

# EMIR – Gearing up for Clearing – PART II

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**SLAUGHTER AND MAY**

# Contents

EMIR – GEARING UP FOR CLEARING – PART II	01
Annex 1 EMIR obligations on CCPs and the CCP Rulebook	09
Annex 2 Segregation of client assets and account structures	14
Annex 3 Updates to “EMIR – Gearing Up for Clearing – PART I”	16

# EMIR – GEARING UP FOR CLEARING – PART II

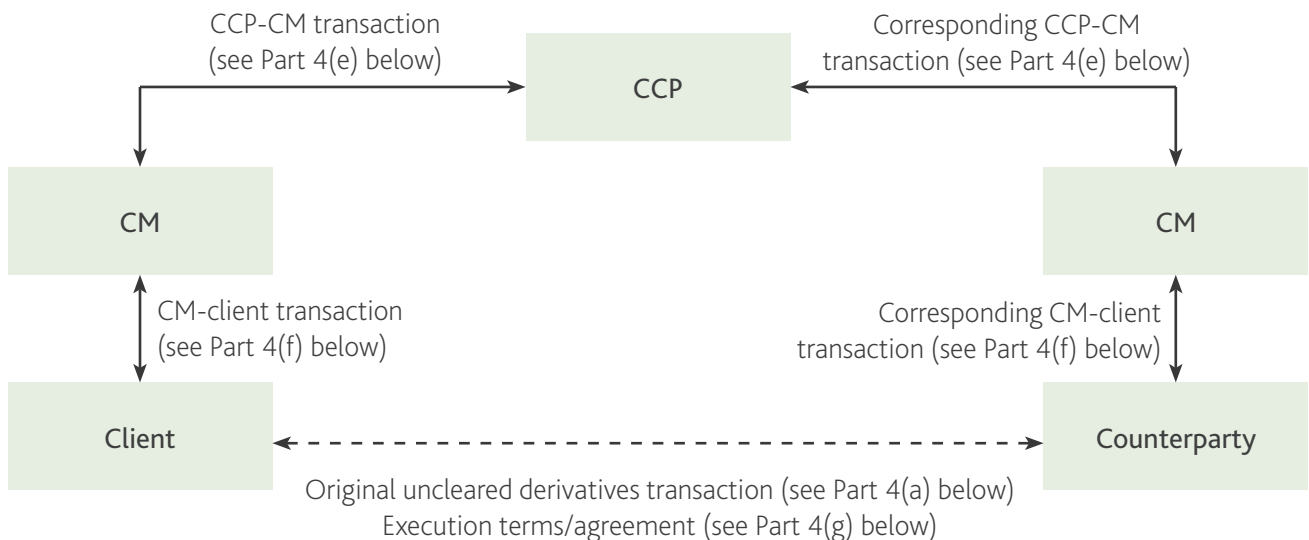
With mandatory central clearing of OTC derivative transactions through central counterparties (“CCPs”) now looking likely to begin in early 2016, according to implementing rules being prepared by the European Commission, derivatives counterparties who have clearing obligations under the European Market Infrastructure Regulation (EU 648/2012) (“EMIR”) should consider the steps which they will have to take to comply with those clearing obligations, in particular, whether it will be necessary for them to enter into client clearing arrangements with a clearing member (a “CM”) of a CCP in order to clear transactions subject to the clearing obligation. As a follow on from our client briefing “EMIR – Gearing Up for Clearing – PART I”, which considered the clearing obligations imposed by EMIR, this briefing is intended to provide an overview of the structure of client clearing, together with key points for clients to consider when choosing their CMs. Annex 3 (updates to “EMIR - Gearing Up for Clearing - PART I”) also contains some useful updates to our first briefing. This briefing will be followed by a separate briefing covering the client clearing documentation between a client and its CM and legal and practical issues which clients should consider in relation to client clearing.

## 1. THE CLIENT CLEARING STRUCTURE

### Non-cleared transaction



### Cleared transaction



## 2. THE MOVE TO CENTRAL CLEARING

EMIR requires certain OTC derivative transactions to be centrally cleared through CCPs (see “EMIR – Gearing up for Clearing – PART I” for further details). Central clearing involves the interposition of a third party (the CCP), directly or indirectly between the two counterparties to an OTC derivative transaction, with the CCP assuming the parties’ rights and obligations with respect to each other.

## 3. DIRECT OR INDIRECT ACCESS TO THE CCP?

A counterparty has to be a member of a CCP in order to access the clearing services offered by that CCP directly. Due to the stringent membership requirements and other commitments which membership of a CCP entails, many users of derivatives which are subject to the mandatory clearing obligation, including certain banks and other financial counterparties as well as non-financial end users, will not be CMs of CCPs. Such users will have to access CCPs indirectly by entering into client clearing arrangements (“**CCAs**”) with CMs.

*See “EMIR obligations on CCPs and the CCP Rulebook” in Annex 1 for further details of the requirements for membership of a CCP.*

## 4. THE CCP CLEARING PROCESS

Where transactions are centrally cleared through a CCP, this process will generally entail the following stages:

- (a) the two counterparties will execute the transaction bilaterally. The transaction will typically be governed by a master agreement such as the 2002 master agreement published by the International Swaps and Derivatives Association, Inc. (“**ISDA**”);
- (b) one or both of the parties will submit the transaction details to the CCP (via an Approved Trade Source System such as Markit Wire, Bloomberg or Tradeweb). The parties will, where relevant, nominate their CMs. Where a counterparty is a CM of a CCP, it may clear its own transactions directly. Where a counterparty is not a CM, it will clear indirectly through its CM;
- (c) the CCP will send a request for acceptance to the parties’ CMs (if the parties are clearing indirectly);
- (d) the parties’ respective CMs then accept the transaction;
- (e) so long as any other conditions imposed by the CCP are satisfied (such as concentration limits), the CCP accepts the transaction for clearing by registering a cleared contract with each of the two CMs. The CCP assumes the opposite position in these contracts, with one being the mirror image of the other (each a “**CCP-CM transaction**”);

(f) under the terms of the CCA, this will create a matching “back-to-back” transaction between the CM and its client (the “**CM-client transaction**”); and

(g) once this process is complete, the original bilateral transaction will terminate under the terms of the execution agreement or execution terms which the counterparties have entered into as part of their clearing arrangements.

## 5. RELATIONSHIP BETWEEN CCP AND CMS

For counterparties obliged to clear derivatives transactions and who therefore may be clients or potential clients of CMs of CCPs (“**clients**”), it is important to understand the relationship between CCPs and their CMs, since this determines many aspects of the relationship of clients with their CM and the form and content of the client clearing documentation.

Under the European clearing model, the relationship between the CCP and its CMs in relation to each cleared transaction is a principal-to-principal relationship. Each transaction is novated to the CCP and, as mentioned above, the CCP is interposed between the original counterparties or, where they are clearing indirectly, the CMs of these two counterparties who in turn have back-to-back transactions with the two original counterparties. The original transaction ceases to exist and the original counterparties no longer owe any obligations to or have any rights against each other. Their rights are against the CCP (or, where a client is clearing indirectly, against their own CM). The CCP should have a “matched book” of corresponding CCP-CM transactions – a position with one counterparty should always be offset by an opposite position with another counterparty. This “matched book” should prevent the CCP from having any net market risk in the ordinary course of business.

As a result of this model, the CCP’s obligations (the primary one being to fulfil its obligations under the relevant transaction as counterparty to each of its members) are owed only to its members (who are also its contractual counterparties). The benefits of performance by the CCP are typically conferred only upon CMs and the rights of third parties, including clients, are generally specifically excluded<sup>1</sup>. Therefore, although CMs may have direct rights against CCPs, clients generally do not and have no direct contractual relationship with the CCP.

*For further details of the relationship between a CCP and its CMs, including the CCP’s rules, regulations and procedures (the “**CCP Rulebook**”) and the requirements which the CCP Rulebook imposes upon CMs, see “EMIR obligations on CCPs and the CCP Rulebook” in Annex 1.*

<sup>1</sup> See, for instance, Regulation 2(a) of LCH.Clearnet Ltd’s *Clearing House: General Regulations* (February 2015).

## 6. RELATIONSHIP BETWEEN CMS AND CLIENTS

The relationship between a CM and its client is also a principal-to-principal relationship and will be governed primarily by the CCA between the CM and the client. These will set out the terms on which the CM agrees to stand between the CCP and the client for the purpose of clearing the client's transactions. Key issues which the CCA will cover include, among other things:

- (a) the CM's obligation to accept trades for clearing;
- (b) conditions for pre-default porting;
- (c) pass-through to the client of changes to the corresponding CCP-CM transaction or the CCP Rulebook; and
- (d) termination following default by the client, the CM or the CCP.

The CCA will also include collateral arrangements whereby the client will provide collateral to the CM to enable the CM to meet its obligations to provide collateral to the CCP. The CM may seek to impose the collateral obligations it owes to the CCP in relation to the CCP-CM transaction as the minimum requirements under the collateral arrangements in relation to the CM-client transaction whilst retaining the flexibility to require additional collateral.

A major point for clients to note is that their relationship with their CM is to a very large extent affected by the relationship between the CCP and its CMs. CMs will generally seek to ensure that their CM-client contracts mirror substantially their CCP-CM contracts and that any changes to the CCP Rulebook or transactions with the CCP are passed through to clients, including passing on any mismatches between the terms of the CCP-CM transaction and the CM-client contract to the client under the terms of the client clearing documentation. In addition, CCPs will require certain "core terms" to be included in client CCAs between CMs and clients. Therefore, although clients have no rights against the CCP, they will nevertheless be bound by a significant part of the CCP Rulebook and subject to many changes made by CCPs.

*For further details in relation to the CCP Rulebook, including the collateral requirements for CMs, see "EMIR obligations on CCPs and the CCP Rulebook" in Annex 1.*

Another key point for clients to note is that, while their trading relationships with their counterparties may be conducted on a fairly equal basis, with both sides having similar contractual protections, this approach is not mirrored in clients' relationships with their CMs. Instead, CMs view themselves as "service providers"; they provide a service to clients to enable them to access CCP clearing services for relatively low fees. As a result, CMs seek to adopt a "riskless principal" approach as far as possible in their relationships with clients. This informs many aspects of the client clearing structure. For instance, the substantial disapplication of the client's termination rights under the terms of the CCA, as well as the passing on of any risk relating to mismatches between the CCP-CM transaction and the CM-client transaction to the client as mentioned above, are justified by CMs on the "riskless principal" approach. In addition, CMs take the view that the client protections offered by the CCP in case of CM default vastly reduce the client's credit risk.

## 7. KEY CONSIDERATIONS IN CHOOSING A CM

### (a) Number of CMs

Clients should maintain clearing arrangements with at least two CMs to allow for pre-default and post-default porting, although many clients will have relationships with three or four CMs. "Porting" refers to the transfer of client positions and associated margin to another CM. Post-default porting refers to the transfer of a cleared trade from one CM to another where such transfer occurs when the original CM is in default according to the relevant CCP Rulebook. Pre-default porting refers to any other transfer of a cleared trade from one CM to another where no such default has occurred. Given the substantial disapplication of the client's termination rights in cleared transactions, pre-default (or "business as usual") porting is the main protection for a client who is unhappy with its CM (although clients should note that their CCA will require certain conditions, such as there being no continuing events of default or unpaid fees outstanding, to be satisfied for the client to be able to port transactions). In addition, clients also need to have a back-up CM to enable post-default porting of their positions and margin in a CM default scenario. The CCP will impose a short timetable within which trades must be transferred before being closed out and clients are unlikely to be able to meet this timetable unless they have an existing relationship with another CM. It is also important for clients to maintain clearing arrangements with a number of CMs as the CCA with the CM will generally give the CM discretion as to whether to accept transactions for clearing. Clients should note, however, that CMs may require a certain minimum level of trades to be cleared through them and should watch out for any such obligation in the relevant client clearing documentation. On the other hand, a client may wish to extract some commitment from its CM to clear transactions; for instance, that the CM will clear transactions subject to pre-agreed trading limits its other conditions.

### (b) Product and CCP coverage

Given the high fixed costs involved in establishing clearing arrangements, one factor clients may wish to consider is whether their CM clears a sufficient range of products or asset classes or is committed to expanding the range of products which they clear as the clearing obligation comes into force for a wider range of OTC derivatives. This may influence the number of clearing relationships which a client has to establish. If a particular CM cannot clear all products which a client trades and which are or may become subject to the mandatory clearing obligation, it may not be worthwhile to clear through that CM.

Likewise, it may be relevant for clients that their CM provides access to a number of CCPs. Currently, there are a number of CCPs authorised to clear different products in Europe, but not all CCPs can clear all products. There are currently five CCPs authorised by the European Securities and Markets Authority ("**ESMA**") in relation to interest rate derivatives: LCH. Clearnet Ltd; CME Clearing Europe; Eurex Clearing AG; KDPW\_CPP; and Nasdaq OMX Clearing AB. LCH. Clearnet Ltd's SwapClear currently clears the majority of volume in respect of global cleared interest rate swaps (including client-cleared interest rate swaps) with CME Clearing Europe being another active participant in this space. Certain CCPs have been authorised to clear certain classes of equity and commodity derivatives but there is no clear indication at present as to when ESMA will produce related draft Regulatory Technical Standards ("**RTS**") for these clauses.

(c) Existing relationships/avoiding conflicts of interest

Some clients may choose a CM on the basis that they enter into a large volume of transactions with that CM and so it is useful for them to clear the transactions as well. This has the advantage of incentivising the CM to accept transactions for clearing; however, it may lead to conflicts of interest if a trade becomes disadvantageous for a CM as CMs generally retain a large amount of discretion under CCAs with clients to call for additional margin, reduce trading limits or take other action which might lead to a client having to close out a trade. Clients should note that, in this respect, CCAs are different from the usual bilateral trading relationship they would have with a counterparty. Alternatively, some clients may try to avoid using their trade counterparty as CM in order to prevent a conflict between their CM and their broker or dealer relationships.

(d) “Workability” of documentation

Although CMs will seek to maintain the maximum discretion for themselves in the clearing documentation and justify this on the basis of the “riskless principal” approach, clients need to ensure that they will be able to comply with their obligations under their CCA. In particular, clients should seek to ensure that the arrangements established by their client clearing documentation are practically workable from their perspective. Arrangements should not, to the extent possible, contain potential “hair triggers” which would result in immediate defaults and a right for the CM to terminate all cleared transactions without the client having a chance to transfer additional collateral or take other remedial action to bring itself back into compliance. Therefore, clients should consider when choosing their CM whether the CM is willing to limit the level of discretion reserved for itself and show some flexibility in making the clearing arrangements workable for the client, for instance, by including reasonable notice requirements for changes to the clearing arrangements such as reductions in trading limits. Similarly, since porting is the client’s primary remedy in a scenario where it is unhappy with its CM, clients should be wary of attempts by CMs to impose onerous conditions for porting or to require consent of the CM for porting.

(e) Margin requirements

For each cleared trade, a client will be required to post margin (both initial margin (“**IM**”) and variation margin (“**VM**”)) to its CM to allow the CM to fulfil its obligation to post margin to the CCP in respect of its corresponding transaction with the CCP. In relation to IM, clients should note that CMs may either require margin significantly in excess of that required by the CCP to be posted by way of operational buffer or may retain the discretion to require additional collateral amounts (which may be significant) to be posted by the client at short notice. Since posting potentially large amounts of collateral at short notice may prove both expensive and operationally difficult, clients should consider the flexibility which CMs are prepared to show when choosing their CM, both in terms of imposing a reasonable limit on the amounts of additional collateral which can be required and agreeing to a reasonable notice period for providing additional collateral. In addition, although CCPs can make multiple margin calls during the course of one day, most CMs will agree to meet intra-day margin calls by a CCP on behalf of their clients while allowing the client in question to meet only one daily margin call (subject to a sufficient operational buffer being provided or other conditions).



An additional point for clients to consider is how the margin which they post to the CM should be held by the CM or CCP. CCPs and CMs may offer a number of different types of account structure and it will be important for clients to choose the account structure which is most appropriate for their commercial needs.

*For further details in relation to IM and VM, see “EMIR obligations on CCPs and the CCP Rulebook” in Annex 1. For more details of the different account structures and their advantages and disadvantages, see “Segregation of client assets and account structures” in Annex 2.*

**(f) Margin optimisation/transformation**

The default position of CMs, in line with the “riskless principal” approach, is that they will only accept margin from clients in respect of CM-client transactions which is of a type that can be posted to the CCP in respect of the corresponding CCP-CM transaction. Clients who are restricted in the collateral which they have available to post may wish to consider whether their CM is able to offer a margin transformation service. Since CCPs have very strict requirements as to the types of collateral which can be posted, CMs of CCPs may offer services allowing their clients to post lower-quality, less liquid assets while they transfer acceptable, liquid collateral to the CCP. Clients should note, however, that CMs will impose a haircut on the illiquid collateral and may charge a fee for providing this service. In addition, collateral transformation transactions are generally relatively short-term and so may be shorter in duration than a typical OTC derivative transaction; as a result, the client may face a mismatch between the maturity of the two transactions.

**(g) Margin return**

It may be important for some clients to ensure that the collateral they receive back from their CM is equivalent to the collateral which they posted, e.g. for pension funds invested in assets matching their liabilities. In practice, it is often the case that CMs will want the ability to substitute collateral so, if clients require equivalent margin to that posted to be returned, they should check whether a CM is willing to limit its discretion to substitute collateral. Even if CMs are prepared to limit this discretion, they will be extremely reluctant to commit to return the same assets as they posted to the CCP in case they receive back different assets from those posted to the CCP, as this would represent a departure from the “riskless principal” approach. Clients should note that their choice of account may impact the likelihood of receiving back the same type of collateral as they provided to the CM (see “Segregation of client assets and account structures” in Annex 2 for further details).

**(h) Netting/net settlement**

It may be important to clients that the CM can net their settlement flows into a single currency for daily/intra-day margin calls, so they only have to make a single payment or delivery. If so, clients should check whether a particular CM is able to facilitate this.

**(i) Cost of services**

CMs may charge for their services in a number of ways, but fees may include a flat fee payable on a monthly or quarterly basis, fees per trade cleared and/or margin related fees. EMIR requires CCPs and CMs to publicly disclose the prices and fees associated with the services they provide<sup>2</sup>. When agreeing clearing documentation and fee arrangements, clients should be careful to ensure that CMs do not have an unlimited right to unilaterally vary the agreed fees or that, at the very least, there is an appropriate notice period before any unilateral variations come into effect to allow clients to make alternative arrangements if they object to the fee increases. Clients should generally also ensure they have a right to terminate the clearing relationship on short notice. CMs may, however, want the right to pass on any fee increases imposed by the CCP to clients either immediately or on a shorter notice period – this is viewed as being in line with the “riskless principal” approach as described above. Clients should ensure that they have sufficient time to meet fee increases and that, where possible, they have the benefit of any notice period given by the CCP.

**8. GEARING UP FOR CLEARING – NEXT STEPS**

The EMIR requirements for clearing and the client clearing structure raise complex risk and operational issues for clients, so getting to grips with these issues in time to understand the implications of any applicable clearing obligations is crucial. Not only is client clearing likely to be expensive for clients due to the margining and other requirements it entails, but clients who need to clear indirectly through a CM will need to consider the different services provided by different CMs and which best meet their commercial needs. Clients should ensure that they identify an appropriate CM in plenty of time to complete the negotiation and “on-boarding” process. In the next briefing, the client clearing documentation between a client and its CM will be explained, with a focus on the ISDA/FOA Client Cleared OTC Derivatives Addendum, published by ISDA and the Futures and Options Association, which is used to document the client clearing relationship. In addition, some key legal risks and practical issues with client clearing will be explained.

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<sup>2</sup> EMIR, Article 38(1).

# Annex 1

## EMIR obligations on CCPs and the CCP Rulebook

The relationship between a CCP and its CM is governed primarily by the relevant CCP's rules, regulations and procedures (the "**CCP Rulebook**"). The CCP Rulebook will cover, for instance, membership requirements, collateral requirements, margin segregation, notice and information requirements, the default management process and any restrictions or exclusions on the CCP's liability to CMs. Although there may be divergences between each CCP Rulebook, many of the requirements in the CCP Rulebook are intended to satisfy the minimum requirements set out in EMIR and the delegated regulations containing RTS adopted by the European Commission (published by ESMA) and so will apply in some form across all CCPs, although the specific rules and requirements may differ.

### 1. MEMBERSHIP REQUIREMENTS FOR CMS OF CCPS

To ensure that CCPs maintain sufficient financial resources and robust operational capacity to meet their obligations, EMIR imposes obligations on CCPs to establish admission criteria for CMs which ensure that CMs have sufficient financial resources and operational capacity to meet their obligations arising from participation in the CCP<sup>3</sup>. CMs clearing on behalf of clients are required to have the necessary additional financial resources and operational capacity to do this<sup>4</sup>. In order to meet these obligations, CCPs will generally impose stringent membership requirements upon CMs. While membership criteria will differ between CCPs, they will generally include, as a minimum, admission requirements, financial commitments and operational and risk management requirements.

#### Admission requirements

CMs are required to meet certain admission requirements as specified by CCPs, such as credit rating strength, liquidity requirements and minimum capital requirements. Although CCPs may take external credit ratings into account, it should be noted that a CCP will require applicants to satisfy a minimum internal credit score which will be determined by the CCP based on a number of quantitative and qualitative inputs such as market data, financial resources and operational capacity (with external credit ratings being only one consideration). As regards minimum capital requirements, LCH. Clearnet's SwapClear service currently has a minimum adjusted net capital requirement of \$50 million for CMs. Each CCP will have its own requirements.

<sup>3</sup> See EMIR, Article 37(1). CCPs are required to establish admission criteria upon the advice of their risk committees.

<sup>4</sup> EMIR, Article 37(3).

## Financial commitments

EMIR requires CCPs to establish a pre-funded “default fund” to cover anticipated losses due to a defaulting CM which are not covered by the collateral posted by that defaulting CM to the CCP<sup>5</sup>. All CMs will be required to contribute to this fund in advance of using the CCP. EMIR requires the CCP to establish a minimum level for the default fund and for the default fund to enable the CCP to withstand under “extreme but plausible market conditions” the default of the CM to which it has the largest exposure, or the second and third largest clearing members combined, if this is greater<sup>6</sup>. If the collateral posted by a defaulting CM to the CCP proves insufficient to meet the obligations of that CM, recourse will be had to the default fund (although the CCP will contribute some of its own equity resources towards covering the loss before using the contributions of non-defaulting CMs – see Section 5 of this Annex for more details of the CCP “default waterfall”). In addition, should the default fund contributions be exhausted, the CCP may require surviving CMs to make further contributions up to a pre-determined limit<sup>7</sup>.

## Operational/risk management requirements

CMs will also be required to have demonstrated the necessary operational capacity to clear transactions on behalf of their clients, including processing trades and posting and calling for liquid margin on a frequent basis. They must have the capacity to participate in and assist the CCP with default management in case of default by another CM and to assist in “fire drills” to simulate a CM default. CCPs may also require CMs to take part in auctions to transfer a defaulting CM’s trades<sup>8</sup>.

## Application of requirements

CMs are reviewed to ensure they meet membership criteria on becoming members of the CCP. In addition, EMIR requires CCPs to test and monitor compliance with their membership criteria on an ongoing basis<sup>9</sup>.

## 2. COLLATERAL REQUIREMENTS

CCPs will typically have collateral arrangements in place requiring each CM to provide a sufficient amount of collateral (determined by the CCP in accordance with the CCP Rulebook) to ensure that their risk is covered. CMs will need to transfer both IM and VM to the CCP. VM is posted to the CCP on a daily or intra-day basis based on price movements of a CM’s transaction<sup>10</sup>. IM is independent of the daily or intra-day valuation and margining process and covers the potential future credit exposure of the CCP to the CM arising from possible future changes in the value of the CM’s transactions. This is intended to cover close-out costs if a CM defaults. While transferred initially at the outset of a transaction, IM requirements may change frequently and CMs may be required to transfer additional IM or have excess collateral returned by the CCP. EMIR and the related RTS

<sup>5</sup> EMIR, Article 42.

<sup>6</sup> EMIR, Article 42(1) and (3).

<sup>7</sup> EMIR, Article 43(3).

<sup>8</sup> EMIR, Article 37(6).

<sup>9</sup> EMIR, Article 37(2).

<sup>10</sup> See EMIR, Article 41(3), which requires CCPs to call and collect margin on an intra-day basis where predefined thresholds are exceeded.

contain minimum margin requirements for CCPs. For instance, in relation to IM, CCPs are required to collect sufficient margin to cover potential exposures that the CCP estimates will occur if a CM defaults until the liquidation of the relevant positions and CCPs must regularly monitor and revise the level of margin required to reflect current market conditions<sup>11</sup>.

Margin accepted by CCPs must be “highly liquid with minimal credit and market risk”<sup>12</sup>; IM will normally be either cash or highly liquid securities, although bank guarantees (for non-financial counterparties) and gold may also be acceptable<sup>13</sup>. VM will generally be required to be posted in cash.

CCPs are required by EMIR to apply haircuts to different types of collateral to cover the risk of a decline in value between the last valuation of the collateral and liquidation of the collateral in a close-out scenario<sup>14</sup>. The RTS specify a minimum list of criteria to be taken into account in calculating haircuts<sup>15</sup>. In addition, concentration limits may also be applied to ensure the collateral which the CCP holds is sufficiently diversified<sup>16</sup>.

The CCP Rulebook should reflect the EMIR requirements, although CCPs may go beyond the minimum requirements and there may be variations between CCPs. The CCP Rulebook will specify, among other things, the procedures for transferring collateral, the types of acceptable collateral and how haircuts are determined. CCPs will generally retain unilateral, unconditional rights to alter any of these provisions on notice and to require substitution of collateral by CMs.

### 3. MARGIN SEGREGATION

EMIR requires CMs to hold client assets and positions separately from their own assets and positions<sup>17</sup>. This means that CMs are required to hold client assets in client accounts separate from their own house accounts and assets in client accounts cannot be used to offset losses incurred by a defaulting CM in relation to transactions entered into by the CM on its own account. This should be reflected in the CCP Rulebook, which should also set out the rules and procedures for each type of account offered by the CCP<sup>18</sup>.

See “Segregation of client assets and account structures” in Annex 2 for further details regarding the segregation of client assets and the different account structures.

<sup>11</sup> EMIR, Article 41(1).

<sup>12</sup> EMIR, Article 46(1).

<sup>13</sup> See Annex I of RTS 153/2013 dated 19 December 2012 for details of when financial instruments, bank guarantees and gold can be considered “highly liquid collateral”.

<sup>14</sup> EMIR, Article 46(1).

<sup>15</sup> RTS 153/2013, Article 41.

<sup>16</sup> RTS 153/2013, Article 42.

<sup>17</sup> EMIR, Article 39(4).

<sup>18</sup> See, for instance, Regulation 10(a) of LCH.Clearnet Ltd’s General Regulations.

#### 4. INFORMATION REQUIREMENTS

CMs will be required to provide information to the CCP to allow it to satisfy its EMIR obligations. For instance, EMIR requires the CCP Rulebook to allow the CCP to gather relevant basic information to identify, monitor and manage relevant concentrations of risk in relation to the provision of services to clients<sup>19</sup>. Therefore, the CCP Rulebook will contain obligations on CMs to notify the CCP within specified notice periods of important events or information such as changes in their financial position, insolvency or loss of authorisation to transact. CCPs are subject to record-keeping obligations under EMIR<sup>20</sup>.

#### 5. DEFAULT MANAGEMENT PROCESS

EMIR sets out requirements for CCPs in relation to managing a clearing member default. CCPs are, for instance, required to have detailed procedures in place to be followed where a CM does not comply with the CCP's participation requirements<sup>21</sup>. Each CCP will have its own default management process set out in the CCP Rulebook.

If a CM defaults, the CCP assumes the defaulting CM's portfolio and no longer has a "matched book", e.g. it now has market risk as it still has to perform the corresponding transaction. The default management process is aimed at closing and offsetting the open risk in order to return the CCP to a "matched book" and deal with any losses which have arisen. In order to facilitate this, the CCP will take actions such as suspension of trading, closing out the CM's positions, transferring or "porting" client positions and liquidating margin. The CCP Rulebook will impose obligations on non-defaulting CMs to assist the CCP in dealing with the default of a CM. Under EMIR, CCPs are required to, at least, "contractually commit" themselves to attempt to port transactions<sup>22</sup>. If porting is not possible, CCPs may try to auction client positions to non-defaulting clearing members<sup>23</sup>; however, if the transfer of transactions to another CM has not taken place within the CCP's transfer window (which will be specified in the CCP Rulebook and which will usually be a very short period), the CCP is permitted to actively manage its risks in relation to transactions, including closing out transactions and performing a close-out calculation in accordance with the CCP Rulebook.

From a client perspective, the default management process may involve porting of client positions to back-up CMs (where clients have appointed such CMs) and then the auctioning of remaining positions to other CMs, followed by the close-out of positions if they are not transferred within the required timeframe.

Where losses have arisen, EMIR sets out requirements for how these should be allocated via the CCP "default waterfall"<sup>24</sup>. A CCP's default waterfall would typically entail assets being applied in the following order:

<sup>19</sup> EMIR, Article 37(3).

<sup>20</sup> See Chapter IV of RTS 153/2013.

<sup>21</sup> EMIR, Article 48(1). See also Chapter IX of RTS 153/2013 which deals with the default waterfall and the calculation of the amount of the CCP's own resources to be used in the default waterfall. Article 35 of RTS 153/2013 sets out how the minimum amount of resources to be held by the CCP should be calculated.

<sup>22</sup> EMIR, Article 48(5) and (6).

<sup>23</sup> The LCH.Clearnet Default Rules, for instance, provide that in relation to the SwapClear default management process non-defaulting CMs should use "all reasonable efforts" to participate in auctions – see Schedule 2, Rule 2.3(g).

<sup>24</sup> EMIR, Article 45; RTS 153/2013, Articles 24 and 26. Article 24 of RTS 153/2013 specifies that the CCP should respect a confidence interval of 99.5% for OTC derivatives.

- (a) *Defaulting CM's margin* – the defaulting CM's margin would be applied first to meet any losses. IM should be calculated at a level so it is sufficient to cover losses that result from at least 99% of the exposure movements over an appropriate time horizon<sup>25</sup>.
- (b) *Default fund contribution of defaulting CM* – the defaulter's default fund contribution should be used before recourse is had to the contributions of non-defaulting CMs.
- (c) *Tranche of CCP capital* – referred to as the CCP's "skin in the game", a specified tranche of the CCP's capital should then be used to meet losses. EMIR requires the CCP to use its own dedicated resources before using the default fund contributions of non-defaulting clearing members<sup>26</sup>. This should, together with the default fund, be sufficient to enable the CCP to withstand the default of at least the two CMs to which it has the largest exposure under "extreme but plausible" market conditions<sup>27</sup>.
- (d) *Default fund contributions of non-defaulting CMs* – recourse should then be had to the remainder of the default fund.
- (e) *Assessments* – CCPs are able under EMIR to call non-defaulting CMs for a further unfunded default fund contribution (although this exposure must be limited)<sup>28</sup>. The method for calculating CM's unfunded contributions will be set out in the CCP Rulebook and will be subject to a cap amount.
- (f) *Remaining capital of the CCP* – if the resources already applied are insufficient to meet the losses incurred, recourse will generally then be had to the remaining capital of the CCP until exhausted. When exhausted, the CCP would cease operations and enter into insolvency or resolution proceedings.
- (g) *VM haircutting and other proposals?* – if losses are still outstanding, it has been proposed that the CCP recovery framework should permit haircutting of unpaid VM; e.g. impose a haircut on cumulative VM gains which have accumulated since the CM default. Other proposals include further limited cash calls to non-defaulting CMs and also the CCP being required to provide an additional senior tranche of capital to which recourse would be had after the default fund contributions of non-defaulting CMs had been exhausted<sup>29</sup>.

## 6. RESTRICTIONS/EXCLUSIONS ON THE CCP'S OBLIGATIONS AND LIABILITIES TO ITS MEMBERS

The CCP Rulebook will normally impose extensive restrictions or exclusions on the CCP's liabilities to CMs. For instance, a CCP will usually exclude liability in respect of external events such as temporary market closure. As discussed in Part 5 of the briefing, the CCP will generally exclude liability to clients who clear indirectly.

<sup>25</sup> EMIR, Article 41(1).

<sup>26</sup> EMIR, Article 45(4). See Article 35 of RTS 153/2013 for details of how this tranche is calculated; essentially, a CCP is required to maintain a minimum contribution equal to 25% of its total minimum capital. Recourse should be had to this ahead of the contributions of non-defaulting CMs in the default waterfall.

<sup>27</sup> EMIR, Article 43(2).

<sup>28</sup> EMIR, Article 43(3).

<sup>29</sup> See, for instance, ISDA's paper on "CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework" (January 2015). Others, including JPMorgan, have also recommended that CCPs should contribute greater resources and that their contributions should correspond more directly to their risk.

## Annex 2

# Segregation of client assets and account structures

CCPs may operate a number of different account structures to facilitate segregation and porting and are required by EMIR to offer at least two different account types to CMs for their clients; “individual client segregation” and “omnibus client segregation”<sup>30</sup>:

### 1. INDIVIDUAL CLIENT SEGREGATION

If a client opts for individual client segregation, its assets are held separately not only from its CM's assets but also from assets belonging to other clients of its CM. The advantages of individual client segregation are that clients' assets are ring-fenced from the assets of other clients of the same CM and clients are not subject to the risk of fellow-client default. Porting transactions is likely to be easier as it will be clear which positions and assets will belong to each client. In addition, EMIR requires CMs who require margin in excess of that required by the CCP in relation to a client's transactions to post that excess margin to the CCP which prevents the client from taking CM credit risk on the excess as it would be held by the CCP<sup>31</sup>. However, individual client segregation does have disadvantages; this option is likely to cost more (because it is more expensive to implement and manage) and transactions will be margined at the gross level (because offsetting against transactions executed by other clients will not be available as might be the case with omnibus client segregation). A client who wishes to have an Individually Segregated Account (an “ISA”) should ensure this option is specified in their client clearing documentation with their CM as omnibus client segregation is likely to be the default position.

### 2. OMNIBUS CLIENT SEGREGATION

This involves commingling the assets of multiple clients in a single account (an omnibus segregated account (“OSA”). Although the client's positions and assets will be accounted for and held separately from the CM's own positions and assets, there will be a mutualisation of losses and a pooling of risk between the clients in the omnibus account and clients will take “fellow-client risk”. Further disadvantages of omnibus client segregation include: (i) CMs are not required to post excess collateral to the CCP as they are required to do with an ISA; (ii) the client is less likely to receive back equivalent assets as those it originally posted from the CM since assets are “pooled” (which could be an issue for clients who are required to hold particular types of assets, such as pension funds); and (iii) porting (both pre - and post-default) is likely to be more difficult since all positions and

<sup>30</sup> EMIR, Article 39(5).

<sup>31</sup> EMIR, Article 39(6).



assets in the account (especially a “net” omnibus client account) will need to be ported to the same back-up CM which all clients in the account will have to have agreed to use in advance. The back-up CM will have to agree to accept all of the positions and assets in the account before porting can take place. However, the advantage of omnibus client segregation is that it is likely to be significantly cheaper for clients than individual client segregation. A distinction should be made between “net” and “gross” omnibus segregation:

(a) “Net” omnibus client segregation – traditionally, omnibus client segregation has been net, so that clients’ positions and assets are accounted for and held net with positions and assets of other clients in the same account. With net OSAs, the CCP does not identify in its books and records positions and assets of individual clients of a CM (unless requested to do so by the CM) but simply records the position of the account as a whole. Margin is calculated on a net basis across all positions in the relevant account. Porting is likely to be harder with a net OSA than a gross OSA due to the risk of a shortfall in the collateral held in relation to the account.

(b) “Gross” omnibus client segregation – with gross omnibus client segregation, the CCP records the positions and assets of individual clients, where known, based on information provided by the CM and the types of assets and value of the related collateral for the entire account. Positions within a gross OSA cannot be netted and, as a result, margin is calculated on a gross basis.

One service which CCPs have been developing is to offer “combined” or “affiliated” OSAs where certain clients have elected to be grouped together due to a common relationship between them, e.g. because they are members of the same group or clients or funds of the same fund manager. This can be done either on a net or gross basis. In addition, as well as the above account structures, CMs may offer more bespoke margin segregation arrangements to clients, such as fully segregated accounts in which collateral is held in a dedicated account at a custodian chosen by the client in the CM’s name and security is granted over those assets in favour of a security trustee for the benefit of the relevant client.

## Annex 3

# Updates to “EMIR – Gearing Up for Clearing – PART I”

The following developments update certain issues outlined in our first briefing (*“EMIR – Gearing Up for Clearing – PART I”, March 2015*).

### CLEARING OF INTEREST RATE DERIVATIVES

*Please read this update together with the section headed “Which classes of OTC derivatives are in the pipeline for mandatory clearing?” in (and the relevant explanation and definitions contained within) our first briefing.*

A new ESMA consultation opened on 11 May 2015 seeking views on a draft RTS which proposes an expansion of the range of currencies of various classes (referred to as “additional classes”) of interest rate derivatives included in the first RTS on clearing of interest rate derivatives (discussed in our first briefing) which is currently still in the process of endorsement by the EC.<sup>32</sup>

The following additional classes of interest rate derivatives are proposed for central clearing:

- **fixed-to-float swaps** denominated in CZK, DKK, HUF, NOK, PLN (all with maturities up to five years) and SEK (with maturities up to 15 years);
- **forward rate agreements** denominated in NOK, PLN (all with maturities up to 15 years) and SEK (with maturities up to two years).

No additional currencies for basis swaps or overnight index swaps are proposed in the draft RTS. The phased-in implementation of the above additional classes is proposed to be the same as for the classes in the first RTS (six months, 12 months, 18 months and 36 months after entry into force of the relevant RTS for counterparty Categories 1, 2, 3 and 4 respectively). However, if the RTS for the additional classes is published less than three months after the first RTS, the implementation periods will be extended by three months.

The draft RTS, like the first RTS, proposes that frontloading requirements apply only to counterparties in Category 1 and Category 2 with frontloading start dates set for two months and five months respectively after the draft RTS enters into force. Like the first RTS, the draft RTS also provides that only contracts entered into or novated on

<sup>32</sup> The most recent version of the first RTS is included in the ESMA Opinion dated 29 January 2015.

or after the frontloading start date, with a minimum remaining maturity of 6 months as at the date the clearing obligation takes effect, will be subject to the frontloading requirement.

## DEFINITION OF PHYSICALLY SETTLED COMMODITY DERIVATIVES

*Please read this update together with the section headed “Which trades are subject to the clearing obligation?” in (and the relevant explanation and definitions contained within) Annex 2 of our first briefing.*

On 6 May 2015, ESMA published its final guidelines on the definition of commodity derivatives contained in C.6 and C.7 of Annex 1 of MiFID. In relation to OTC commodity derivatives (C.7), the guidelines include all commodity derivatives that are not traded on regulated markets or on MTFs that can be physically settled, and that have the characteristics of financial derivatives with the exclusion of spot contracts and of contracts for commercial purpose. The guidelines clarify what is meant by “can be physically settled” and “must be physically settled”. The guidelines also clarify that the existence of a force majeure clause or default clause in physically settled contracts does not render those contracts cash settled from the outset. The guidelines specify the meaning of ‘physically settled’ to include a broad range of delivery methods including physical delivery of the commodity itself or ownership documents or another method leading to the transfer of rights of an ownership nature.

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