European Securities and Markets Authority

Consultation Paper

Clearing Obligation under EMIR (no. 3)

1 October 2014 | ESMA/2014/1185 – Amended version published on 10 October 2014

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the questions listed in this Consultation Paper on the Clearing Obligation under EMIR (no. 3).

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Please follow the instructions given in the document 'Reply form for the Consultation Paper on the Clearing Obligation under EMIR (no. 3) also published on the ESMA website http://www.esma.europa.eu/system/files/esma-2014-1185_response_form.docx.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **06 November 2014**.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Legal Notice'.

Who should read this paper

[1] amended version published on 10 October 2014. This amended version modifies paragraph 128. The description of Period B between brackets erroneously referred to Period A. The correct definition of Period B is: between the date of publication of the RTS in the Official Journal and the date of application of the clearing obligation for those counterparties.

All interested stakeholders are invited to respond to this consultation paper. In particular, responses are sought from financial and non-financial counterparties of OTC derivatives transactions which will be subject to the clearing obligation, as well as central counterparties (CCPs).

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Acronyms used

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive (Directive 2011/61/EU)
CCP	Central Counterparty
CDS	Credit Default Swap
CFD	Contract for difference
Class+	Class of OTC derivatives subject (or proposed to be subject) to the clearing obligation
EMIR	European Market Infrastructures Regulation – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories
EMTA	Emerging Markets Traders Association
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETD	Exchange Traded Derivatives
FC	Financial Counterparty
FX	Foreign Exchange
FSB	Financial Stability Board
ISDA	International Swaps and Derivatives Association
IRS	Interest Rate Swap
LEI	Legal Entity Identifier
MiFID	Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and the Council

MTF	Multilateral Trading Facility
NCA	National Competent Authority
NDF	Non-Deliverable Forward
NFC	Non-Financial Counterparty
NFC+	Non-Financial Counterparty subject to the clearing obligation, as referred to in Article 10(1)(b) of EMIR
ODSG	OTC derivatives Supervisors Group
OTC	Over-the-counter
Q&A on EMIR	Questions and Answers on the implementation of EMIR available on ESMA's website
RTS	Regulatory Technical Standards
RTS on OTC Derivatives	Commission Delegated Regulation (EU) No 149/2013
RTS on CCP	Commission Delegated Regulation (EU) No 153/2013
SPV	Special Purpose Vehicle
TR	Trade Repository

Executive Summary

Reasons for publication

This consultation paper seeks stakeholders' views on the regulatory technical standards that ESMA is required to draft under Article 5(2) "Clearing Obligation Procedure" of the Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (EMIR). This paper follows the publication in July 2013 of a discussion paper on the clearing obligation under EMIR, the publication of the first consultation papers on the clearing obligation on interest rate classes[2] and credit classes[3], and the publication of the Final Report on the clearing obligation on interest rate classes[4].

The input from stakeholders will help ESMA in finalising the relevant technical standards to be drafted and submitted to the European Commission for endorsement in the form of Commission Regulations, i.e. a legally binding instrument directly applicable in all Member States of the European Union. One essential element in the development of draft technical standards is the analysis of the costs and benefits that those legal provisions will imply. Input in this respect and any supportive data will be highly appreciated and kept confidential where required.

Contents

This paper provides explanations on the draft regulatory technical standards establishing a clearing obligation on a class of foreign-exchange non-deliverable forward (FX NDF) OTC derivatives. The structure of this paper is the following: Section 1 provides an overview of the clearing obligation procedure. Section 2 provides clarifications on the structure of the class of OTC FX NFD that is proposed for the clearing obligation. Section 3 includes the determination of the class of OTC derivatives that should be subject to mandatory clearing with an analysis of the relevant criteria. Section 4 presents the approach for the definition of the categories of counterparties, and the proposals related to the dates from which the clearing obligation should apply per category of counterparty. Section 5 provides explanations on the approach considered for frontloading and the definition of the minimum remaining maturities of the contracts subject to it.

Next steps

As provided for by Regulation No 1095/2010 of the European Parliament and Council establishing ESMA, a public consultation is conducted on the draft technical standards before they are submitted to the European Commission for endorsement in the form of Commission Regulations. In addition ESMA shall consult the ESRB and, where relevant, the competent authorities of third-countries when developing the technical standards on the clearing obligation.

[2] 2014-ESMA-799 Consultation Paper, Clearing Obligation under EMIR no. 1 published on 11 July 2014
[3] 2014-ESMA-800 Consultation Paper, Clearing Obligation under EMIR no. 2 published on 11 July 2014
[4] 2014-ESMA-1184 Final Report, Clearing Obligation under EMIR no. 1 published on 1 October 2014

According to ESMA decision ESMA/2011/BS/4a on the procedure for developing and adopting draft technical standards and guidelines, the consultation paper includes the actual legal text of the provisions constituting the draft technical standards, an explanation of the measures adopted and a cost-benefit analysis. Other consultation papers proposing to subject other classes to the clearing obligation may be published in the future.

Introduction

1. With the overarching objective of reducing systemic risk, the European Market Infrastructure Regulation ("EMIR") introduces the obligation to clear certain classes of OTC derivatives in Central Counterparties (CCPs) that have been authorised (for European CCPs) or recognised (for Third-country CCPs) under the EMIR framework. Ensuring that the clearing obligation reduces systemic risk requires a process of identification of classes of derivatives that should be subject to mandatory clearing.

2. EMIR foresees two possible processes for the identification of the relevant classes of OTC derivatives:

   - The "bottom-up" approach described in EMIR Article 5(2), according to which the determination of the classes to be subject to the clearing obligation will be done based on the classes which are already cleared by authorised or recognised CCPs.
   - The "top-down" approach described in EMIR Article 5(3), according to which ESMA will on its own initiative identify classes which should be subject to the clearing obligation but for which no CCP has yet received authorisation.

3. This consultation paper results from the bottom-up approach only and it is the third consultation paper on the clearing obligation. This paper is published after the delivery to the European Commission of the Final Report on the clearing obligation for interest rate swap classes (IRS)[5] and shortly after the end of the consultation period for the second clearing obligation paper on Credit Default Swaps (CDS). It therefore incorporates the feedback received to the first consultation paper on IRS only and is consistent with the Final Report on IRS.

4. The clearing obligation procedure begins when a CCP clearing OTC derivatives is authorised under EMIR, or when ESMA has recognised a third-country CCP in accordance with the procedure set out in EMIR Article 25. It has therefore started in Q1 2014 following the first CCPs authorisations. The list of CCPs that have been authorised to clear OTC derivatives, and the classes for which they are authorised, are available in the public register[6]. With regards to third-country CCPs, so far no equivalence decision on third-country regulatory regime has been made and no third-country CCP has yet been recognised.

5. In accordance with the clearing obligation procedure and the Commission mandate shown in Annex I, ESMA shall develop and submit to the European Commission for endorsement draft technical standards specifying:

   (a) the class of OTC derivatives that should be subject to the clearing obligation referred to in Article 4;

   (b) 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

   (c) the minimum remaining maturity of the OTC derivative contracts referred to in Article 4(1)(b)(ii).

6. This consultation paper results from the analysis of a class of OTC foreign-exchange non-deliverable forward ("NDF") cleared by LCH.Clearnet Ltd (UK), and is proposing to subject this class to the clearing obligation.

[5] 2014-ESMA-1184 Final Report, Clearing Obligation under EMIR no. 1 published on 1 October 2014
[6] The "Public Register for the Clearing Obligation under EMIR" is available under the post-trading section of : http://www.esma.europa.eu/page/Registries-and-Databases

7. This class is expected to be cleared by additional European CCPs: CME Clearing Europe Ltd[7], ICE Clear Europe Ltd[8] and Nasdaq OMX Clearing AB[9]. CME Clearing Europe Ltd and Nasdaq OMX Clearing AB were authorised respectively on 04 August 2014 and 18 March 2014, but this class was not part of their authorisation at the time. Finally, ICE Clear Europe Ltd is not yet authorised under EMIR at the time of publication of this consultation. As the information about the contracts these CCPs intend to clear is known, without pre-judging the conclusion of the related authorisation process, the corresponding information could be considered where relevant. Lastly, NDF are also cleared by several third-country CCPs.

8. This consultation paper being published after the Final Report on the clearing obligation for IRS was submitted to the Commission, the draft RTS on NDF included in Annex II was built on the basis of this first submitted draft RTS on IRS.

[7] Link to the CME Clearing Europe webpage: http://www.cmegroup.com/trading/fx/otc-fx-clearing.html
[8] Link to the ICE Clear Europe webpage: https://www.theice.com/clear-europe/circulars
[9] Link to the Nasdaq OMX Clearing webpage: http://www.nasdaqomx.com/transactions/markets/fx/fx-europe/clearing

1. The clearing obligation procedure

9. The clearing obligation procedure of Article 5 is triggered every time a European CCP is authorised to clear a class of OTC derivatives under Article 14 (initial authorisation) or Article 15 (extension of activity) of EMIR. The procedure is also triggered by the recognition of a third-country CCP by ESMA in accordance with Article 25 of EMIR. To date ESMA has not recognised any third-country CCP, therefore this process is not covered by the current consultation.

10. The procedure of Article 5(1) for European CCPs implies that potentially, depending on the date of authorisation of the CCPs, ESMA could submit separate draft RTS on the clearing obligation after each CCP authorisation. ESMA has determined that this process would be highly sub-optimal, as stakeholders would need to answer to numerous consultations potentially running in parallel.

11. Therefore ESMA has aimed at grouping, to the extent possible, the analysis of the notified classes of OTC derivatives in a minimal set of consultation papers, and at least to group them per asset-class, where an asset-class, in accordance with market practice, is one of the five following categories: (1) interest rate, (2) credit, (3) foreign-exchange, (4) equity and (5) commodity. Respondents to the first consultation paper on the clearing obligation have commented on their broad support for this grouping approach.

12. This is the reason why, after the publication of a first consultation paper on interest rate and a second consultation paper on credit OTC derivatives, the paper is proposing a clearing obligation on foreign-exchange non-deliverable forward OTC derivatives.

13. Table 1 below provides an overview of the European CCPs that are authorised, or in the process of being authorised, with an indication of the asset-class that they clear[10]. For the authorised CCPs, the information on the cleared asset-classes is based on the formal notifications to ESMA under Article 5(1) whereas for the CCPs that are not yet authorised, the information on the cleared asset-classes is based on the notifications received by ESMA in March 2013 in accordance with Article 89(5), as well as on information gathered by ESMA. Therefore it should be understood that for those non-authorised CCPs, the scope of the cleared asset-classes may be subject to changes.

[10] The detail of the classes that the CCPs are authorised to clear is available in the “Public Register for the Clearing Obligation under EMIR” , available under the post-trading section of : http://www.esma.europa.eu/page/Registries-and-Databases

Table 1: Asset-Classes cleared by European CCPs

#	CCP Name	Country	Authorised on	RTS Deadline	OTC Interest Rate	OTC Credit	OTC Commodity	OTC Equity	OTC FX
1	Nasdaq OMX Clearing AB[1]	Sweden	18-Mar-14	18-Sep-14	1			1	
2	KDPW_CCP	Poland	08-Apr-14	18-Oct-14	1				
3	Eurex Clearing AG	Germany	10-Apr-14	12-Oct-14	1				
4	LCH.Clearnet SA	France	22-May-14	22-Nov-14		1			
5	European Commodity Clearing (ECC)	Germany	11-Jun-14	11-Dec-14			1		
6	LCH.Clearnet Limited	UK	12-Jun-14	12-Dec-14	1		1	1	1
7	CME Clearing Europe[1]	UK	4-Aug-14	4-Feb-15	1		1		
8	LME Clear	UK	3-Sept-14	3-Mar-15			1		
9	ICE Clear Europe	UK				1			1
10	OMI Clear	Portugal					1		
11	Holland Clearing House	Netherlands						1	
	Number of CCP per asset class				**5**	**2**	**6**	**3**	**2**

(1) CME Clearing Europe and Nasdaq OMX Clearing AB were authorised on 4 september 2014 and 18 March 2014 respectively. The Public Register indicates the classes of OTC derivatives that the CCPs are authorised to clear. However, these two CCPs are now working on new clearing offerings of FX OTC derivative classes.

Legend:

Class proposed to be subject to the clearing obligation in previous consultation papers	Class proposed not to be subject to the clearing obligation in the first consultation paper	Class proposed to be subject to the clearing obligation in this consultation	Class not covered by the present consultation	Class not yet notified (CCP not authorised)

Question 1: Do you have any comment on the clearing obligation procedure described in Section 1?

2. Structure of the non-deliverable forward derivatives classes

2.1. Definition of non-deliverable forward

14. Non-deliverable forwards (NDFs) are cash-settled foreign exchange forward contracts. Such a cash-settled forward contract specifies an exchange rate against the currency of delivery (the convertible currency), typically the US dollar, a notional amount of the non-convertible currency and a settlement date. A cash-settled FX forward contract is akin to a classical physically-settled FX forward contract, but with the former there is no physical delivery of the designated currencies at maturity. On the settlement date, the spot market exchange rate is instead compared to the forward rate and the cash-settled contract is settled on a net basis, in the convertible currency based on the notional amount.

15. The standard market practise is to refer to those cash-settled contracts as NDFs for a specific group of currency pairs, typically when the non-convertible currency is the currency of an emerging market. Therefore this terminology is used throughout the paper.

16. The NDF market has traditionally developed because of some legal or regulatory constraints preventing the offshore settlement of transactions in certain currencies. In some countries, the monetary authorities impose restrictions on the convertibility of their currency to regulate the inflow and outflow of currencies. Therefore, it may be difficult for counterparties located outside those countries to enter into physically-settled FX forward contracts because such transactions might not be allowed under the currency restrictions. As a result, the demand has grown for non-deliverable forwards, which do not require any payment in the non-convertible currency.

17. As a result, the risks borne by CCPs clearing cash settled or physically settled contracts are radically different. With the former, a CCP will settle the profits and losses in a single currency, in a way that is very similar to any other types of derivatives, whereas physically settled contracts would require CCPs to meet settlement obligations in numerous currencies, and on significantly higher amounts as physically settled contracts require the full exchange of notional in the currencies of the contract at maturity.

2.2. Proposed structure for the class of non-deliverable forward

18. The proposed structure for the non-deliverable forward class is leveraging the feedback from the discussion paper[11] on the clearing obligation. ESMA has ensured it is consistent with the structure used in the Public Register following the first notified FX OTC derivative class.

19. In the discussion paper on the clearing obligation, ESMA explained the approach that was considered to define the class of FX NDF OTC derivatives. A key feedback from respondents to this consultation was that ESMA should make it clear that the only FX OTC derivative class that can be cleared so far are cash settled (as opposed to physically settled) contracts[12].

20. Respondents noted that this distinction between cash settled and physically settled FX contracts is key, as the two categories of products expose the CCPs to completely different types of risk.

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[11] "The Clearing Obligation under EMIR", Discussion Paper, ESMA-2013-925 published on 12 July 2013 and available at: http://www.esma.europa.eu/content/Clearing-Obligation-under-EMIR

[12] Some physically settled FX derivatives are offered for clearing, but these contracts are exchange traded, not OTC derivatives.

21. In terms of structure of the class, some respondents proposed to use the GFMA Global FX Division taxonomy[13] which was developed for other regulatory purpose i.e. the reporting obligation in the US. The taxonomy proposed by ESMA below is compatible with the GFMA taxonomy in which NDF appears as a specific category of the FX market.

22. Against this background, ESMA agrees that cash settled and physically settled contracts should belong to distinct classes with the following clarification:

- Cash settled are non-deliverable contracts i.e. contracts that cannot result in physical delivery of currency (exchange of principal) under any circumstances;
- Physically settled are deliverable contracts i.e. contracts that can result in physical delivery of currency (exchange of principal) if participants wish, whether by intention at inception or by subsequent election.

23. The class of OTC derivative that is proposed to be subject to the clearing obligation in this consultation paper only covers the first category i.e. <u>cash-settled contracts</u>. This is reflected in the RTS by a column labelled "Settlement type" taking the value "Cash" in the table that sets out the NDF classes to be subject to the clearing obligation. The other characteristics used to define the NDF classes are unchanged from the discussion paper. The characteristics proposed to be used are therefore the following:

- <u>Type</u>, which take the value "NDF"
- <u>Currency pair</u>, which indicates the notional currency and the settlement currency
- <u>Settlement currency</u>, which takes the value "USD"
- <u>Settlement type</u>, which takes the value "Cash"
- <u>Maturity</u>, which indicates the range of maturities or tenors of the contracts covered

Question 2: Do you consider that the proposed structure for the FX NDF classes enables counterparties to identify which contracts are subject to the clearing obligation?

[13] Available at:
http://www.gfma.org/uploadedFiles/Initiatives/Foreign_Exchange_(FX)/GFMA%20FX%20Division%20Paper%20(2011-11-30)%20-%20FX%20Market%20Architecture%20Group%20-%20FX%20Taxonomy%20Proposal.pdf

3. Determination of the classes of OTC derivatives to be subject to the clearing obligation

3.1. Legal basis

24. In accordance with Article 5(4) of EMIR, with the overarching aim of reducing systemic risk, the draft RTS for the part referred to in Article 5(2)(a) of EMIR (i.e. the specification of the class of OTC derivatives that should be subject to the clearing obligation) shall take into consideration the following criteria:

    (a) the degree of standardisation of the contractual terms and operational processes of the relevant class of OTC derivatives;

    (b) the volume and liquidity of the relevant class of OTC derivatives;

    (c) the availability of fair, reliable and generally accepted pricing information in the relevant class of OTC derivatives.

25. Those criteria are further specified in Article 7 of the RTS on OTC derivatives. EMIR also provides for a primary source of information for ESMA to perform its assessment of the classes of OTC derivatives against the criteria, in the form of the "CCP notifications", the details of which are defined in Article 6 of the RTS on OTC derivatives.

26. The paragraphs below provide for an analysis of the class of OTC NDF against those criteria. Please note that the notified class can be found in ESMA's public register[14], whereas the class proposed for the clearing obligation are defined on the basis of the relevant criteria and summarised in section 3.2.4.

27. As presented in Table 2, the NDF that LCH.Clearnet Ltd is authorised to clear and that are expected also to be cleared by one or several other EU CCPs are contracts with maturities between 3 days and 2 years, settled in USD, in the following 11 currencies: Brazilian Real (BRL), Chilean Peso (CLP), Chinese Yuan (CNY), Colombian Peso (COP), Indonesian Rupiah (IDR), Indian Rupee (INR), Korean Won (KRW), Malaysian Ringgit (MYR), Philippine Peso (PHP), Russian Ruble (RUB) and Taiwan Dollar (TWD).

[14] The "Public Register for the Clearing Obligation under EMIR" is available under the post-trading section of : http://www.esma.europa.eu/page/Registries-and-Databases

Table 2: NDF classes authorised to be cleared

Type	Currency Pair	Settlement Currency	Settlement Type	Maturity
NDF	BRL / USD Brazilian Real / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	CLP / USD Chilean Peso / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	CNY / USD Chinese Yuan / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	COP / USD Colombian Peso / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	IDR / USD Indonesian Rupiah / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	INR / USD Indian Rupee / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	KRW / USD Korean Won / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	MYR / USD Malaysian Ringgit / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	PHP / USD Philippine Peso / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	RUB / USD Russian Ruble / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	TWD / USD Taiwan Dollar / U.S. Dollar	USD	Cash settlement	3D-2Y

3.2. Analysis of the criteria for the foreign-exchange non-deliverable forwards (NDF)

3.2.1. Criteria 1: degree of standardisation

28. To assess the degree of standardisation of NDF contracts, ESMA has used the following sets of data:

- The CCP-notification that was made by Bank of England to ESMA in June 2014 under Article 5(1) and that launched this consultation paper i.e. the notification following the authorisation of LCH.Clearnet Ltd;
- Relevant public information and reports that were published by ISDA, EMTA and by the FSB using data of the ODSG.

29. As presented above in section 2, NDF are relatively simple products which include few characteristics that can be customised by market participants.

30. The level of standardisation of NDF has increased as a result of industry initiatives led by associations such as the Emerging Markets Trade Association (EMTA) and the International Swaps and Derivatives Association (ISDA).

31. The EMTA provides recommended template terms for NDF in 21 currencies, including the 11 currencies covered by the current paper[15]. More currencies are added on a regular basis, e.g. the most recent template for ZMW (Zambian kwacha) is dated from July 2014.

32. This leads to counterparties agreeing to a common Master Agreement which lays out the generic contractual terms that exist between the market participants and allows for a short form, and predominately electronic, confirmation exchange process to take place on a contract by contract basis.

33. The master agreement includes, among others, the following standardised terms:

- the reference currency e.g. BRL
- the settlement currency e.g. USD
- the settlement type: non-deliverable
- information on the prices to be used for pricing and settlement purposes (primary rate, secondary rate and price materiality percentage)
- information on the business days calendar to be used for valuation and settlement

34. One of the most important characteristics is the reference price, or Fixing Price, i.e. the price which prevails on the settlement date for the calculation of the amounts to be settled, which is agreed to within the Master Agreement. The agreement also documents the Fixing Conventions to be adhered to for each currency which is most commonly the spot process published by the relevant central bank at fixed times each business day.

35. Each market participant, including the ForexClear service provided by LCH.Clearnet, utilises this operating and fixing protocol to enhance standardisation across the NDF market. Since the launch of ForexClear in March 2012, there have been no instances of a failure to publish the Fixing Price, meaning fall-back conventions, as set out by EMTA, have not been required.

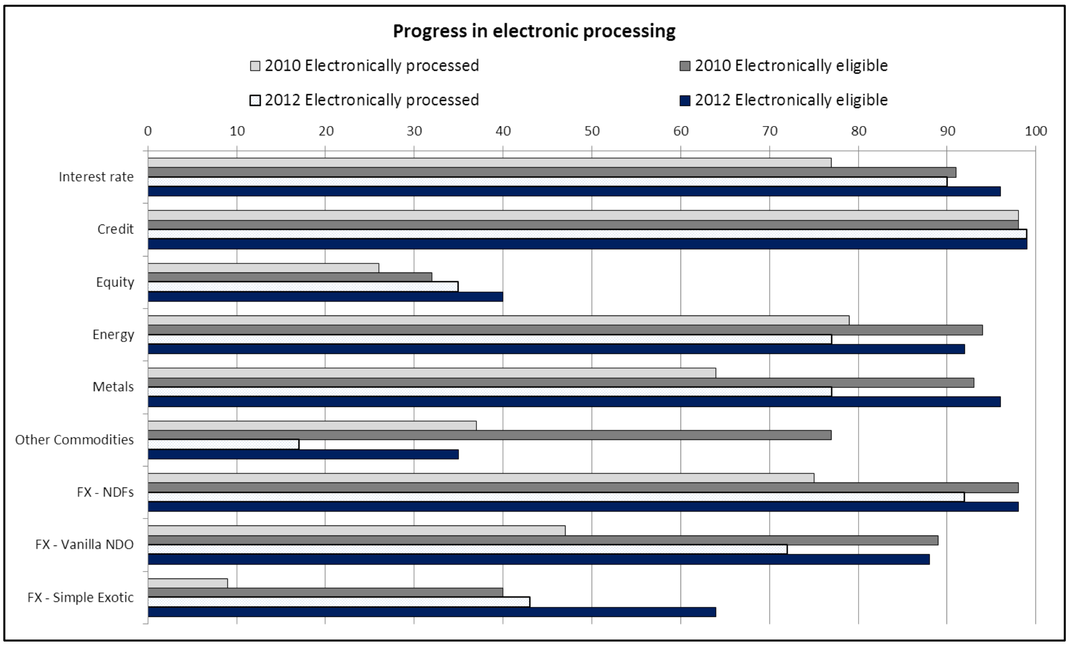
36. In terms of process, LCH.Clearnet Ltd service auto validates all incoming trades to the CCP within seconds and where a trade is ineligible for clearing it is rejected to the matching source with rejection code attached. All trade flow is in FpML format with upgrades being performed in line with market developments.

37. Electronic affirmation is performed upstream to the CCP by matching providers. Trades executed on platform are currently received via the matching provider and no restrictions are placed by the CCP as the execution venue of the transaction.

38. The data available on the current level of standardisation dates back to 2012 but according to the FSB, already in 2012 the volume of electronically confirmed NDF transaction was above 90%, a level that is similar to the one for the interest rate or the credit asset class (Figure 1).

[15] The EMTA templates are available at http://www.emta.org/ndftt.aspx#ndf

Figure 1: Progress in electronic processing for OTC derivatives



Source: FSB

3.2.2. Criteria 2: liquidity of non-deliverable forward

Criteria 2(a): Proportionate margins – EMIR 5(4)(b) and RTS 7(2)(a)

39. Provision 7(2)(a) of the RTS on OTC derivatives states that, in relation to the volume and liquidity of the relevant classes of OTC derivative contracts, ESMA shall take into consideration whether the margins or financial requirements of the CCP would be proportionate to the risk that the clearing obligation intends to mitigate.

40. In this respect there could be two situations in which the margins would be considered as disproportionate: if they are too high or if they are too low.

41. The case of margins that are too low is covered by various provisions in EMIR on the margins and financial resources requirements for CCPs. This includes e.g. stringent requirements on the confidence intervals to be applied when calculating initial margins, the time horizon for the calculation of the liquidation period and for the calculation of historical volatility as well as conditions under which portfolio margining can be applied.

42. The case of margins that are too high is of greater importance in the context of the clearing obligation. The risk of prohibitively high margins is naturally mitigated by the existence of competition. Although at the time of publication of this paper, the NDF classes covered are cleared by only one *authorised* CCP, this CCP is not in a monopoly situation at international level as NDFs are also cleared by third-country CCPs which may be recognised by the time the clearing obligation takes effect. In addition, three other European CCPs, CME Clearing Europe, ICE Clear Europe and Nasdaq OMX Clearing AB, are expected to clear NDFs, which would increase competition further.

43. Overall, ESMA is confident that the determination process would follow the overarching goal of reducing systemic risk, and that for instance a less liquid product currently cleared but with a disproportionate

margin would not be part of a class. ESMA has determined that the inclusion of the OTC derivative class presented in this consultation paper for the clearing obligation would not result in disproportionate margin and financial requirements.

Criteria 2(b): Stability of the market size and depth – EMIR 5(4)(b) and RTS 7(2)(b)

44. The FX market in general and the NDF market in particular have experienced a significant growth in the past five years (see Figure 2 and Figure 3). One of the elements put forward to explain the growth of the NDF market is a generally increased appetite from investors towards emerging markets.

45. The average daily volume of NDF traded in London almost doubled from April 2008 to October 2013, from 23 to 43 billion of USD. Although historical figures similar to the ones provided in Figure 3 are not available for other European countries, those numbers are considered to be sufficiently representative in light of the share of London trading in the FX markets[16].

46. Although those numbers tend to point to an overall growth in the NDF market in the recent years, the specific nature and origin of this market need to be taken into consideration in the context of the clearing obligation. As explained in 2.1 above, the demand for NDF products traditionally originated from restrictions imposed on foreign investors to invest in certain currencies. One could therefore reasonably assume that once (and when) those constraints are relaxed, the demand and therefore the liquidity of such products could fade away, which may in itself constitute an obstacle to the establishment of a clearing obligation on them.

47. The phenomenon has been studied in various research papers that reach the conclusion that even when the regulatory constraints on offshore investors are removed or alleviated in such a way that they are allowed to buy and sell the relevant currencies, NDF trading declines at a slow pace (i.e. years).

48. This can be illustrated by the Australian Dollar where the NDF market started to decline in 1983 when the currency restrictions were removed, which corresponded to the time when the currency was floated. Yet there were still volumes in the Australian Dollar NDF market until around 1987[17] (Figure 4).

49. Another more recent example is the case of the Russian Rouble: although the Russian authorities have made the rouble fully convertible in mid-2006, the share of NDF in the global Rouble-denominated FX forward market persists at a high level (above 60% in the London market, Figure 5).

50. From the same Figure 5, it can be seen that the share of NDF in the FX forward market denominated in Chinese Renminbi has also declined significantly from close to 100% in 2008 to 74% in October 2013, but the reason for this decline is different than for the Russian Rouble, as it is linked to the development of a market of *offshore deliverable* forward, in addition to the onshore deliverable and the offshore non-deliverable, which has attracted some of the NDF liquidity[18].

[16] According to the BIS publication "Non-deliverable forwards: 2013 and beyond", London accounts for 36% of NDF trading. The publication is available at: http://www.bis.org/publ/qtrpdf/r_qt1403h.htm

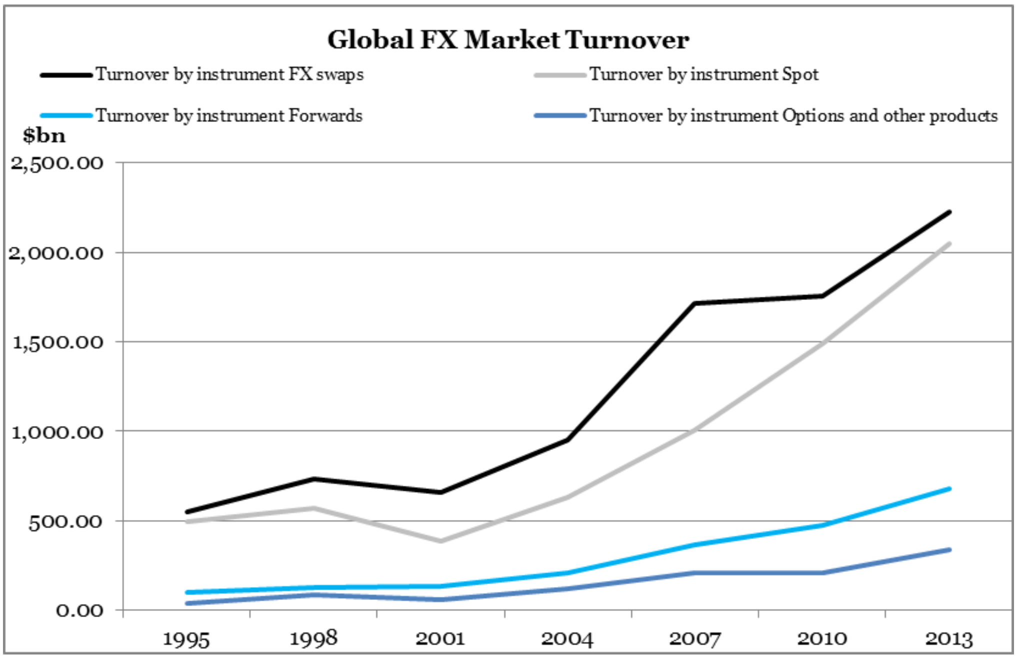
[17] "Forward currency markets in Asia: lessons learnt from the Australian experience". http://www.bis.org/repofficepubl/arpresearch_dev_200609.01.pdf

[18] More details can be found in the BIS paper "Non-deliverable forwards: 2013 and beyond" available at http://www.bis.org/publ/qtrpdf/r_qt1403h.htm

51. As a conclusion it appears that the sustainability of the NDF market is closely interconnected with the regulatory framework and monetary decisions of the respective emerging-market countries. As the economies are making the domestic FX market more directly accessible to offshore investors, the demand for NDF contracts may fade away. However, this process may take years as illustrated by the example of the Australian Dollar or the Russian Rouble. The two markets (deliverable forward and NDF) may also continue to exist in parallel.

52. To take this feature into consideration, ESMA is proposing to monitor regularly the variables mentioned above that may affect the liquidity of the NDF market, so as to detect a potential need to remove some NDF contracts from the scope of the clearing obligation. The slow pace at which the changes are occurring should be compatible with the time required to modify the relevant RTS, as this is currently the only possibility foreseen by EMIR to remove a contract from the scope of the clearing obligation[19].

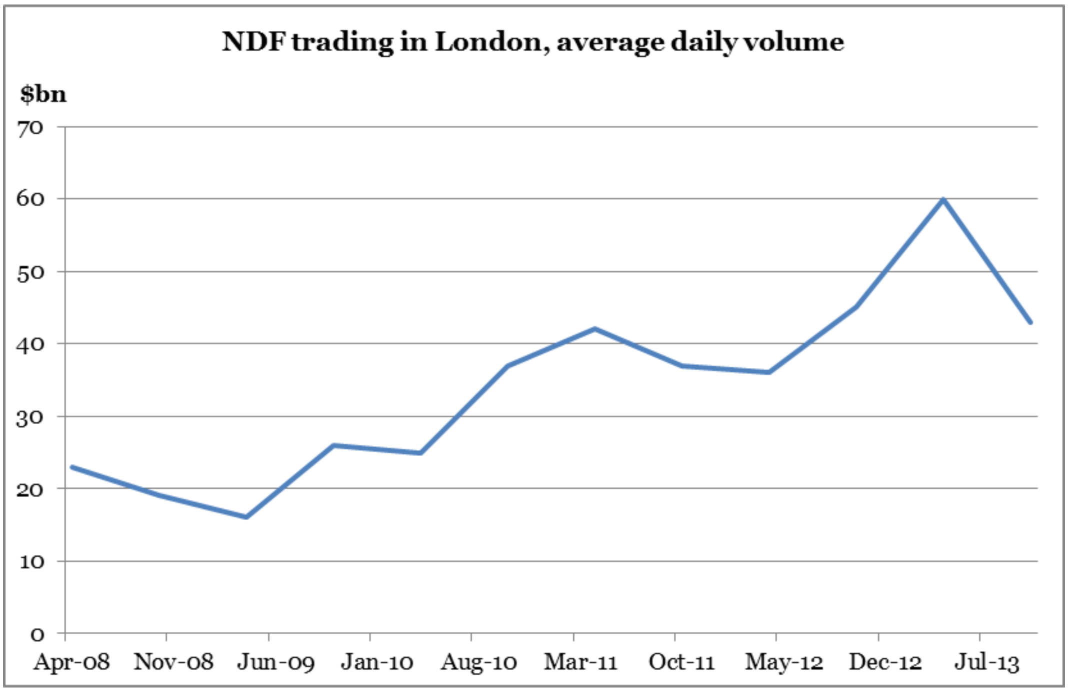
Figure 2: Global FX market turnover



Net-net basis, daily averages in April, in billions of US dollars - Sources: BIS Triennial Central Bank Survey; BIS calculations.

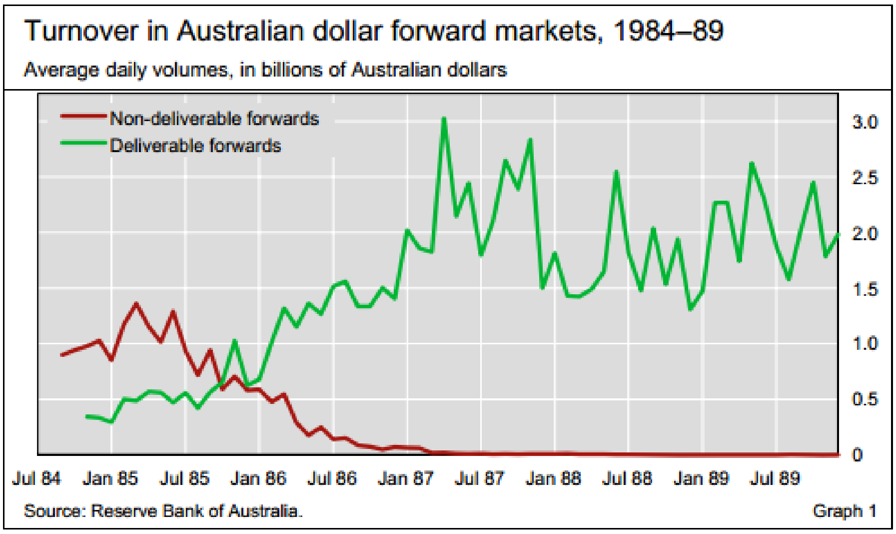
[19] For more information of the procedure to remove a class from the clearing obligation, see the Final Report on the clearing obligation on interest rate swaps.

Figure 3: NDF trading in London, average daily volume



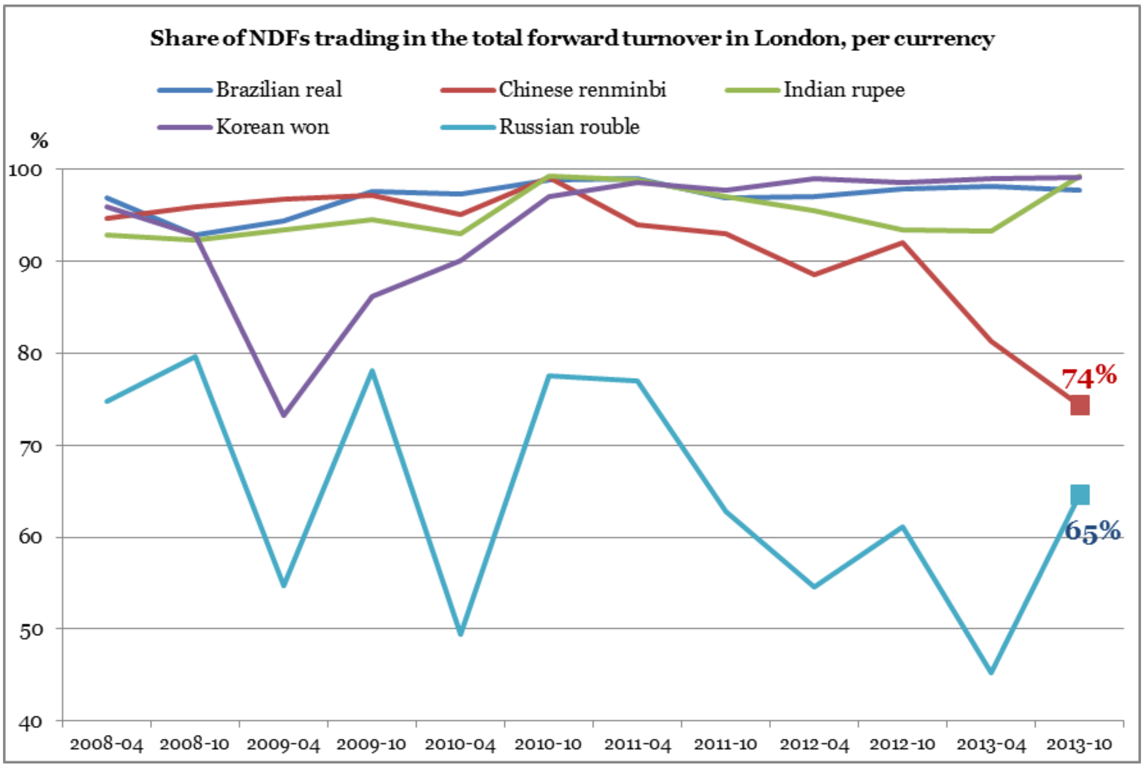
Adjusted for local and cross-border inter-dealer double-counting - Source: London Foreign Exchange Joint Standing Committee.

Figure 4: Turnover in Australian Dollar forward markets, 1984-1989



For illustration purposes this is a reproduction of Graph 1 of the BIS paper "Forward currency markets in Asia: lessons learnt from the Australian experience".

Figure 5: Share of NDF trading in the total forward turnover in London, per currency



Source: London Foreign Exchange Joint Standing Committee.

<u>Criteria 2(c): Market dispersion – EMIR 5(4)(b) and RTS 7(2)(c)</u>

53. Article 7(2)(c) of the RTS on OTC derivatives requires ESMA to take into consideration the likelihood that market dispersion would remain sufficient in the event of the default of a clearing member.

54. As explained in more detail in 4.1.2, LCH.Clearnet Ltd currently has 20 clearing members for NDF, and 17 at group level (i.e. when clearing members of the same group are counted only once). The NDF clearing members of LCH.Clearnet Ltd are large international or European banks[20]. These clearing members are relatively limited in number but account for a significant portion of the traded volume and usually are the most relevant liquidity providers. The total number of clearing members for NDF is expected to be higher by the time the clearing obligation takes effect, when more European and Third-Country CCPs are authorised/recognised to clear them but at this stage it is difficult to evaluate the total number of future NDF clearing members.

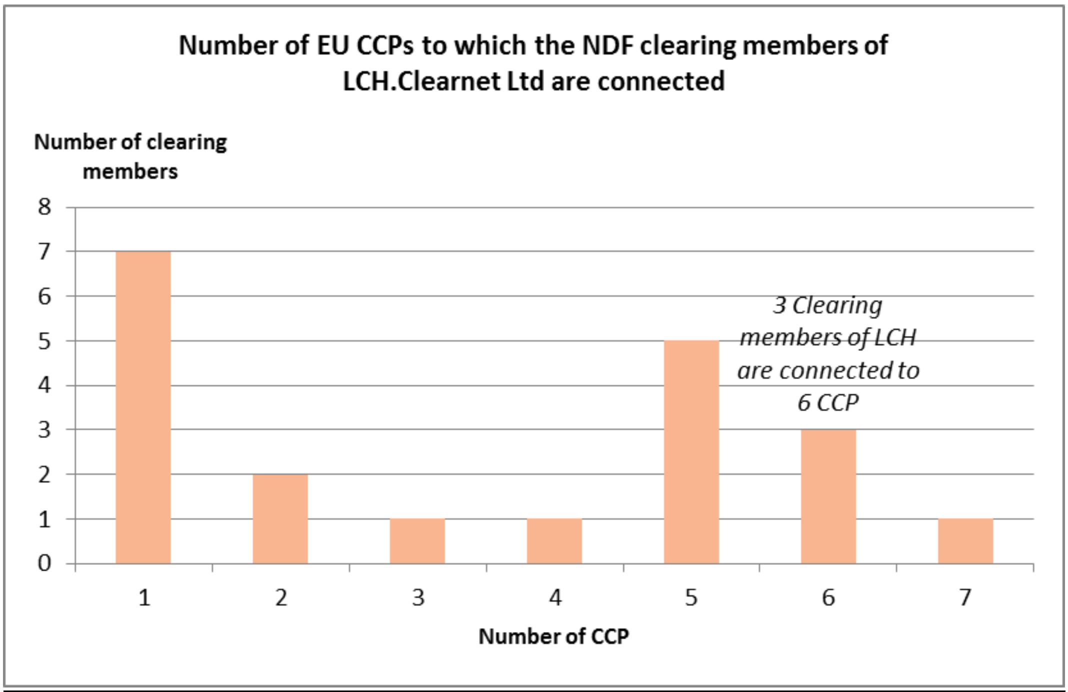
55. As a result, in addition to the fact that the EMIR requirements on default management are part of the authorisation process of the CCP, the profile and number of the clearing members of LCH.Clearnet Ltd would ensure that market dispersion remains sufficient in the event of the default of one of them.

56. Finally, taking the example of the interest rate and credit derivative classes, when the clearing activity develops, these types of clearing members typically become clearing members of two or more CCPs for a given class. For example, Figure 6 indicates that apart from some entities that are only a member of this

[20] The list of clearing members is available on the LCH Clearnet website at: http://www.lchclearnet.com/members-clients/members/current-membership

EU CCP, the majority of these clearing members are connected to multiple CCPs and tend to have a multi-asset strategy to clearing. These numbers increase further when third-country entities are added. As a result, it is reasonable to expect that when other CCPs are authorised or when third country CCPs are recognised to offer clearing of OTC NDF classe, the analysis of the previous two paragraphs on the likelihood that market dispersion would remain sufficient would still hold for the wider clearing offering.

Figure 6: Number of EU CCPs to which the NDF clearing members of LCH.Clearnet Ltd are connected



Source: ESMA calculations

<u>Criteria 2(d): Number and value of the transactions – EMIR 5(4)(b) and RTS 7(2)(d)</u>

57. As presented in Table 3 and Table 4 below, according to the Bank of International Settlements as of December 2013, OTC foreign exchange contracts represented $70.6 trillion in outstanding notional amounts and $2.3 trillion in market value, accounting for 9.9% and 12.2% of the OTC derivative market respectively[21]. OTC foreign exchange derivatives are therefore the second largest asset class both in terms of notional amounts and market value, however NDFs only represent a fraction of the global OTC FX derivative market.

[21] Bank for Settlement Instructions statistics as of end of December 2013: http://www.bis.org/statistics/derdetailed.htm

Table 3: Notional amounts outstanding in OTC derivatives, per asset class

as of December 2013	Notional Amounts Outstanding (trillion of USD)	% of total
Foreign exchange contracts	70.6	9.9%
Interest rate contracts	584.4	82.3%
Equity-linked contracts	6.6	0.9%
Commodity contracts	2.2	0.3%
Credit default swaps	21.0	3.0%
Unallocated	25.5	3.6%
TOTAL	710.2	100%

Source: BIS semi-annual OTC derivatives statistics

Table 4: Gross market values in OTC derivatives, per asset class

as of December 2013	Gross Market Values (trillion of USD)	% of total
Foreign exchange contracts	2.3	12.2%
Interest rate contracts	14.0	75.2%
Equity-linked contracts	0.7	3.8%
Commodity contracts	0.3	1.4%
Credit default swaps	0.7	3.5%
Unallocated	0.7	3.8%
TOTAL	18.7	100%

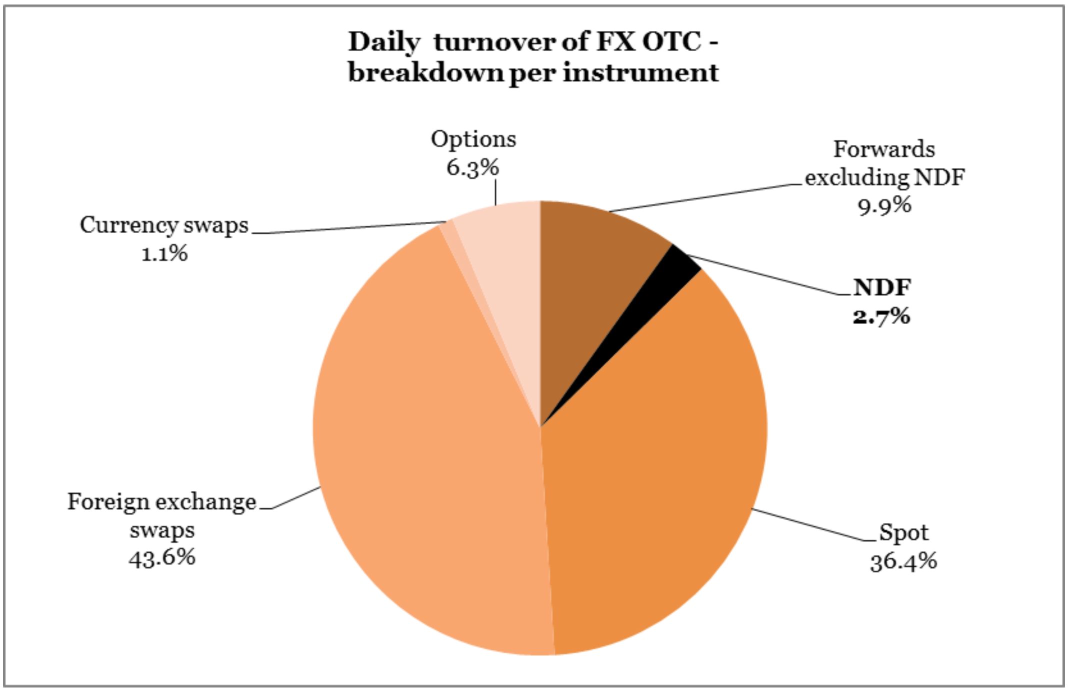
Source: BIS semi-annual OTC derivatives statistics

58. Looking at the breakdown per type of FX instruments in the latest BIS Triennal Survey, as shown in Figure 7, the turnover in the FX OTC market is largely dominated by spot contracts (36%) and foreign-exchange swaps (43%). NDFs, which are included in the category “outright forward”, account for 21% of this category i.e. 2.7% of the FX turnover in total.

59. In absolute terms, the average daily turnover of NDF contracts was reported by BIS to be $127 billion in April 2013[22]. In comparison, the daily turnover in interest rate OTC derivatives denominated in GBP was reported to be $187 billion in April 2013[23]. Although the NDF market represents a smaller share of the OTC derivative market than other classes, subjecting NDF classes meeting the criteria of EMIR to the clearing obligation would allow addressing a further share of the overall systemic risk of the OTC derivatives market, still significant.

[22] Data on NDF are provided in the BIS “Triennial Central Bank Survey of foreign exchange and derivatives market activity in 2013”, with data collected in April 2013, while the most recent data on OTC derivatives globally are dated from December 2013.
[23] Data presented in Table 4 of the consultation paper on the clearing obligation No.1 covering interest rate derivative classes.

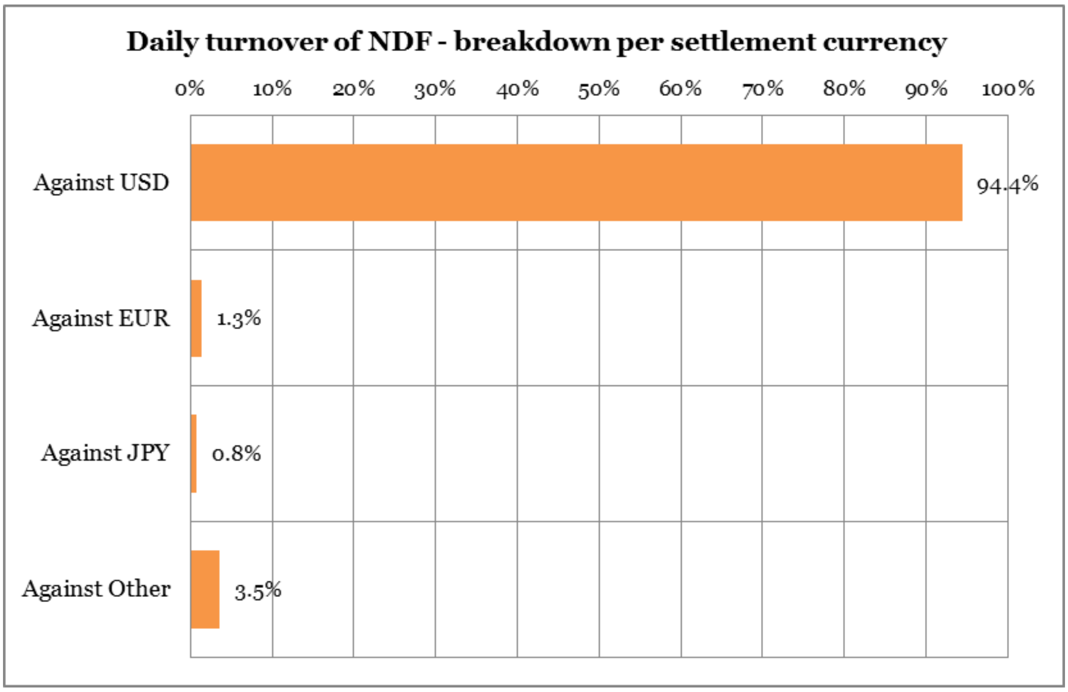
Figure 7: Daily turnover of FX OTC - breakdown per instrument



Source: BIS Triennal Central Bank Survey, data of April 2013

60. The contracts in the class of NDF notified to ESMA are all settled in USD. This means that the currency pairs are exclusively composed of a non-deliverable currency versus the U.S. Dollar. As shown in Figure 8 below, NDF settled in USD accounted for the very large majority (close to 95%) of NDF transactions, as measured by the average daily turnover in April 2013.

Figure 8: Daily turnover of NDF - breakdown per settlement currency



Source: BIS Triennal Central Bank Survey, data of April 2013

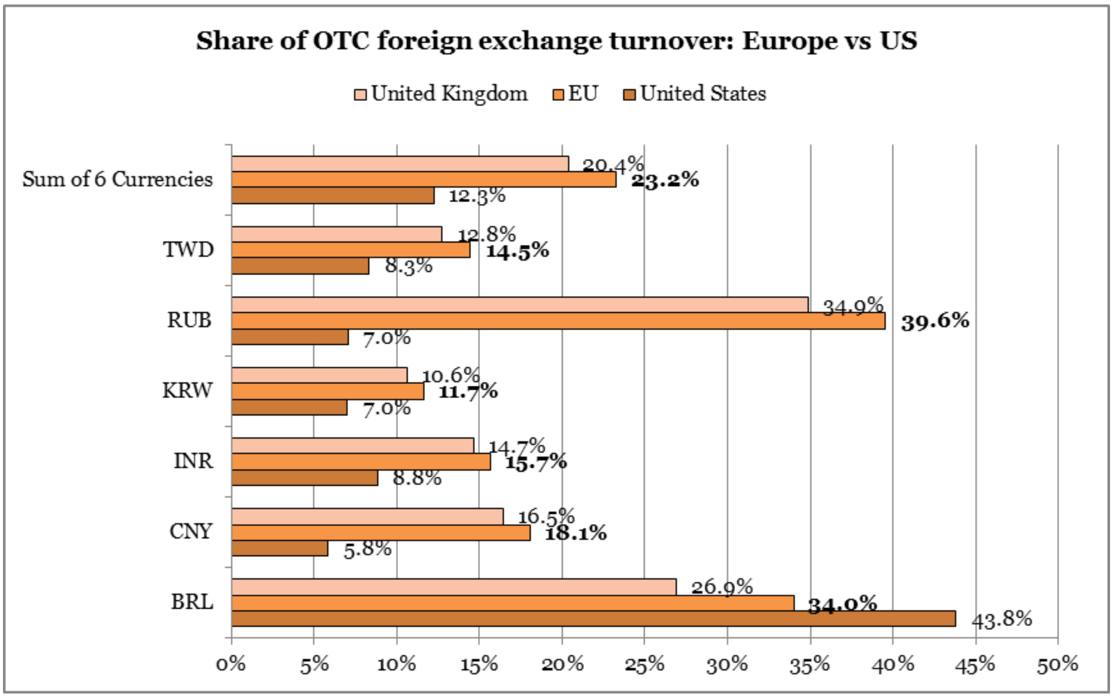
Breakdown per currency

61. Focusing on the NDFs that settle in USD, data from both the BIS as well as from DTCC has been used to look at the breakdown of activity across currency pairs in the NDF market. This is used in order to analyse the relative importance of the 11 notified currencies that are covered by this paper. Looking at both sources of data allowed to complement the respective sets of metrics and validate the overall findings. The BIS data provides a comprehensive view of the NDF activity but does not include a currency breakdown for all the currencies that are offered for clearing. It was therefore complemented by more granular metrics based on data from DTCC.

62. With regards to DTCC data, ESMA has used data on NDF transactions reported in July 2014 to DTCC Global Trade Repository ("GTR"), although this reflects transactions executed mainly by US counterparties. As evidence in Figure 9, the respective share of European and US markets in NDF vary depending on the currencies. An estimation of the European NDF market using data from the US market is expected to overestimate liquidity for BRL and underestimate liquidity for the other currencies, especially RUB. Indeed the BIS data presented in Figure 9 indicates that the share of FX turnover in RUB executed in the US is 7% whereas the share of turnover executed in Europe is close to 40%.

63. The most problematic data limitation therefore concerns BRL, the only currency included in the BIS dataset where the share of turnover executed in the US (43.8%) is higher than that of Europe (34%), therefore likely leading to an overestimation of the size of the European market. However, given that BRL is one of the most liquid NDF currencies, it is unlikely that the analysis of the liquidity for Europe only would have led to significantly different conclusions.

Figure 9: Share of OTC foreign exchange turnover: Europe vs US

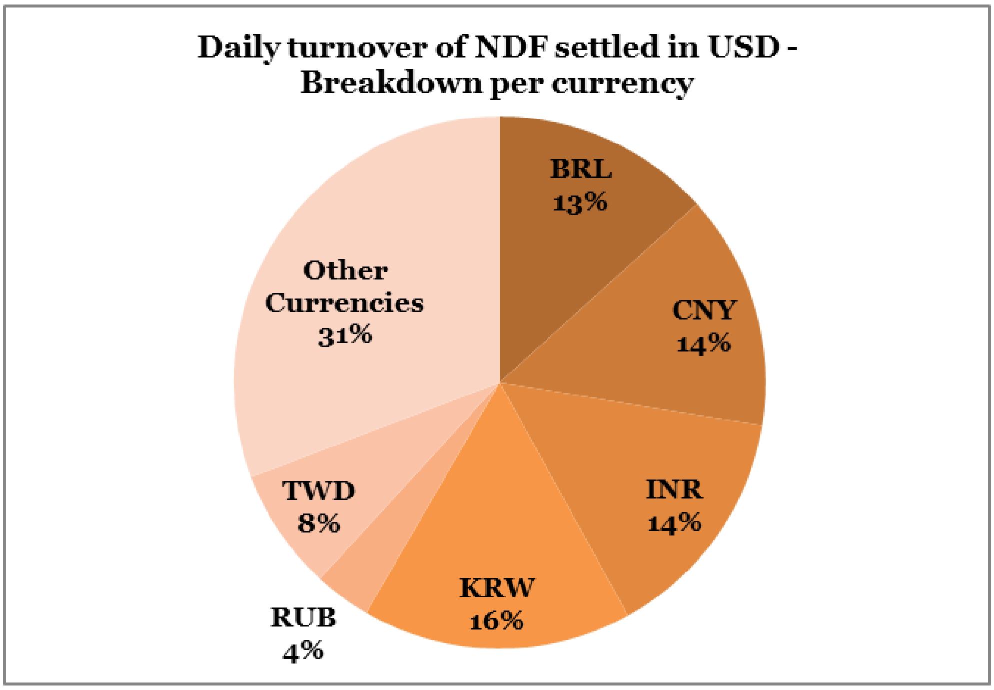


Source: BIS Quarterly Review March 2014 based on data as of April 2013 – The BIS data on NDF are only available in the 6 currencies presented above.

64. In the DTCC dataset, the average daily turnover across currencies amounts to 45 billion of USD, which represents roughly 35% of the amount reported by BIS. This comparison is made to have an insight on the significance of the DTCC sample, knowing that the two data samples do not cover the same time period (April 2013 for BIS, July 2014 for DTCC).

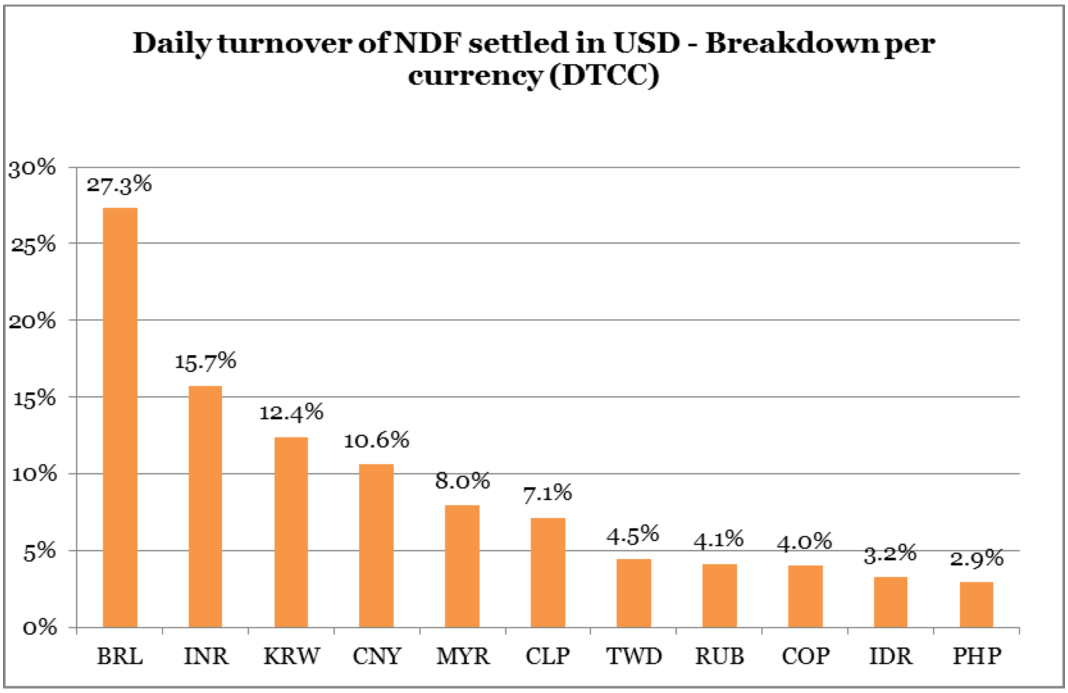
65. Further validating the use of both data sets to draw conclusions, a comparison between Figure 10 and Figure 11 shows that in the two datasets the 4 most traded currencies as measured by average daily turnover are identical (BRL, CNY, INR, KRW) and roughly in the same proportion and order with the exception of BRL, which accounts for 13% of the average daily turnover in the BIS dataset and 27% of the sample in the DTCC dataset. This is consistent with the finding that US counterparties are particularly active in the BRL market.

Figure 10: Daily turnover of NDFs settled in USD - Breakdown per currency (BIS)



Source: BIS Quarterly Review March 2014 based on data as of April 2013. The BIS data on NDF are only available in the 6 currencies presented above.

Figure 11: Daily turnover of NDF settled in USD - Breakdown per currency (DTCC)

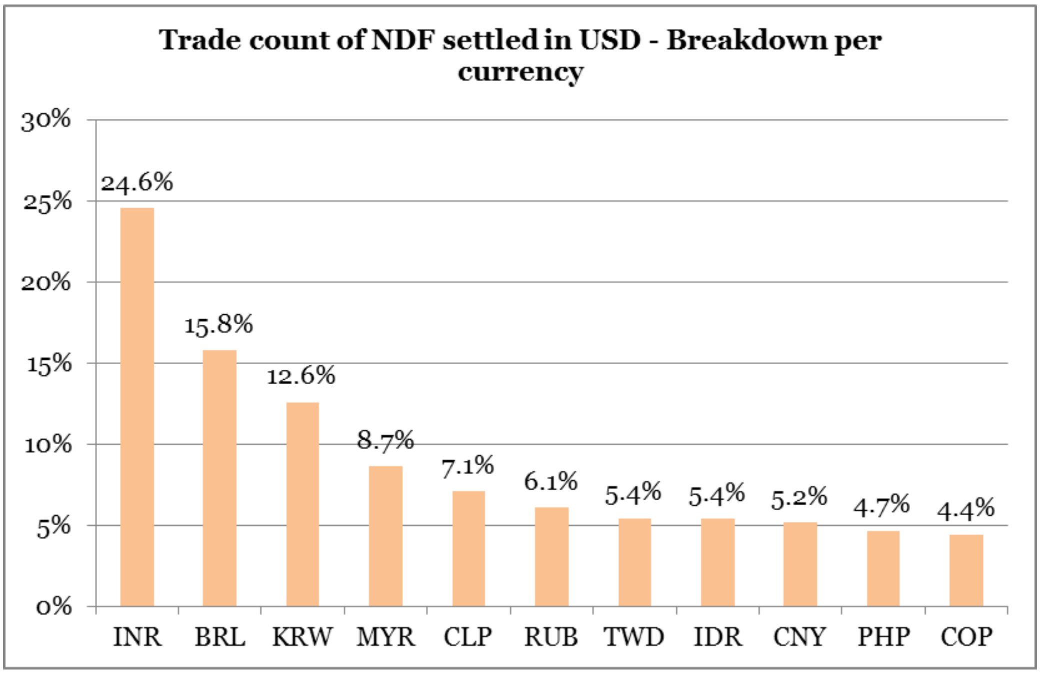


Source: DTCC, trades reported in July 2014

66. When the breakdown per currency is performed on trade count rather than turnover, the results are slightly different (Figure 12). INR is found to be the most frequently traded currencies with 24% of the

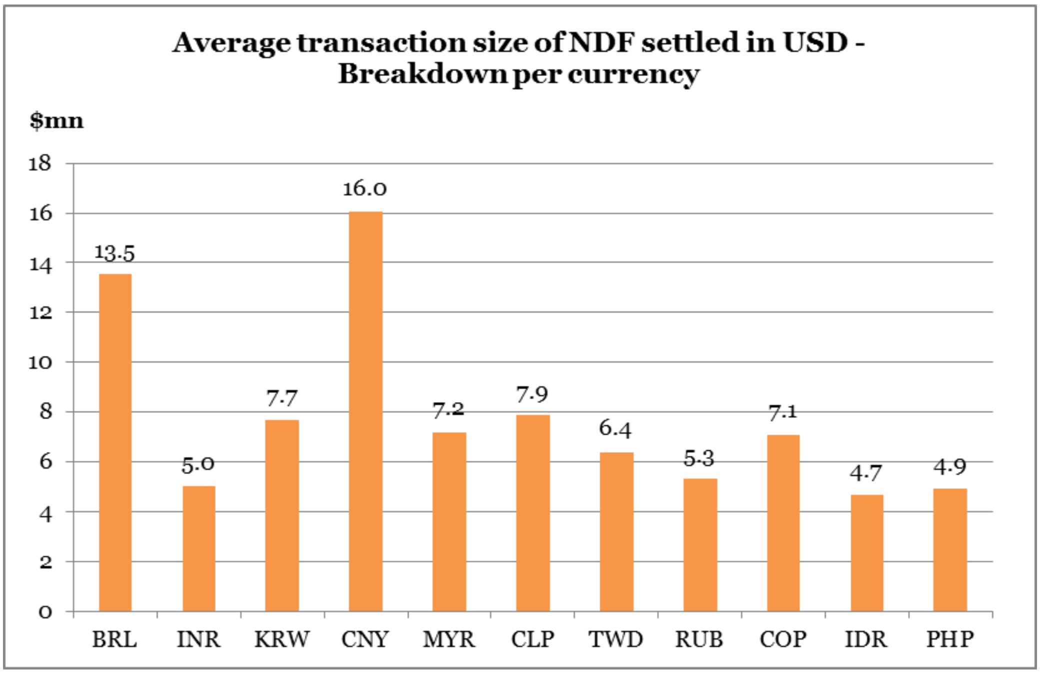
number of transactions, whereas CNY falls to the 10th position with 5.2% of the trade count, versus 10% of the average daily turnover. This is reflected by the average size of transactions (Figure 13), showing that CNY has the highest transaction size (16 million of USD) and INR the lowest (5 million of USD).

Figure 12: Trade count of NDF settled in USD - Breakdown per currency



Source: DTCC, trades reported in July 2014

Figure 13: Average transaction size of NDF settled in USD - Breakdown per currency



Source: DTCC, trades reported in July 2014

67. As a result, ESMA finds that although the level of liquidity is different from one currency to the other, it is sufficiently consistent across currencies to consider all of them for the clearing obligation in respect of the criteria 2(d) i.e. the number and value of the transactions. Indeed the analysis of the number and value of the transactions does not evidence that one currency in particular is trading in volumes that are significantly lower than the others, and the three currencies with the smallest market share (PHP, COP and IDR) still account altogether to circa 10% of the daily turnover.

Cleared volumes

68. The analysis of the NDF transactions cleared by LCH.Clearnet Ltd provides further information on the liquidity per currency. The dataset used by ESMA includes the following metrics on the 11 currency pairs that are offered for clearing:

- Outstanding notional amount as of 28 August 2014, in monetary value (metric 1) and in number of transactions (metric 2)
- Average daily turnover between 9 July and 28 August 2014, in monetary value (metric 3) and in number of transactions (metric 4)

69. The detailed results are shown in Table 5 and Table 6 below. The outstanding notional amounts range from less than a billion USD for CLP to more than 48 billion USD for CNY. As of 28 August 2014, the outstanding number of trades was highest for INR with 3,344 outstanding contracts, followed by CNY and KRW with respectively 2,294 and 1,430 outstanding contracts.

70. Looking at average daily turnover data in Table 6, the top three currencies in terms of liquidity are INR, KRW and CNY, covering roughly 75% of the total cleared turnover. At the other side of the distribution, the three less active currencies are CLP, RUB and COP which together amount to circa 2% of the total cleared turnover.

Table 5: Outstanding notional of NDF cleared at LCH.Clearnet Ltd

Currency	Currency Pair	(1) Outstanding notional ($bn)	Breakdown of (1)	(2) Outstanding number of trade	Breakdown of (2)
CNY	USD/CNY	48.5	37.8%	2,294	23.6%
INR	USD/INR	36.9	28.7%	3,344	34.4%
KRW	USD/KRW	14.7	11.4%	1,430	14.7%
TWD	USD/TWD	8.2	6.4%	514	5.3%
MYR	USD/MYR	6.1	4.7%	714	7.3%
IDR	USD/IDR	2.8	2.2%	404	4.2%
BRL	USD/BRL	6.0	4.7%	234	2.4%
PHP	USD/PHP	2.8	2.2%	570	5.9%
CLP	USD/CLP	1.2	1.0%	148	1.5%
RUB	USD/RUB	1.1	0.8%	50	0.5%
COP	USD/COP	0.2	0.1%	26	0.3%

Source: LCH.Clearnet Ltd, ESMA calculations. As of 28 August 2014. Not adjusted for double-counting.

Table 6: Daily turnover of NDF cleared at LCH.Clearnet Ltd

Currency	Currency Pair	(3) Daily Turnover ($mn)	Breakdown of (3)	(4) Daily Turnover (number of trades)	Breakdown of (4)
CNY	USD/CNY	873.6	25.0%	40	12.4%
INR	USD/INR	1,251.7	35.8%	135	41.9%
KRW	USD/KRW	452.7	13.0%	53	16.4%
TWD	USD/TWD	259.9	7.4%	18	5.6%
MYR	USD/MYR	189.1	5.4%	26	7.9%
IDR	USD/IDR	107.4	3.1%	17	5.1%
BRL	USD/BRL	193.7	5.5%	7	2.1%
PHP	USD/PHP	91.7	2.6%	20	6.1%
CLP	USD/CLP	32.9	0.9%	5	1.7%
RUB	USD/RUB	30.2	0.9%	1	0.4%
COP	USD/COP	9.4	0.3%	1	0.4%

Source: LCH.Clearnet Ltd, ESMA calculations. Transaction cleared between 9 July and 28 August 2014. Not adjusted for double-counting.

Comparison between cleared and non-cleared NDF volumes

71. For the currencies that are available in the BIS report, it is possible to establish a comparison between the cleared and the non-cleared volumes, as the data is available on the same metric (the average daily turnover measured in USD) both from BIS for the whole market and from LCH.Clearnet Ltd for the cleared market, although this comparison must be interpreted with prudence as the numbers are not available on the same time period.

72. As an order of magnitude, as shown in more detail in Table 7 below, the portion of cleared NDF market is currently limited, with a ratio close to 3% for the two most cleared currency (INR and CNY), while for the remaining 4 currencies (KRW, TWD, BRL and RUB), the percentage of cleared turnover is around 1%. It is reasonable to extrapolate this analysis to the entire set of the 11 currencies covered by this consultation paper to estimate their ratio of cleared trades, and consider it limited in the low single digits.

Table 7: comparison between cleared and non-cleared NDF turnover

Currency Pair	Daily turnover cleared at LCH.Clearnet Ltd ($mn)*	Daily turnover from BIS data ($mn)	% of turnover cleared at LCH.Clearnet Ltd
USD/CNY	436.8	17,083.1	2.6%
USD/INR	625.9	17,204.2	3.6%
USD/KRW	226.4	19,564.9	1.2%
USD/TWD	129.9	8,856.1	1.5%
USD/BRL	96.8	15,893.9	0.6%
USD/RUB	15.1	4,117.7	0.4%

Source: LCH.Clearnet Ltd (average daily turnover calculated between 9 July and 27 August 2014, adjusted for double counting), BIS data of April 2013.

Determination of the relevant maturities for the clearing obligation

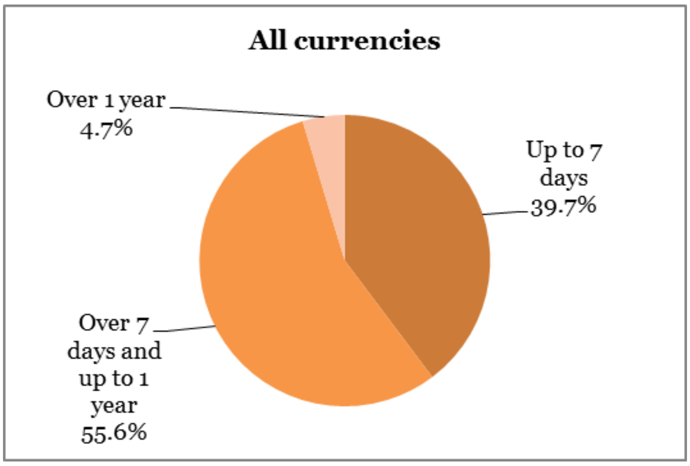
73. The CCP notification from LCH.Clearnet Ltd indicates that it clears NDF contracts with a tenor between 3 days and 2 years. In order to evaluate the liquidity of the NDF contracts as a function of the maturity, ESMA has used BIS data that provides a breakdown of the daily average turnover per currencies for the following three maturity buckets: up to 7 days, between 7 days and 1 year and over one year.

74. However this breakdown is only available for the Outright forward category as a whole, but not specifically for the NDF contracts within this category. In addition, within the 11 currencies covered by this consultation paper, only 6 are covered by the BIS data. Therefore ESMA has also based its analysis of the maturities on the aforementioned sample of data from DTCC.

Analysis of the BIS Data (FX Forward including NFD)

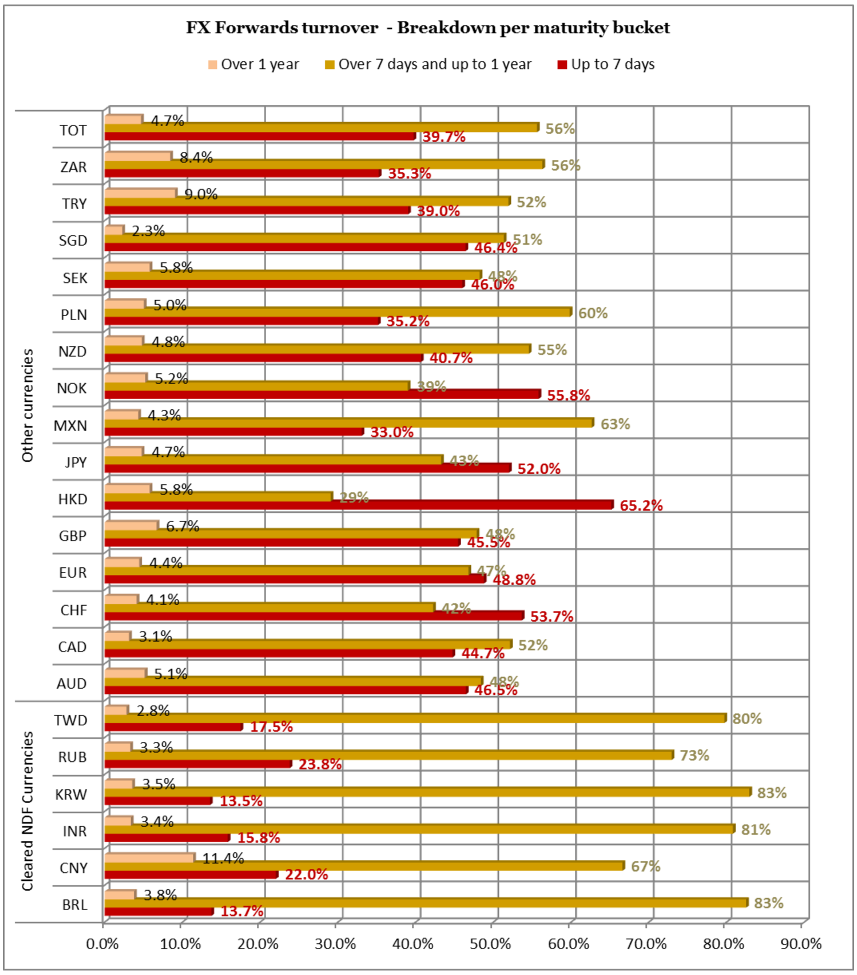
75. As presented in Figure 14 and Figure 15, it appears that for all currencies the turnover is concentrated for contracts with a maturity below 1 year. Indeed the average turnover across currencies of FX forward contracts with a maturity above 1 year is 4.7%.

Figure 14: FX forward – Breakdown per maturity bucket



Source: BIS Triennal Central Bank Survey, data of April 2013

Figure 15: FX forward – Breakdown per maturity bucket per currency



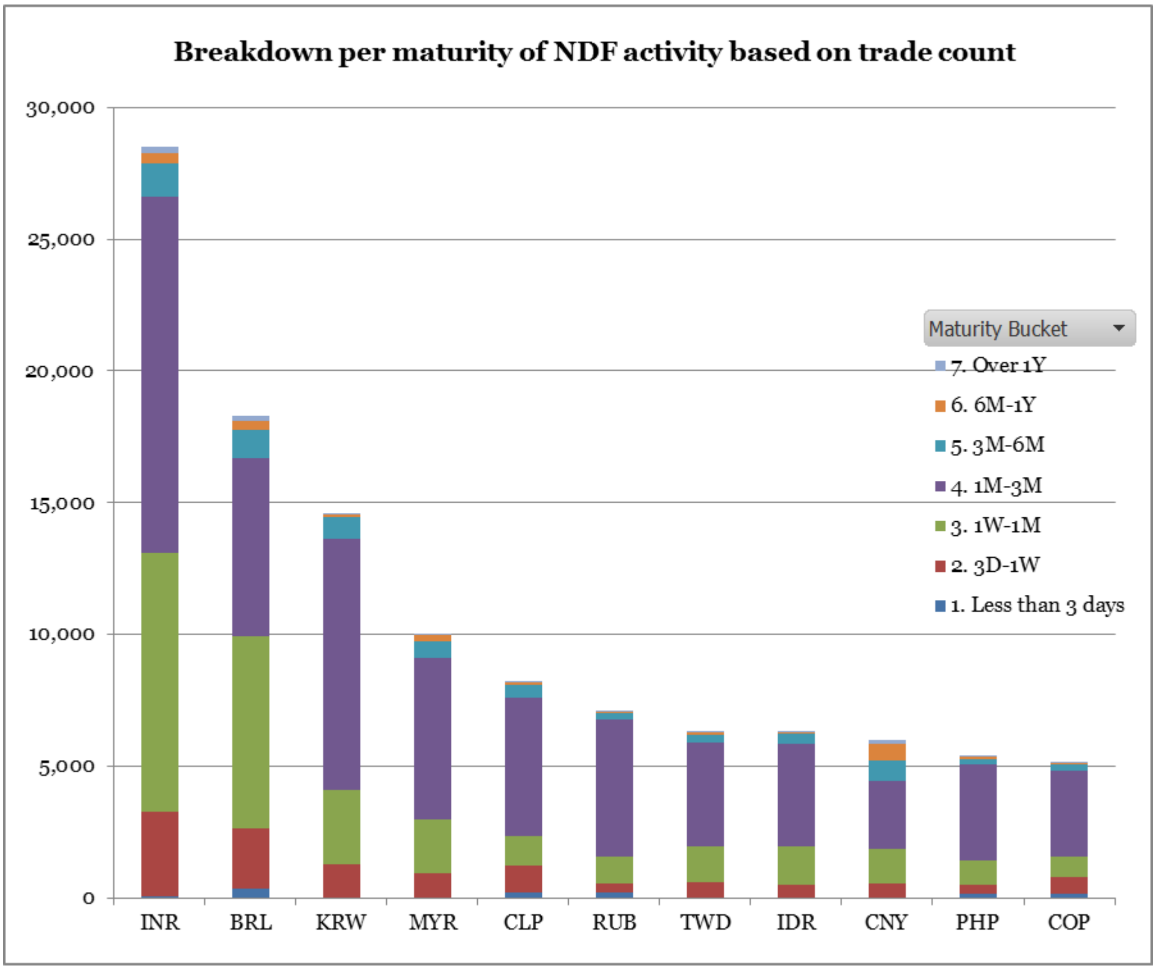
Source: BIS Triennal Central Bank Survey, data of April 2013

Analysis of the DTCC data (NDF only)

76. The DTCC dataset, which includes only NDF transactions, confirms that the liquidity is concentrated on the shortest maturities. For all currencies except CNY, 90% of the contracts in the sample have a maturity below 3 months, 98% of the contracts in the sample have a maturity below 6 months. The share of contracts with a maturity above one year is around 1%, again with the exception of CNY where it reaches 2.8% (Figure 16, Figure 17 and Table 8).

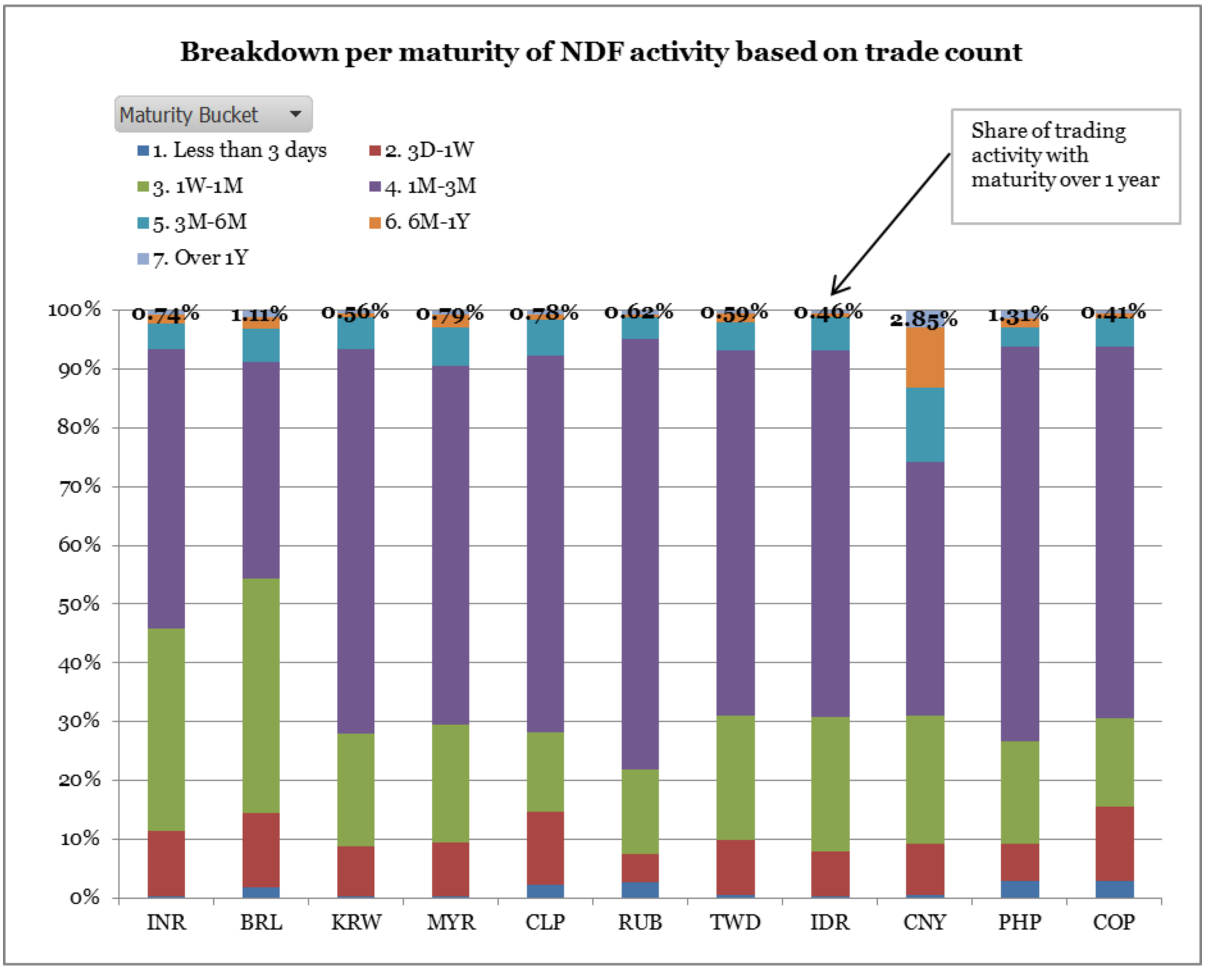
77. Table 8 shows that except for CNY, for which the share of the trades with a maturity between 6 months and 1 year is 10%, for all the other currencies the shares of the trades in the two longest maturity buckets are close to each other and range from 0.5% to 2% of the total.

Figure 16: Breakdown per maturity of NDF activity based on trade count (absolute)



Source: DTCC

Figure 17: Breakdown per maturity of NDF activity based on trade count (relative)



Source: DTCC

Table 8: Breakdown per maturity of NDF activity based on trade count

	1. Less than 3 days	2. 3D-1W	3. 1W-1M	4. 1M-3M	5. 3M-6M	6. 6M-1Y	7. Over 1Y	Grand Total
INR	0.29%	11.1%	34.5%	47.6%	4.3%	1.5%	0.7%	100.0%
BRL	1.85%	12.6%	39.8%	37.0%	5.8%	1.9%	1.1%	100.0%
KRW	0.18%	8.5%	19.2%	65.3%	5.4%	0.7%	0.6%	100.0%
MYR	0.22%	9.1%	20.2%	61.0%	6.6%	2.1%	0.8%	100.0%
CLP	2.27%	12.4%	13.6%	64.0%	6.2%	0.8%	0.8%	100.0%
RUB	2.69%	4.7%	14.5%	73.3%	3.8%	0.5%	0.6%	100.0%
TWD	0.41%	9.4%	21.2%	62.0%	4.8%	1.5%	0.6%	100.0%
IDR	0.29%	7.6%	22.9%	62.4%	5.7%	0.7%	0.5%	100.0%
CNY	0.45%	8.7%	22.0%	43.0%	12.8%	10.2%	2.8%	100.0%
PHP	2.99%	6.2%	17.4%	67.2%	3.3%	1.5%	1.3%	100.0%
COP	2.91%	12.5%	15.2%	63.1%	4.9%	0.9%	0.4%	100.0%
Grand Total	**1.06%**	**9.98%**	**25.80%**	**55.00%**	**5.52%**	**1.77%**	**0.87%**	**100.00%**

Source: DTCC

78. The concentration of liquidity in the short term is also evidenced by the number of days without trades (see Table 9) which rises above 30% after the 6 months maturity for 6 of the currencies of the sample (CLP, COP, IDR, PHP, RUB and TWD). In this respect however one need to keep in mind the limited size of the dataset, which includes only 20 business days.

Table 9: Percentage of days without trades per currency and maturity bucket

	BRL	CLP	CNY	COP	IDR	INR	KRW	MYR	PHP	RUB	TWD
Less than 3 days	30%	55%	55%	30%	70%	50%	65%	60%	35%	25%	60%
3D-7D	0%	5%	0%	5%	10%	0%	0%	0%	5%	5%	0%
1W-1M	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
1M-3M	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
3M-6M	0%	0%	0%	5%	5%	0%	0%	0%	0%	0%	0%
6M-9M	5%	30%	0%	35%	45%	0%	10%	0%	30%	45%	25%
9M-1Y	5%	25%	0%	60%	55%	0%	40%	5%	55%	70%	25%
Over 1Y	5%	30%	0%	50%	25%	5%	10%	5%	45%	35%	40%

Source: DTCC

79. Although there is evidence of a concentration of liquidity on the shortest maturities, the decision on the maturities to be included in the scope of the clearing obligation should also take into consideration other elements, such as the fact that, by construction, the longer dated contracts bear more risks than the short dated ones, hence having in mind the overall reduction of systemic risk there are incentives to include also the longer maturities.

80. In addition, limiting the maturities in scope of the clearing obligation could have the unintended effect of creating possible avoidance practice or fragmentation whereby counterparties would enter into contracts with a slightly higher maturity, although it is acknowledged that this could not be done on a systematic basis. In addition this risk could be naturally mitigated by the potential costs of maintaining two sets of NDF portfolios, one CCP-cleared for the short maturities and one bilateral for the long maturities, hence losing the netting benefits of a global cleared NDF portfolio.

81. At this stage it appears challenging to conclude that including maturities up to the 2 year maturity in the clearing obligation would create material risks for the CCPs. In addition, for the reasons expressed above, it does not seem appropriate to limit the scope to short-term maturities only. Therefore, ESMA is proposing a clearing obligation on the full range of maturities (3 days to 2 years).

3.2.3. Criteria 3: availability of the pricing information in NDF

82. In relation to the availability of fair, reliable and generally accepted pricing information in the relevant class of OTC derivative contracts, Article 7(3) of the RTS on OTC derivatives requires ESMA to take into consideration whether the information needed to accurately price the contracts within the relevant class of OTC derivative contracts is easily accessible to market participants on a reasonable commercial basis and whether it would continue to be easily accessible if the relevant class of OTC derivative contracts became subject to the clearing obligation.

83. The availability of pricing information varies from one currency to the next but FX prices are easily available on all the major platforms. FX contracts being executed almost exclusively OTC, there is no standardisation of pricing for the FX asset class, as opposed to OTC contracts that are also traded on regulated markets.

84. The price data used in LCH.Clearnet's ForexClear service is provided in real-time directly by clearing members. Price data received includes FX spot rates and swap points for specified tenors for all currency pairs. Price data is automatically snapped and cleaned by LCH.Clearnet at least every thirty minutes, up to a maximum frequency of once every five minutes, in order to ensure accurate and up-to-date prices are used for valuation and margining purposes. In addition, an alert is raised should the number of prices received fall below specific thresholds throughout the operational day. ForexClear's price

discovery methodology is closely aligned with the standard market survey procedures adopted by EMTA for determining a Back-Up Price.

3.2.4. Conclusion: NDF OTC derivative class to be subject to the clearing obligation

85. Following the review of the NDF contracts offered for clearing against the criteria set in EMIR and their analysis in light of the overarching principle of reduction of systemic risk, ESMA is of the view that the following NDF classes should be subject to the clearing obligation:

Table 10: Foreign-exchange non-deliverable forward class

Type	Currency Pair	Settlement Currency	Settlement Type	Maturity
NDF	BRL / USD Brazilian Real / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	CLP / USD Chilean Peso / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	CNY / USD Chinese Yuan / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	COP / USD Colombian Peso / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	IDR / USD Indonesian Rupiah / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	INR / USD Indian Rupee / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	KRW / USD Korean Won / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	MYR / USD Malaysian Ringgit / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	PHP / USD Philippine Peso / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	RUB / USD Russian Ruble / U.S. Dollar	USD	Cash settlement	3D-2Y
NDF	TWD / USD Taiwan Dollar / U.S. Dollar	USD	Cash settlement	3D-2Y

86. The determination of the phase in and the categories of counterparties to which the clearing obligation should apply are discussed in the next section of this consultation paper.

Question 3: In view of the criteria set in Article 5(4) of EMIR, do you consider that the determination of this class addresses appropriately the objective of reduction of the systemic risk associated to NDF derivatives?

Question 4: For the currency pairs proposed for the clearing obligation on the NDF class, do you consider there are risks to include longer maturities, up to the 2 year tenor?

4. Determination of the dates on which the obligation applies and the categories of counterparties

87. Article 5(2)(b) of EMIR requires ESMA to include in the draft technical standards on 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.

88. ESMA considers that there are strong arguments supporting the idea of adopting a phased-in implementation, as a number of market participants do not yet have in place any clearing arrangements. A phased-in implementation should encourage a timely and orderly application of the clearing obligation, avoiding "bottleneck" situations to the extent possible, i.e. situations in which an important number of counterparties look for an access to CCP at the same time, complicating the on-boarding process both for CCPs and for clearing members. It would also ensure that homogeneous groups of counterparties are subject to the same date of application, and that more time is granted to counterparties to which access to clearing is more difficult.

89. In defining the dates from which the clearing obligation applies and the categories of counterparties, ESMA shall take into consideration the criteria listed in Article 5(5) of EMIR:

    (a) the expected volume of the relevant class of OTC derivatives

    (b) whether more than one CCP already clear the same class

    (c) the ability of the CCP to handle the expected volume

    (d) the type and number of counterparties active in the market

    (e) the period of time a counterparty subject to the clearing obligation needs to put in place arrangements to clear

    (f) the risk management and the legal and operational capacity of the counterparties

90. ESMA has determined that the first three criteria are essentially relevant for the determination of the dates while the last three criteria are more relevant for defining the different categories of counterparties to which the clearing obligation applies.

91. Those criteria are analysed in the following paragraphs.

4.1. Analysis of the criteria relevant for the determination of the dates

92. In relation to criteria (c), as presented in paragraph 71 and Table 7 above, the current proportion of cleared NDF turnover is relatively limited. This could be explained by the fact that NDF clearing is relatively recent. In addition it is likely that some CCPs have developed a clearing offer for NDF in anticipation of a clearing obligation being imposed on those products, hence expecting that the demand for clearing would rise significantly after the regulatory requirements enter into force. It can therefore be expected that the CCPs have developed their clearing offer for NDF taking into account the expected volumes that the clearing obligation would bring.

93. In addition, the scalability of the CCPs is part of the authorisation process of CCPs under EMIR which in the case of LCH.Clearnet Ltd has taken place recently.

94. In relation to criteria (a), the current and expected volume of the class that is proposed for the clearing obligation in this paper have been analysed in detail in the section above. Therefore the following paragraphs focus on criteria (b) and add to this criteria an analysis of the clearing members.

4.1.1. Number of CCP per class

95. Although there is currently only one European CCP that is authorised to clear NDF in Europe (LCH.Clearnet Ltd), ESMA is aware that three additional CCPs (CME Clearing Europe, ICE Clearing Europe and Nasdaq OMX Clearing) have plans to start clearing NDF, covering some or more than the set of currencies envisaged in this paper. Therefore it is expected that before the clearing obligation takes effect, there will be 2 or more European CCPs available to clear the NDF classes proposed to be subject to the clearing obligation in this paper.

96. In addition, three CCPs established in third-countries are also clearing NDFs: CME Clearing in the US, Singapore Exchange Derivatives Clearing and OTC Clearing Hong Kong. The set of currencies is more limited for the latter two as they focus on Asian currencies (see Table 11). The three of them have applied to ESMA to be recognised as a third-country CCP in accordance with Article 25 of EMIR[24]. Upon recognition, those CCPs would be added to the list of CCPs that counterparties can use for the purpose of the clearing obligation.

[24] Details on the recognition process for third country CCPs is available at the following link: http://www.esma.europa.eu/page/Third-non-EU-countries

Table 11: CCPs with a live NDF clearing offer clearing some of the considered currency pairs, as of July 2014

Currency Pair	Total number of CCP	LCH.Clearnet Ltd	CME Clearing US	Singapore Exchange Derivatives Clearing[25]	OTC Clearing Hong Kong[26]
BRL / USD Brazilian Real / U.S. Dollar	2	1	1		
CLP / USD Chilean Peso / U.S. Dollar	2	1	1		
CNY / USD Chinese Yuan / U.S. Dollar	4	1	1	1	1
COP / USD Colombian Peso / U.S. Dollar	2	1	1		
IDR / USD Indonesian Rupiah / U.S. Dollar	3	1	1	1	
INR / USD Indian Rupee / U.S. Dollar	4	1	1	1	1
KRW / USD Korean Won / U.S. Dollar	4	1	1	1	1
MYR / USD Malaysian Ringgit / U.S. Dollar	3	1	1	1	
PHP / USD Philippine Peso / U.S. Dollar	3	1	1	1	
RUB / USD Russian Rubble / U.S. Dollar	2	1	1		
TWD / USD Taiwan Dollar / U.S. Dollar	4	1	1	1	1

[25] http://www.sgx.com/wps/portal/sgxweb/home/products/asiaclear/fxforwards/fxforwards/!ut/p/a1/jc_LCsIwFATQT8qkialdpvaVqkRbG2s20pUEtLoQv98IBZFi9e4unIEZYklLbN893Km7u2vfnV-_FceVBi8Cjmg-W8dQmzzTCV9S3cCDgweBlLzAAlGe0wyq2ZlEmpKlpfgvjy8n8Su_J3aSVHQA74qiSqBCDSnqiEGJERhv-ATaIPRAx3VtDN2mbAATK26Xp0VT7glXBJGI/dl5/d5/L0lDU0lKSWdrbUEhIS9JRFJBQUlpQ2dBek15cXchLzRKQ2hEb01kdEJnY2huQVZHRUEhL103X0xPMDRIMjQwOTg1TUIwSVBHRk9ENEsxT1AxMDE3MjY4_WCM&WCM_GLOBAL_CONTEXT=/wps/wcm/connect/sgx_en/home/products/asiaclear/fxforwards/fxforwards/specifications

[26] https://www.hkex.com.hk/eng/prod/clr/otcclrsett/otcedpoc/otcndf.htm

4.1.2. Number of clearing members per class

97. The market for cleared NDF is still in its first years of existence. NDF clearing started in 2011 in the US and Singapore, at CME and SGX respectively, closely followed by Europe where LCH.Clearnet Ltd launched its NDF clearing offer in 2012. This should be taken into consideration when evaluating the current number of clearing members in the CCPs that offer this asset class.

98. In order to evaluate the deployment of CCP clearing members in Europe, ESMA has collected in May 2014 information on the clearing members of CCPs in coordination with the national competent authorities responsible for their supervision. The purpose of this data collection was to gather information on the number of clearing members for each asset class and, among those clearing members, those offering client clearing and/or indirect client clearing.

99. It was possible to aggregate the clearing members per group and have a view not only at entity but also at group level. Indeed this is important because the choice of a clearing member by a counterparty would likely be done at group rather than entity level. Once a counterparty has selected a clearing member, the choice between one entity of the group or the other would mainly be driven by legal or practical reasons (e.g. the geographical location), but it is likely that the offer of the clearing member would be identical for various entities of the same group. From the point of view of a counterparty seeking to become the client of a clearing member, the number of "groups" clearing member is therefore more relevant that the number of entities.

100. LCH.Clearnet Ltd currently has 20 clearing members for NDF, and 17 at group level, of which 2 are offering client clearing. Therefore, the absolute number of clearing members is smaller for NDF than for the interest rate asset class (see the first consultation paper on the clearing obligation) and is roughly the same as the number of clearing member for the credit asset class (see the second consultation paper on the clearing obligation). Taking also into account the relative size of the various asset-classes (see Table 3), the number of clearing member for NDFs appears to be proportionate.

101. These clearing members are large international or European banks that although relatively limited in number, account for a significant portion of the traded volume and usually are the most relevant liquidity providers. Considered at the group level, they include most of the clearing members that, once a clearing offer develops in a market segment, offer it in their client clearing multi-asset class service. This is expected to be the case with this class too as the initial client clearing trades have demonstrated in Europe and abroad.

102. Based on the above, ESMA concludes that the number of clearing members seems sufficient to support the clearing obligation of the NDF classes proposed in the current determination.

Question 5: Do you have any comment on the analysis presented in Section 4.1?

4.2. Determination of the categories of counterparties (Criteria (d) to (f))

103. The approach regarding the categories of counterparties has been detailed in the first consultation papers on the clearing obligation, which cover interest rate derivatives and credit derivatives.

104. Taking into account the feedback received to the first consultation paper on IRS, ESMA has modified its proposal as explained in the Final Report that was submitted to the European Commission for endorsement.

105. In this Final Report proposing a clearing obligation on IRS, the categories of counterparties are as follows:

- Category 1: clearing members of one of the class subject to the clearing obligation, including the current NDF classes as well as the interest rate and credit classes proposed for the clearing obligation in previous RTS;
- Category 2: financial counterparties and AIFs that are NFC+, not included in Category 1, and which belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for the entry into force of the RTS is above EUR 8 billion;
- Category 3: financial counterparties and AIFs that are NFC+, not included in Category 1 nor in Category 2;
- Category 4: NFC+ not included in Category 1, Category 2 nor Category 3.

Cumulative classification for clearing members

106. According to the information on clearing members collected by ESMA, all the clearing members of LCH.Clearnet Ltd for NDF are also clearing members for at least one of the credit or interest rate classes that are proposed to be subject to the clearing obligation in the first two consultation papers on the clearing obligation.

107. The definition of the clearing member category implies that all the counterparties falling under Category 1 for NDF are also included in Category 1 for the interest rate classes, the credit classes, or both.

108. In addition, under this cumulative classification of clearing members, any counterparty already included in Category 1 for the IRS or the CDS classes is automatically classified in Category 1 for the NDF class, even if it is not a clearing member of LCH.Clearnet Ltd for NDF.

109. As explained in the Final Report on the clearing obligation for IRS, ESMA has sought to group in Category 1 the most sophisticated counterparties which already have a significant experience with CCP clearing. It is reasonable to assume that the level of sophistication of counterparties is appropriately assessed at the global level rather than at the level of the asset-class.

110. Therefore the categories of counterparties in the draft RTS on NDF follows the same approach as the one presented in the Final Report on the clearing obligation for IRS.

Date of assessment of the quantitative threshold for Category 2 and 3

111. In the Final Report on the clearing obligation for IRS, the definition of Category 2 and Category 3 depends on a quantitative threshold. For example, to be included in Category 2, the counterparty needs to belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for *[November 2014, December 2014 and January 2015]* is above EUR 8 billion.

112. As explained in the Final Report, the dates on which the notional amount of non-centrally cleared derivatives should be calculated (November 2014, December 2014 and January 2015) were chosen under the assumption that the RTS on the clearing obligation for IRS would enter into force during the month of February 2015. If this assumption was incorrect, the months of calculation would be adjusted so that they include the three months preceding the entry into force of the RTS, excluding the month of entry into force.

113. To reduce the compliance costs, ESMA is proposing that the same three months are used in the draft RTS on the clearing obligation for NDF. This means that counterparties will only need to do the calculation once to determine whether they belong to Category 2 or to Category 3. If they have determined that they belong to Category 2 for the IRS classes, then they should also belong to Category 2 for the NDF classes. The same approach should also be reflected in the draft RTS on CDS.

Question 6: Do you agree with the proposal to keep the same definition of the categories of counterparties for the NDF classes than for the credit and the interest rate classes? Please explain why and possible alternatives.

4.3. Determination of the dates from which the clearing obligation takes effect

114. The original approach regarding the dates from which the clearing obligation applies has been detailed in the first consultation papers on the clearing obligation for IRS and CDS. Following the public consultation on IRS classes the approach has been modified as presented in the Final Report on the clearing obligation on IRS. The phase-in periods for the IRS classes are 6 month for Category 1, 12 months for Category 2, 18 months for Category 3 and 3 years for Category 4.

115. At the time of publication of this consultation paper on NDF, there is one CCP authorised to clear NDFs in Europe, and three CCPs clearing NDFs outside Europe. It is likely that by the time the RTS on NDF enter into force, one or two more additional European CCPs are authorised to clear the same contracts and that third-country CCPs clearing them are recognised.

116. The NDF clearing offer of the European CCPs not being live yet, if the clearing obligation on NDF entered into force before another European CCP is authorised to clear them, counterparties already clearing NDF on a voluntary basis would not have to change CCP, since the only one with which they can voluntarily clear today is also the one with which they will have to clear under the mandatory clearing regime.

117. In addition, the general readiness of counterparties towards central clearing should have raised by the time the RTS on the clearing obligation for NDF enter into force, given that it would constitute the third wave of mandatory clearing in Europe, after IRS and CDS.

118. Therefore for Category 1 to Category 3, ESMA is proposing to use the same phase-in periods as the ones proposed in the Final Report on the clearing obligation for IRS.

119. Regarding Category 4 (NFC+ not included in the other categories), in line with the objective of the Commission to provide NFC+ with an extended period of time to meet the clearing obligation requirements, ESMA had proposed a 3 year phase-in period in the first two draft RTS on IRS and CDS. However this should not be understood as meaning that the 3 year phase-in should reset each time a new clearing obligation is established.

120. Indeed NFC+ benefiting from an extended three year period to establish clearing arrangements with CCPs for IRS and CDS, there should be no timing issues in establishing clearing arrangements for NDFs at the same time.

121. Therefore, to ensure proportionate treatment in comparison with the other counterparties subject to the clearing obligation, it is reasonable that the original 3 year phase-in period for NFC+ is respected for the first RTS on the clearing obligation, and shortened progressively for the subsequent RTS.

122. Hence for Category 4 ESMA is proposing to shorten the original phase-in by 3 months, i.e. establishing a phase-in period of 33 months. The 3 month period corresponds to the estimated period of time elapsing from the delivery to the Commission of the first draft RTS on IRS and the delivery to the Commission of this draft RTS on NDF.

123. To summarise, the phase-in periods for the NDF classes included in this draft RTS are as follows:

- Category 1 (Clearing members): 6 months after the entry into force of the RTS
- Category 2 (Non-Clearing members above the 8bn threshold): 12 months after the entry into force of the RTS
- Category 3 (Non-Clearing members below the 8bn threshold): 18 months after the entry into force of the RTS
- Category 4 (Non-Financial counterparties): 33 months after the entry into force of the RTS

Question 7: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

5. Remaining maturity and frontloading

124. The frontloading requirement as foreseen by Article 4(1)(b)(ii) of EMIR is the obligation to clear the OTC derivative contracts (pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation) that are entered into after the notification as referred to in Article 5(1) and before the date of application of the clearing obligation[27].

125. The approach regarding frontloading was detailed in the first consultation papers on the clearing obligation, covering interest rate derivatives and credit derivatives. It was then modified following the first consultation on IRS as presented in the Final Report on the clearing obligation for IRS.

126. For consistency reasons ESMA has built the current draft RTS on NDF on the basis of the draft RTS submitted to the European Commission for IRS without modification to the approach to frontloading and the minimum remaining maturity.

127. However the absolute levels of the minimum remaining maturities in the RTS on NDF were lowered to take into account the fact that the maximum maturity of the NDF classes is lower than the maximum maturity of the IRS class.

128. Hence the proposal included in this draft RTS for NDF is as follows:

- Minimum remaining maturity for contracts concluded with counterparties of Category 3: 2 years;
- Minimum remaining maturity for contracts concluded between counterparties of Category 1 and/or Category 2 during Period B (between the date of publication of the RTS in the Official Journal and the date of application of the clearing obligation for those counterparties): 3 months;
- Minimum remaining maturity for any other contract: 1 year and 6 months.

Question 8: Do you have comments on the minimum remaining maturities for NDF?

[27] In accordance with EMIR Article 4(1)(b), the clearing obligation applies to contracts entered into or novated either:
(i) on or after the date from which the clearing obligation takes effect; or
(ii) on or after notification as referred to in Article 5(1) but before the date from which the clearing obligation takes effect if the contracts have a remaining maturity determined by the Commission in accordance with Article 5(2)(c).

Annex I – Legislative mandate to develop technical standards

Article 5 of Regulation (EU) No 648/2012

Clearing obligation procedure

2. Within six months of receiving notification in accordance with paragraph 1 [of Article 5] or accomplishing a procedure for recognition set out in Article 25, ESMA shall, after conducting a public consultation and after consulting the ESRB and, where appropriate, the competent authorities of third countries, develop and submit to the Commission for endorsement draft regulatory technical standards specifying the following:

(a) the class of OTC derivatives that should be subject to the clearing obligation referred to in Article 4;

(b) 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

(c) the minimum remaining maturity of the OTC derivative contracts referred to in Article 4(1)(b)(ii).

Power is delegated to the Commission to adopt regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010.

Annex II - Draft Regulatory Technical Standards on the Clearing Obligation

COMMISSION DELEGATED REGULATION (EU) No …/..

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[28], and in particular Article 5(2) thereof,

Whereas:

(1) The European Securities and Markets Authority (ESMA) has been notified of the classes of foreign-exchange non-deliverable forwards OTC derivatives that a central counterparty (CCP) has been authorised to clear in accordance with Regulation (EU) No 648/2012. For each of those classes ESMA has assessed the criteria that are essential for 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 ones that should be subject to the clearing obligation in accordance with the procedure defined in Regulation (EU) No 648/2012.

(2) Following this process, the set of classes covered by this Regulation has been based on a selection of the classes which the CCP had been authorised to clear at the time of their authorisation. The selection covered only contracts that the authorised CCP have accepted for clearing at the time of authorisation.

(3) Regulation (EU) No 648/2012 considers in Recital (16) that, 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 OTC derivative subject to the clearing obligation should not encompass

28 OJ L 201, 27.7.2012, p. 1.

contracts concluded by covered bond issuers or covered pools, meeting the conditions established in this Regulation.

(4) Defining different categories of counterparties enables to schedule a series of successive dates when the clearing obligation should take effect for each respective category, and therefore to ensure an orderly and timely implementation.

(5) The categories of counterparties to which the clearing obligation applies should be defined in such a way that counterparties included in the same category are sufficiently similar with regards to the criteria set out in Regulation (EU) No 648/2012.

(6) The first category (Category 1) should include clearing members for the classes subject to the clearing obligation as they already have an experience with voluntary clearing and have already established the connections with at least one of the relevant CCPs, i.e. European CCPs authorised under Regulation (EU) No 648/2012 and third-country CCPs recognised under Regulation (EU) No 648/2012 to clear the classes subject to the clearing obligation. These clearing members are relatively limited in number but account for a significant portion of the traded volume and usually are the most relevant liquidity providers. In addition, they constitute the access point to clearing for the counterparties that will not become clearing members. Non-financial counterparties that are clearing members should also be included in Category 1 as their experience and preparation towards central clearing is comparable with that of financial counterparties included in Category 1.

(7) Category 1 should not capture counterparties which are clearing members only for classes not covered by the clearing obligation. In addition, to ensure legal certainty, this category should only encompass clearing members of CCPs authorised or recognised before this Regulation enters into force.

(8) The second and third categories (Category 2 and Category 3) should cover financial counterparties not included in Category 1. The criteria set in Regulation (EU) No 648/2012 to be taken into consideration when defining the categories of counterparties to which the clearing obligation applies refer to the number and type of active counterparties, to their risk management and to their legal and operational capacity. In this respect, since the financial counterparties not included in Category 1 are numerous and demonstrate heterogeneous levels of sophistication, they should be grouped in different categories. For that purpose, the level of activity in derivatives can be used as a proxy to differentiate the degree of sophistication between counterparties. When the level of activity exceeds the quantitative threshold defined in this Regulation, the counterparties should be included in Category 2; otherwise they should be included in Category 3. The quantitative threshold being aligned with the threshold agreed at international level related

to margin requirements for non-centrally cleared derivatives, this would enhance regulatory convergence and limit the compliance costs for counterparties.

(9) Certain alternative investment funds ("AIFs") are not captured by the definition of financial counterparties under Regulation (EU) No 648/2012 although they have a similar degree of sophistication than AIFs captured by this definition. Therefore AIFs classified as non-financial counterparties should be included in the same categories of counterparties than AIFs classified as financial counterparties.

(10) The fourth category (Category 4) should include non-financial counterparties not included in the other categories, because they have a limited experience with central clearing.

(11) The date on which the clearing obligation takes effect for counterparties in Category 1 should take into account the fact that they do not necessarily have a pre-existing CCP access for all the classes subject to the clearing obligation. A reasonable timeframe for them to prepare for clearing these additional classes should be from 3 to 6 months.

(12) The date on which the clearing obligation takes effect for counterparties in Category 2 and Category 3 should take into account the fact that most of them will get access to CCP by becoming client or indirect client of a clearing member, which may require between 12 and 18 months depending on the level of sophistication and preparation of the counterparties.

(13) The date on which the clearing obligation takes effect for counterparties in Category 4 should take into account their legal and operational capacity, and the fact that most of them have a limited experience with central clearing.

(14) Regulation (EU) No 648/2012 imposes an obligation to clear a posteriori some 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 (the frontloading obligation). The objectives of the frontloading obligation as per Recital (20) of Regulation (EU) No 648/2012 should be achieved by the definition of appropriate minimum remaining maturities.

(15) The objective of the frontloading obligation is to ensure a uniform and coherent application of Regulation (EU) No 648/2012 as well as a level playing field for market participants when a class of OTC derivatives is declared subject to the clearing obligation, without undermining the overarching objective of the clearing obligation to reduce systemic risk. The application of the frontloading requirement needs to be adjusted in order to allow the achievement of its objectives by determining the minimum remaining maturity of the contracts that should be subject to frontloading and to avoid the negative effects it may have on the market.

(16) The frontloading obligation is directly linked to the date of application of the clearing obligation for each category of counterparties. The longer the period of time from the date of publication of this Regulation in the Official Journal to the date of application of the clearing obligation for a given category of counterparties, the longer the frontloading obligation applies. Therefore the minimum remaining maturity could be different for the different categories of counterparties. In this respect, it is to be noted that counterparties in Category 3 are less sophisticated and would have more difficulties to comply with the frontloading obligation.

(17) The frontloading requirement should not apply to contracts concluded before counterparties could reasonably foresee that those contracts would be subject to clearing. In this respect, before this Regulation is published in the Official Journal of the European Union, counterparties cannot foresee whether the OTC derivative contracts they conclude would be subject to the clearing obligation, on the date of application of the clearing obligation, and the CCPs that will be authorised or recognised to clear the notified classes. This uncertainty has a significant impact on the capacity of market participants to accurately price the OTC derivative contracts they enter into until they know whether they pertain to the derivative classes that will be subject to clearing. This is particularly important due to the fact that a contract that is centrally cleared is subject to a different collateral regime than a contract that is not.

(18) Therefore, to preserve the orderly functioning and the stability of the market as envisaged in Regulation (EU) No 648/2012, as well as a level playing field between counterparties entering into contracts before and after this Regulation is published in the Official Journal of the European Union, the minimum remaining maturity applicable to contracts concluded before the date of publication of this Regulation in the Official Journal should be set at a level that excludes any OTC derivative contract concluded before the publication of this Regulation in the Official Journal of the European Union from the frontloading obligation, for any category of counterparties.

(19) However, contracts concluded after the publication of this Regulation in the Official Journal of the European Union should be subject to the clearing obligation unless they are not significantly relevant for systemic risk and could jeopardise at the same time any other of the objectives of frontloading.

(20) Counterparty credit risk associated to contracts with longer maturities remains in the market for a longer period. Therefore, the minimum remaining maturities should be set at a level ensuring that only contracts with remaining maturities of no more than a few months are exempted from the frontloading obligation to avoid a disproportionate burden on counterparties to those transactions. Those short-dated contracts represent a relatively small portion of the total market and will mature shortly. As a result, the frontloading

obligation would address the largest share of the trading volume and the associated systemic risk.

(21) However, counterparties in Category 3 are specific in several aspects in relation to the frontloading obligation. First, given that the counterparties in Category 3 are defined as those below a quantitative threshold linked to the level of activity of the counterparties in OTC derivatives, counterparties in Category 3 should be the ones with the smallest portfolios of non-centrally cleared derivative contracts, hence bearing a relatively small share of the portfolios of non-centrally cleared derivative contracts, hence bearing a relatively small share of the overall systemic risk.

(22) Secondly, the prices of the OTC derivative contracts subject to the frontloading obligation will have to incorporate forward-clearing which will only take place several months after execution, requiring pricing model changes and amendments to the contracts documentation. This could limit the ability of counterparties to hedge their market risk adequately and impact the functioning of the market and financial stability, especially for counterparties in Category 3 as they are the least sophisticated of the categories subject to the frontloading obligation (counterparties in Category 4, being non-financial counterparties, should not be subject to the frontloading obligation as they should only clear contracts concluded after the date on which they become subject to the clearing obligation, i.e. once the frontloading obligation is no longer applicable).

(23) On the basis of the above, and in order to achieve an adequate balance between the risk mitigation concerns of the clearing obligation and the level playing field on one side and the coherent and uniform application of Regulation (EU) No 648/2012 on the other side, the minimum remaining maturities applicable to counterparties in Category 3 should be set at a level that excludes those counterparties from the frontloading obligation.

(24) The remaining maturity of a contract to be compared to the minimum remaining maturity should be the one as of the date of application of the clearing obligation for this contract.

(25) This Regulation is based on the draft regulatory technical standards submitted by the European Securities and Markets Authority to the Commission.

(26) The European Securities and Markets Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Security and Markets Stakeholder Group established by Article 37 of Regulation (EU) No 1095/2010.

HAS ADOPTED THIS REGULATION:

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

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

2. The classes of OTC derivatives listed in Annex I shall not include contracts associated to covered bonds when such contracts satisfy all of the following conditions:

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

   (b) the derivative counterparty ranks at least pari-passu with the covered bond holders except when the derivative counterparty (i) is the defaulting or the affected party, or (ii) waives the pari-passu rank;

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

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

   (e) the covered bond to which they are associated meets the requirements of Article 129 of Regulation (EU) No 575/2013; and

   (f) the covered bond to which they are associated is subject to a regulatory collateralisation requirement of at least 102%.

Article 2 – Categories of counterparties to which the clearing obligation applies

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

   (a) Category 1 covers 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 subject to the clearing obligation, of at least one of the CCPs authorised or recognised before that date in accordance with Regulation (EU) No 648/2012 to clear at least one of those classes;

   (b) Category 2 covers counterparties not included in Category 1 which belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for *[November 2014, December 2014 and January 2015]* is above EUR 8 billion and which are:

      (i) financial counterparties; or

      (ii) alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU that are non-financial counterparties meeting the conditions referred to in Article 10(1)(b) of Regulation (EU) No 648/2012.

(c) Category 3 covers counterparties not included in Category 1 or Category 2 which are:

(i) financial counterparties; or

(ii) alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU that are non-financial counterparties meeting the conditions referred to in Article 10(1)(b) of Regulation (EU) No 648/2012.

(d) Category 4 covers non-financial counterparties meeting the conditions referred to in Article 10(1)(b) of Regulation (EU) No 648/2012 and that are not included in Category 1, Category 2 or Category 3.

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

Article 3 – Dates from which the clearing obligation takes effect

1. For the classes of OTC derivatives listed 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 33 months 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 as defined in Article 2, the date from which the clearing obligation takes effect for that contract shall be the latest of the two.

Article 4 – Minimum remaining maturity

1. For financial counterparties in Category 1 or Category 2 as defined in Article 2, the minimum remaining maturity referred to in Article 4(1)(b)(ii) of Regulation (EU) No 648/2012 shall be:

(a) 1 year and 6 months for contracts entered into or novated before the date of publication of this Regulation in the Official Journal that belong to the classes of Table 1 of Annex I;

(b) 3 months for OTC derivative contracts entered into or novated on or after the date of publication of this Regulation in the Official Journal that belong to the classes of Table 1 of Annex I.

2. For financial counterparties in Category 3 as defined in Article 2, the minimum remaining maturity referred to in Article 4(1)(b)(ii) of Regulation (EU) No 648/2012 shall be 2 years for contracts that belong to the classes of Table 1 of Annex I.

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]

[For the Commission
On behalf of the President]

[Position]

Annex I

Foreign-Exchange OTC derivatives classes subject to the clearing obligation

Table 1: Non-deliverable forward classes

Id	Type	Currency Pair	Settlement Currency	Settlement Type	Maturity
C.1.1	NDF	BRL / USD Brazilian Real / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.2	NDF	CLP / USD Chilean Peso / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.3	NDF	CNY / USD Chinese Yuan / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.4	NDF	COP / USD Colombian Peso / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.5	NDF	IDR / USD Indonesian Rupiah / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.6	NDF	INR / USD Indian Rupee / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.7	NDF	KRW / USD Korean Won / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.8	NDF	MYR / USD Malaysian Ringgit / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.9	NDF	PHP / USD Philippine Peso / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.10	NDF	RUB / USD Russian Ruble / U.S. Dollar	USD	Cash settlement	3D-2Y
C.1.11	NDF	TWD / USD Taiwan Dollar / U.S. Dollar	USD	Cash settlement	3D-2Y

Question 9: Please indicate your comments on the draft RTS other than those already made in the previous questions.

Annex III – Impact assessment

1. Introduction

129. This impact assessment was conducted by ESMA while developing the regulatory technical standards ("RTS") on the clearing obligation, as foreseen by the clearing obligation procedure of Regulation (EU) 648/2012 (EMIR).

130. In accordance with the clearing obligation procedure, within 6 months of being notified that a CCP has been authorised to clear a class of OTC derivatives, ESMA shall develop and submit to the European Commission for endorsement draft RTS specifying:

(a) the class of OTC derivatives that should be subject to the clearing obligation

(b) 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

(c) the minimum remaining maturity of the OTC derivative contracts referred to in Article 4(1)(b)(ii) of EMIR (i.e. the contracts subject to frontloading).

131. It should be noted that this impact assessment only covers the technical options under the specific mandate of ESMA in respect of the clearing obligation, given that an impact assessment covering the general aspects of the clearing obligation has already been performed by the European Commission as part of the impact assessment of EMIR.

132. This impact assessment follows the publication of a discussion paper on the clearing obligation published on 12 July 2013[29] and incorporates feedbacks and comments received from stakeholders.

133. This impact assessment also follows the publication on 11 July 2014 of the first two consultation papers on the clearing obligation on interest rate derivative classes[30] and credit derivative classes[31] respectively as well as the publication of the first Final Report on the clearing obligation[32], which included an impact assessment not duplicated here.

134. Only the policy choices that were considered by ESMA, when developing the technical standard on the clearing obligation, that are above and beyond the ones addressed in the first papers are addressed here. They relate to the best way to ensure a smooth and appropriately phased-in implementation of the clearing obligation.

135. The determination of the classes of OTC derivatives that should be subject to the clearing obligation has been presented both in quantitative and qualitative terms in the explanatory part of the consultation paper and is therefore not repeated in the impact assessment.

136. The impact assessment presented in the tables below is of qualitative nature only, and the Final Report to be submitted to the European Commission after the consultation period should include elements of a more quantitative nature including, when possible, references to the monetary value

[29] http://www.esma.europa.eu/content/Clearing-Obligation-under-EMIR
[30] 2014-ESMA-799 Consultation Paper, Clearing Obligation under EMIR no. 1 published on 11 July 2014
[31] 2014-ESMA-800 Consultation Paper, Clearing Obligation under EMIR no. 2 published on 11 July 2014
[32] 2014-ESMA-1184 Final Report, Clearing Obligation under EMIR no. 1 published on 1 October 2014

attached to the identified costs and benefits. Where relevant, respondents to this consultation paper are invited to justify their answers by providing supporting evidences of a quantitative nature that may feed into the cost-benefit analysis.

2. Definition of the categories of counterparties

Policy Objective	**Determine the categories of counterparties to which different phase-in would apply**
Option 1	The categories of counterparties for the OTC NDF classes are defined in the same way as the categories of counterparties for the other OTC derivative classes to be subject to the clearing obligation (as presented in the Final Report No.1 on the clearing obligation)
Option 2	The categories of counterparties for the OTC NDF classes are defined in a different way than the categories of counterparties for the other OTC derivative classes to be subject to the clearing obligation (as presented in the Final Report No.1 on the clearing obligation)
Preferred Option	**Option 1**

Option 1	**The categories of counterparties for the OTC NDF classes are defined in the same way as the categories of counterparties for the other OTC derivative classes to be subject to the clearing obligation (as presented in the Final Report No.1 on the clearing obligation)**
	Qualitative description
Benefits	The way in which the categories of counterparties are defined for the OTC interest rate derivatives introduces some compliance costs related to the classification of counterparties. The approach of keeping the definition of the categories of counterparties in the RTS unchanged is the simplest one, as the vast majority of counterparties will thus be familiar with the criteria defining their status and the status of their counterparties, with only a minority of counterparties possibly being in a different category for the new class+. Counterparties will be able to leverage on the classification work already accomplished in relation with the previous clearing obligation determination. Notably, this is the same proposal as for the categorisation of counterparties for the purpose of the OTC credit derivative classes to be subject to the clearing obligation (as presented in the consultation paper on the clearing obligation no.2 and which responses are being reviewed).
Costs to regulator - *One-off*[33]	This is the baseline scenario and it is not expected to add specific costs to regulators or counterparties.
Compliance costs - *One-off*	This is the baseline scenario and it is not expected to add specific costs to regulators or counterparties.

Option 2	**The categories of counterparties for the OTC NDF classes are defined in the same way as the categories of counterparties for the other OTC derivative classes to be subject to the clearing obligation (as presented in the Final Report No.1 on the clearing obligation)**
	Qualitative description

[33] On-going costs are irrelevant with respect to phase-in.

Benefits	This option, which is more complex, adds the flexibility to better take into account the nature of the counterparties that are specifically active in the OTC NDF market.
Costs to regulator - *One-off*[34]	The costs would depend on the way such a new classification would be framed. In any case, this option would necessitate another round of counterparty classification on top of the one already performed in connection with the clearing obligation on OTC interest rate derivative market. This would necessarily add costs to regulators and counterparties.
Compliance costs - *One-off*	The costs would depend on the way such a new classification would be framed. In any case, this option would necessitate another round of counterparty classification on top of the one already performed in connection with the clearing obligation on OTC interest rate derivative market. This would necessarily add costs to regulators and counterparties.

3. Scope of clearing members to be included in Category 1

Policy Objective	**Determine the clearing members that are included in category 1**
Option 1	Category 1 includes only the clearing members in NDFs of the CCP authorised to clear this class (definition *per asset class*)
Option 2	Category 1 includes counterparties that are clearing members in any class subject to the clearing obligation (including IRS and CDS classes defined in different RTS) (cumulative definition).
Preferred Option	**Option 2**

Option 1	**Category 1 includes only the clearing members in NDFs of the CCP authorised to clear this class (definition *per asset class*)**
	Qualitative description
Benefits	The shortest phase-in is applicable only to clearing members clearing NDFs. As the clearing infrastructure from execution to CCP reporting can be for some part specific to the asset class, for instance certain middleware platforms or CCP APIs are only available for one asset class, this categorisation ensures that only clearing members with a high level of integration for that asset class are included.
Costs to regulator - *One-off*[35]	This is not expected to add specific costs to regulators.
Compliance costs - *One-off*	This option would result in additional classification costs for counterparties because all the counterparties would need to reassess the entire population of clearing members after each RTS to verify whether or not they belong to Category 1.

Option 2	**Category 1 includes counterparties that are clearing members in any class subject to the clearing obligation (including IRS and CDS classes defined in different RTS) (cumulative definition).**
	Qualitative description
Benefits	This approach allows for a bigger Category 1, composed of counterparties that all have experience in connecting to CCPs or with a high level of sophistication to be

[34] On-going costs are irrelevant with respect to phase-in.
[35] On-going costs are irrelevant with respect to phase-in.

	able to establish client clearing arrangements with one of the clearing members for this class+. With more counterparties included in the group subject to the shortest phase-in period, the objective of reduction of systemic risks is achieved at a better pace.
Costs to regulator - *One-off*[36]	This is not expected to add specific costs to regulators.
Compliance costs - *One-off*	This option would result in less classification costs for counterparties than option 1 because once a counterparty is classified in Category 1 for one asset-class, it necessarily stays in Category 1 for all the subsequent asset classes.

Question 10: Please indicate your comments on the Impact Assessment.

[36] On-going costs are irrelevant with respect to phase-in.