the arrangements with clearing members that are necessary for clearing the contracts.

(11) The date on which the clearing obligation takes effect for counterparties in the fourth category should take into account their legal and operational capacity, and their limited experience with central clearing.

(12) Regulation (EU) No 648/2012 requires the application of the clearing obligation to contracts concluded after the notification to ESMA that follows the authorisation of a CCP to clear a certain class of OTC derivatives, but before the date on which the clearing obligation takes effect, provided the remaining maturity of such contracts at the date on which the obligation takes effect justifies it. This obligation applies only to financial counterparties. The application of the clearing obligation to those contracts should pursue the objective of ensuring the uniform and coherent application of that Regulation, that is, ensuring financial stability and the reduction of systemic risk, as well as ensuring a level playing field for market participants when a class of OTC derivative contracts is declared subject to the clearing obligation. The minimum remaining maturity should therefore be set at a level that ensures the achievement of those objectives.

(13) Before regulatory technical standards adopted pursuant to Article 5(2) of Regulation (EU) No 648/2012 enter into force, counterparties cannot foresee whether the OTC derivative contracts they conclude would be subject to the clearing obligation on the date that obligation takes effect. This uncertainty has a significant impact on the capacity of market participants to accurately price the OTC derivative contracts they enter into since centrally cleared contracts are subject to a different collateral regime than non-centrally cleared contracts. Imposing forward-clearing to contracts concluded before the entry into force of this Regulation, irrespective of their remaining maturity on the date in which the clearing obligation takes effect, could limit counterparties' ability to hedge their market risks adequately and either impact the functioning of the market and financial stability, or prevent them from exercising their usual activities by hedging them by other appropriate means. Moreover, contracts concluded after this

Regulation enters into force and before the clearing obligation takes effect should not be subject to the clearing obligation until counterparties to those contracts can determine the category they are comprised in, whether they are subject to the clearing obligation for a particular contract, including their intragroup transactions, and before they can implement the necessary arrangements to conclude those contracts taking into account the clearing obligation. Therefore, in order to preserve the orderly functioning and the stability of the market, as well as a level playing field between counterparties it is appropriate to consider that those contracts should not be subject to the clearing obligation, irrespective of their remaining maturities.

(14) OTC derivative contracts concluded after the notification to ESMA that follows the authorisation of a CCP to clear a certain class of OTC derivatives, but before the date on which the clearing obligation takes effect should not be subject to the clearing obligation when they are not significantly relevant for systemic risk, or when subjecting those contracts to the clearing obligation could otherwise jeopardise the uniform and coherent application of Regulation (EU) No 648/2012. Counterparty credit risk associated to interest rate OTC derivative contracts with longer maturities remains in the market for a longer period than with .interest rate OTC derivatives with low remaining maturities. Imposing the clearing obligation on contracts with short remaining maturities would imply a burden on counterparties disproportionate to the level of risk mitigated. In addition, interest rate OTC derivatives with low remaining maturities represent a relatively small portion of the total market and thus a relatively small portion of the total systemic risk associated to this market. The minimum remaining maturities should therefore be set at a level ensuring that contracts with remaining maturities of no more than a few months are not subject to the clearing obligation.

(15) Counterparties in the third category bear a relatively limited share of overall systemic risk and have a lower degree of legal and operational capacity regarding OTC derivatives than counterparties in the first and second categories. Essential elements of the OTC contracts, including the pricing of interest rate OTC derivatives subject to the clearing obligation and concluded before that obligation takes effect, will have to be adapted within short timeframes in order to incorporate the clearing that will only take place several months after the contract is concluded. This process of forward-clearing involves important adaptations to the pricing model and amendments to the documentation of those OTC derivatives contracts. Counterparties in the third category have a very limited ability to incorporate forward-clearing in their OTC derivative contracts. Thus, imposing the clearing of contracts concluded before the clearing obligation takes effect for those counterparties could limit their ability to hedge their risks adequately and either impact the functioning and the stability of the market or prevent them from exercising their usual activities if they cannot continue to hedge. Therefore, contracts concluded by counterparties in the third category before the date on which the clearing obligation takes effect should not be subject to the clearing obligation.

(16) This Regulation is based on the draft regulatory technical standards submitted by ESMA to the Commission.

(17) ESMA has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits, requested the opinion of the Security and Markets Stakeholder Group

established by Article 37 of Regulation (EU) No 1095/2010 of the European Parliament and of the Council[10], and consulted the European Systemic Risk Board.

HAS ADOPTED THIS REGULATION:

Article 1– Classes of OTC derivatives subject to the clearing obligation

1. The classes of OTC derivatives set out in Annex I shall be subject to the clearing obligation.

2. The classes of OTC derivatives set out in Annex I shall not include contracts concluded with covered bond issuers or with covered pools for covered bonds, provided those contracts satisfy all of the following conditions:

(a) they are used only to hedge the interest rate or currency mismatches of the cover pool in relation with the covered bond;

(b) they are registered or recorded in the cover pool of the covered bond in accordance with national covered bond legislation;

(c) they are not terminated in case of resolution or insolvency of the covered bond issuer;

(d) the counterparty to the OTC derivative concluded with covered bond issuers or with covered pools for covered bonds ranks at least pari-passu with the covered bond holders except where the counterparty to the OTC derivative concluded with covered bond issuers or with covered pools for covered bonds is the defaulting or the affected party, or waives the pari-passu rank;

(e) the covered bond referred to in point (a) meets the requirements of Article 129 of Regulation (EU) No 575/2013;

(f) the covered bond referred to in point (a) is subject to a regulatory collateralisation requirement of at least 102%.

[10] Regulation (EU) No 1095/2010 of THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC OJ L 331, 15.12.2010, p.84

Article 2 – Categories of counterparties

1. For the purposes of Article 3, the counterparties subject to the clearing obligation shall be divided in the following categories:

(a) Category 1, comprising counterparties which, on the date of entry into force of this Regulation, are clearing members, within the meaning of Article 2(14) of Regulation (EU) No 648/2012, for at least one of the classes of OTC derivatives set out in Annex I, of at least one of the CCPs authorised or recognised before that date to clear at least one of those classes;

(b) Category 2, comprising counterparties not belonging to Category 1 which belong to a group whose aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives for *[three months after the publication of the RTS in the OJ excluding the month of publication]* is above EUR 8 billion and which are any of the following:

(i) financial counterparties;

(ii) alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU that are non-financial counterparties.

(c) Category 3, comprising counterparties not belonging to Category 1 or Category 2 which are any of the following:

(i) financial counterparties;

(ii) alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU that are non-financial counterparties.

(d) Category 4, comprising non-financial counterparties that do not belong to Category 1, Category 2 or Category 3.

2. For the purposes of calculating the group aggregate month-end average of outstanding gross notional amount referred to in point (b) of paragraph 1, all of the group's non-centrally cleared derivatives, including foreign exchange forwards, swaps and currency swaps, shall be included.

3. When counterparties are alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU or UCITS as defined in Article 1(2) of Directive 2009/65/EC, the EUR 8 billion threshold referred to in point (b) of paragraph 1 shall apply individually at fund level.

Article 3 – Dates from which the clearing obligation takes effect

1. In respect of contracts pertaining to a class of OTC derivatives set out in Annex I, the clearing obligation shall take effect on:

(a) [the date 6 months after the date of entry into force of this Regulation] for counterparties in Category 1;

(b) [the date 12 months after the date of entry into force of this Regulation] for counterparties in Category 2;

(c) [the date 18 months after the date of entry into force of this Regulation] for counterparties in Category 3;

(d) [the date 3 years after the date of entry into force of this Regulation] for counterparties in Category 4.

2. Where a contract is entered into between two counterparties included in different categories of counterparties, the date from which the clearing obligation takes effect for that contract shall be the later of the two.

Article 4 – Minimum remaining maturity

1. For financial counterparties in Category 1, the minimum remaining maturity referred to in point (ii) of Article 4(1)(b) of Regulation (EU) No 648/2012, at the date the clearing obligation takes effect, shall be:

(a) 50 years for contracts entered into or novated before [two months after the date of entry into force of this Regulation] that belong to the classes of Table 1 or Table 2 set out in Annex I;

(b) 3 years for contracts entered into or novated before [two months after the entry into force of this Regulation] that belong to the classes of Table 3 or Table 4 of Annex I;

(c) 6 months for OTC derivative contracts entered into or novated on or after [two months after the entry into force of this Regulation] that belong to the classes of Table 1 to Table 4 of Annex I.

2. For financial counterparties in Category 2, the minimum remaining maturity referred to in Article 4(1)(b)(ii) of Regulation (EU) No 648/2012, at the date the clearing obligation takes effect, shall be:

(a) 50 years for contracts entered into or novated before [five months after the date of entry into force of this Regulation] that belong to the classes of Table 1 or Table 2 set out in Annex I;

(b) 3 years for contracts entered into or novated before [five months after the entry into force of this Regulation] that belong to the classes of Table 3 or Table 4 of Annex I;

(c) 6 months for OTC derivative contracts entered into or novated on or after [five months after the entry into force of this Regulation] that belong to the classes of Table 1 to Table 4 of Annex I.

3. For financial counterparties in Category 3, the minimum remaining maturity referred to in Article 4(1)(b)(ii) of Regulation (EU) No 648/2012, at the date the clearing obligation takes effect, shall be:

(a) 50 years for contracts that belong to the classes of Table 1 or Table 2 of Annex I;

(b) 3 years for contracts that belong to the classes of Table 3 or Table 4 of Annex I.

4. Where a contract is entered into between two counterparties belonging to different categories, the minimum remaining maturity to be taken into account for the purposes of this Article shall be the longer of the two.

Article 5 – Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

ANNEX I

Interest Rate OTC derivatives classes subject to the clearing obligation

TABLE 1: BASIS SWAPS CLASSES

id	Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
A.1.1	Basis	EURIBOR	EUR	28D-50Y	Single currency	No	Constant or Variable
A.1.2	Basis	LIBOR	GBP	28D-50Y	Single currency	No	Constant or Variable
A.1.3	Basis	LIBOR	JPY	28D-30Y	Single currency	No	Constant or Variable
A.1.4	Basis	LIBOR	USD	28D-50Y	Single currency	No	Constant or Variable

TABLE 2: FIXED-TO-FLOAT INTEREST RATE SWAPS CLASSES

id	Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
A.2.1	Fixed-to-Float	EURIBOR	EUR	28D-50Y	Single currency	No	Constant or Variable
A.2.2	Fixed-to-Float	LIBOR	GBP	28D-50Y	Single currency	No	Constant or Variable
A.2.3	Fixed-to-Float	LIBOR	JPY	28D-30Y	Single currency	No	Constant or Variable
A.2.4	Fixed-to-Float	LIBOR	USD	28D-50Y	Single currency	No	Constant or Variable

TABLE 3: FORWARD RATE AGREEMENT CLASSES

id	Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optiona-lity	Notional Type
A.3.1	FRA	EURIBOR	EUR	3D-3Y	Single currency	No	Constant or Variable
A.3.2	FRA	LIBOR	GBP	3D-3Y	Single currency	No	Constant or Variable
A.3.3	FRA	LIBOR	USD	3D-3Y	Single currency	No	Constant or Variable

TABLE 4: OVERNIGHT INDEX SWAPS CLASSES

id	Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optiona-lity	Notional Type
A.4.1	OIS	EONIA	EUR	7D-3Y	Single currency	No	Constant or Variable
A.4.2	OIS	FedFunds	USD	7D-3Y	Single currency	No	Constant or Variable
A.4.3	OIS	SONIA	GBP	7D-3Y	Single currency	No	Constant or Variable