

# The Delta Report

## Derivatives Newsletter

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**September 2016**

In this issue of The Delta Report, we bring you further updates on developments in the global derivatives space. In Europe, the focus is on Brexit and the newly-released EU final regulatory standards on the valuation of derivatives for the purpose of bail-in. We also highlight recent rulings of the US Bankruptcy Court and German Federal Court which impact CDO transactions and netting clauses under German law respectively. Across the globe, we continue to provide insight to the latest regulatory developments.

## The EMIR Clearing Obligation Update – Where Are We?

### Background

Article 4(1)(b) of Regulation (EU) 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (“EMIR”) requires certain counterparties to clear OTC derivative contracts (pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation) that are entered into or novated either on or after the date from which the clearing obligation takes effect or during the frontloading period. Under EMIR, the following entities may be subject to obligations:

<b>Financial counterparty (“FC”)</b>	An entity established in the European Union (“EU”) that falls in one of the following categories: <ul style="list-style-type: none"> <li>• investment firms;</li> <li>• credit institutions;</li> <li>• insurance/reinsurance undertakings;</li> <li>• Undertakings for Collective Investment in Transferable Securities (UCITs) (i.e., mutual funds based in the EU) and their management companies;</li> <li>• certain pension schemes; and</li> <li>• alternative investment funds managed by alternative investment fund managers;</li> </ul> in each case authorised or registered in accordance with the relevant EU Directive.
<b>Non financial counterparty (“NFC”)</b>	An entity established in the EU that does not fall into any of the above categories for FCs. An NFC is not subject to the clearing obligation unless the gross notional value of all OTC derivative contracts entered into by the NFC and other NFCs (and third country equivalents) in its “group”, <b>excluding eligible hedging transactions</b> , exceeds the relevant threshold below (in this case, the entity is referred to as an “NFC+”).
<b>Third country entity</b>	All undertakings other than FCs and NFCs

The relevant thresholds to establish whether an NFC is an NFC+ are as follows:

**EUR 1 billion** for equity or credit derivatives; or

**EUR 3 billion** for interest rate, foreign exchange or commodities derivatives

Under EMIR the clearing obligation<sup>71</sup> applies to OTC derivative contracts concluded between:

Type of counterparty 1	Type of counterparty 2
FC	FC
FC	NFC+
NFC+	NFC+
FC or NFC+	Third country entity that would be subject to the clearing obligation if it was established in the EU.
Third country entity that “ <b>would be subject to the clearing obligation if it was established in the EU</b> ” provided the contract has a “ <b>direct, substantial and foreseeable effect within the EU</b> ” or where such an obligation is necessary or appropriate to <b>prevent the evasion of any provisions of EMIR</b> .	Third country entity that “ <b>would be subject to the clearing obligation if it was established in the EU</b> ” provided the contract has a “ <b>direct, substantial and foreseeable effect within the EU</b> ” or where such an obligation is necessary or appropriate to <b>prevent the evasion of any provisions of EMIR</b> .

<sup>71</sup> However, Article 3 of EMIR sets out a number of intra-group transactions that may be exempted from the clearing requirement. The exemptions may apply to FCs and NFC+s provided they meet the intra-group requirements.

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Under EMIR, the clearing obligation is established by Commission Delegated Regulations based on a draft regulatory technical standard (“**RTS**”) developed by the European Securities and Market Authority (“**ESMA**”). Following the first clearing counterparties authorisations in 2014, the process of identification of classes of OTC derivatives has been going on ever since.

To date, the European Commission (the “**Commission**”) has already approved three RTSs covering two different classes of assets: OTC interest rate derivatives and OTC credit derivatives. The Public Register for the Clearing Obligation<sup>72</sup> includes the classes of OTC derivatives that central counterparties (“**CCPs**”) are authorised to clear. The classes of OTC derivatives subject to the clearing obligation are also listed in the Public Register once the process is finalised, i.e. after the publication of the relevant RTS in the Official Journal of the EU.

#### G4 Currency Interest Rate Swaps

To date, ESMA has been notified of four classes of interest rate OTC derivatives denominated in a G4 currency that certain CCPs have been authorised to clear. ESMA launched a public consultation on 11 July 2014<sup>73</sup> and on October 2014 submitted to the Commission its final report and RTS proposal<sup>74</sup> to impose a clearing obligation on various classes of interest rate swaps denominated in the G4 currencies (EUR, GBP, JPY and USD). Subject to the relevant Category (please see below), the EMIR clearing obligation for the following G4 interest rate swaps commenced from 21 June 2016, under the Commission’s Delegated Regulation 2015/2205 of 6 August 2015 (the “**G4 IRS RTS**”):

- (a) Fixed-to-floating interest rate swaps (also referred to as plain vanilla)
- (b) Floating to floating swaps (also referred to as basis swaps)
- (c) Forward Rate Agreements
- (d) Overnight Index Swaps

Please see the Annex hereto for a detailed description of the economic parameters of the relevant G4 interest rate swaps that are covered in the G4 IRS RTS.

#### Non-G4 Currency Interest Rate Swaps

The Commission’s Delegated Regulation 2016/1178 of 10 June 2016 (the “**Non G4 RTS**”) is a nearly identical delegated regulation to the G4 RTS but for fixed-to-floating interest rate swaps and forward rate agreements denominated only in Norwegian Krone (NOK), Polish Zloty (PLN) and Swedish Krona (SEK). Initially, the relevant consultation paper for the Non G4 RTS contemplated six EEA currencies (NOK, PLN, SEK, CZK, HUF and DKK)<sup>75</sup> but eventually, the final report included only NOK, PLN and SEK.<sup>76</sup> Although the EU G4 currencies represent a significant share of the total OTC derivatives activity in the EU (around 92%), the segment of the non-G4 currencies can still be relevant.

The Non G4 RTS is based on the G4 IRS RTS but includes the foregoing non-G4 currencies and fewer classes of swaps. Please see the Annex hereto for a detailed description of the economic parameters of the relevant Non G4 interest rate swaps that are covered in the Non G4 RTS.

#### The Covered Bond Exemption

Both the G4 and the Non G4 RTSs include a provision<sup>77</sup> to exclude contracts concluded with covered bond

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<sup>72</sup> Available at: [https://www.esma.europa.eu/sites/default/files/library/public\\_register\\_for\\_the\\_clearing\\_obligation\\_under\\_emir.pdf](https://www.esma.europa.eu/sites/default/files/library/public_register_for_the_clearing_obligation_under_emir.pdf) (21 July 2016)

<sup>73</sup> Available at <https://www.esma.europa.eu/press-news/consultations/consultation-paper-clearing-obligation-no1-irs>

<sup>74</sup> Available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-1184\\_final\\_report\\_clearing\\_obligation\\_irs.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-1184_final_report_clearing_obligation_irs.pdf)

<sup>75</sup> Available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-807\\_-\\_consultation\\_paper\\_no\\_4\\_on\\_the\\_clearing\\_obligation\\_irs\\_2.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-807_-_consultation_paper_no_4_on_the_clearing_obligation_irs_2.pdf)

<sup>76</sup> Available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-1629\\_-\\_final\\_report\\_clearing\\_obligation\\_irs\\_other\\_currencies.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-1629_-_final_report_clearing_obligation_irs_other_currencies.pdf)

<sup>77</sup> Article 1 of each RTS.

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issuers or with cover pools for covered bonds (“**CBs**”), provided that those contracts satisfy *all* of the following conditions:

- (a) they are used only to hedge interest rate or currency mismatches of the cover pool in respect of the CBs;
- (b) they are registered or recorded in the cover pool of the CBs;
- (c) they are not terminated in case of the resolution or insolvency of the issuer of CBs or the cover pool;
- (d) the counterparty ranks at least *pari passu* with the covered bond holders (except if it is the defaulting or affected party or the *pari passu* rank is waived); and
- (e) the CB meets the requirements of Article 129 of Regulation (EU) No 575/2013 and is subject to a regulatory collateralisation requirement of at least 102%.

### Credit Default Swaps

ESMA opened a consultation<sup>78</sup> on credit default swaps on 11 July 2014 and submitted its final report and draft RTS on 1 October 2015.<sup>79</sup> The Delegated Regulation 2016/592 of 1 March 2016 for Credit Default Swaps (the “**CDS RTS**”) applies the EMIR clearing obligation to Untranchet iTraxx Index CDS (Main, EUR, 5Y) and Untranchet iTraxx Index CDS (Crossover, EUR, 5Y). Please see the Annex hereto for a detailed description of the parameters of the two untranchet Index CDS classes.

The provisions of the CDS RTS mirror the overall approach of the two IRS RTSs, in particular as regards the categorisation of counterparties, the treatment of intragroup transactions, and the scope of the front-loading requirement.

### Categories of Counterparties

Different counterparties need different periods of time to put in place the necessary arrangements to clear the interest rate and credit default OTC derivatives subject to the EMIR clearing obligation. To ensure an orderly and timely implementation of the clearing obligation, counterparties are classified into categories in which sufficiently similar counterparties become subject to the clearing obligation from the same date. Therefore, the EMIR clearing obligation as contemplated in the G4 IRS RTS, Non G4 RTS and CDS RTS takes effect on different dates depending on the classification of the counterparties to the OTC derivative transactions.

Category 1 firms will necessarily have the ability to clear at least one of the classes of OTC derivatives subject to the clearing obligation at an authorised or recognised CCP. Category 2 firms by definition do not necessarily have the ability to clear at least one of the classes of OTC derivatives subject to the clearing obligation at an authorised or recognised CCP

Where firms are unable to determine which category a counterparty belongs to (i.e. either Category 2 or Category 3), ESMA has confirmed that a firm “will assume it is classified in Category 2 for the purpose of compliance with the clearing obligation. In this situation, counterparties should immediately inform their counterparty of the assumption that has been made about them.”<sup>80</sup>

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<sup>78</sup> Available at: <https://www.esma.europa.eu/press-news/consultations/consultation-paper-clearing-obligation-no2-cds>

<sup>79</sup> Available at: [https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1481\\_final\\_report\\_clearing\\_obligation\\_index\\_cds.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1481_final_report_clearing_obligation_index_cds.pdf)

<sup>80</sup> Questions and Answers, 26 July 2016, ESMA, OTC Answer 24. Available at: [https://www.esma.europa.eu/sites/default/files/library/2016-1176\\_qa\\_xix\\_emir.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-1176_qa_xix_emir.pdf)

Category	Types of counterparties	Dates from which the clearing obligation takes effect		
		G4 -IRS	Non G4 IRS <sup>81</sup>	CDS
1	Entities that are clearing members for at least one of the classes of OTC derivatives subject to clearing and included in the relevant RTS	21 Jun 2016	9 Feb 2017	9 Feb 2017
2	Counterparties not belonging to Category 1 which belong to a <i>group</i> <sup>82</sup> whose aggregate month-end average of <b>outstanding gross notional amount</b> of non-centrally cleared derivatives for January, February and March 2016 <b>is above EUR 8 billion</b> and which are any of the following: <ul style="list-style-type: none"> <li>• an FC; or</li> <li>• an alternative investment fund<sup>83</sup> (as defined in Article 4(1)(a) of Directive 2011/61/EU) that is a NFC</li> </ul>	21 Dec 2016	9 Aug 2017	9 Aug 2017
3	Counterparties not belonging to Category 1 or Category 2 which are any of the following: <ul style="list-style-type: none"> <li>• an FC; or</li> <li>• an alternative investment fund (as defined in Article 4(1)(a) of Directive 2011/61/EU) that is a NFC</li> </ul>	21 Jun 2017	9 Feb 2018	9 Feb 2018
4	NFCs that do not belong to Category 1, Category 2 or Category 3.	21 Dec 2018	9 Aug 2019	9 May 2019

Category 1 entities may be either an FC or an NFC, the essential condition being the requirement to be a clearing member. For counterparties which are neither in Category 1 or Category 4, the determination of the category of counterparty depends on the aggregate month-end average of outstanding gross notional amount on non-centrally cleared derivatives for January, February and March 2016 (at group level), as set out above for Category 2. Essentially, the level of activity in OTC derivative contracts will serve as a basis to differentiate the degree of operational capacity of FCs. Category 4 counterparties will invariably be NFC-s.

Where a contract is concluded between two counterparties included in different categories of counterparties, the date from which the clearing obligation takes effect for that contract shall be the later one. Third country entities must determine the category to which they would belong if they were established in the EU.

On 13 July 2016 ESMA published a consultation paper that discusses a new phase-in period for FCs with a limited volume of activity (Counterparty 3) to comply with the EMIR clearing obligation.<sup>84</sup> According to ESMA, Category 3 counterparties are facing important difficulties in preparing the arrangements with clearing

<sup>81</sup> The European Commission published in the Official Journal (21 July 2016) a corrigendum to the Non G4 RTS, which amended the phase-in dates for Category 2 and Category 4 firms from 9 July 2017 and 9 July 2019, to 9 August 2017, and 9 August 2019, respectively. Available at: [http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1178R\(01\)&from=EN](http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1178R(01)&from=EN)

<sup>82</sup> For the purpose of calculating the group aggregate month-end average outstanding gross notional amount, all of the group's non-centrally cleared derivatives, including foreign exchange, forwards, swaps and currency swaps must be included.

<sup>83</sup> Where counterparties are alternative investment funds as defined in Article 4 (1)(a) of Directive 2011/61/EU or undertakings for collective investment in transferable securities as defined in Article 1(2) of Directive 2009/65/EC, the EUR 8 billion threshold will apply individually at fund level.

<sup>84</sup> Available at: <https://www.esma.europa.eu/press-news/esma-news/esma-consults-proposed-central-clearing-delay-small-financial-counterparties>

members that are necessary for clearing the relevant OTC derivative contracts, due to complexities affecting both types of access, client clearing and indirect client clearing, which were not foreseen at the time the proposals related to the clearing obligation were developed. In addition, clearing members' appetite to provide client clearing services beyond their largest clients has been limited. Since EMIR does not contemplate any specific exemption for FCs with limited activity, the additional two year phase-in<sup>85</sup> would ensure that Category 3 firms benefit from a 42 month phase in.

### Same Group Exemption

The above dates will not apply in respect of contracts pertaining to a class of OTC derivative contracts as set out in the annex hereto and concluded between counterparties (other than Category 4) that meet the requirements set out in the table below:

<b>Counterparties that are part of the same group</b>	This exemption is contemplated in Art. 3.2 of the G4 RTS, the Non 4G RTS and the CDS RTS and is subject to the following conditions:
<b>Where one counterparty is established in a third country and the other in the EU</b>	(a) the third country entity is either a FC or a NFC;
	(b) the EU counterparty is: (i) a FC, a NFC, a financial holding company, a financial institution or an ancillary services undertaking and the counterparty referred in (a) above is a FC; <b>or</b> (ii) either a FC or a NFC and the counterparty referred in (a) above is a NFC;
	(c) both counterparties are included in the same consolidation basis on a full basis;
	(d) both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures; and
	(e) the EU counterparty has notified its competent authority that the above conditions are met and the competent authority has confirmed so within 30 calendar days.

If the above conditions apply, the date from which the EMIR clearing obligation will apply will be as set out in the table below:

Decision Status	G4 IRS	Non G4 IRS	CDS
<b>If no equivalent decision has been adopted</b>	21 December 2018	9 August 2019 <sup>86</sup>	9 May 2019
<b>If an equivalent decision<sup>87</sup> has been adopted, the latter of the following two dates</b>	60 days after the relevant equivalent decision has been adopted		
	The date the relevant clearing obligation takes effect in accordance with the relevant RTS		

### Frontloading

Frontloading as foreseen by Article 4(1)(b)(ii) of EMIR is the obligation to clear OTC derivative contracts (pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation) if they have a remaining maturity higher than the *minimum remaining maturity* that are entered into after ESMA has been notified of the authorisation of a CCP and before the date of application of the clearing obligation.

<sup>85</sup> See page 24 of the consultation paper.

<sup>86</sup> The European Commission published in the Official Journal (21 July 2016) a corrigendum to the Non G4 RTS, which amended the date specified in Article 3(2)(a), i.e. from 9 July 2019 to 9 August 2019.

<sup>87</sup> Pursuant to Article 13(2) of EMIR.

Article 5(2)(c) of EMIR requires ESMA to specify in the relevant RTS the “*minimum remaining maturity of the OTC derivative contracts referred to in Article 4(1)(b)(ii)*”. Frontloading does not apply to Category 4 entities.

#### G4 and Non-G4 Interest Rate Swaps

		G4 Swaps		Non G4 Swaps	
		Class of derivatives	Minimum remaining maturity	Class of derivatives	Minimum remaining maturity
Category 1	Table 1 or Table 2		50 years for contracts entered into or novated before 21 February 2016	Table 1	15 years for contracts entered into or novated before 9 October 2016
	Table 3 or Table 4		3 years for contracts entered into or novated before 21 February 2016	Table 2	3 years for contracts entered into or novated before 9 October 2016
	Table 1 or Table 4		6 months for contracts entered into or novated on or after 21 February 2016	Table 1 or Table 2	6 months for contracts entered into or novated before 9 October 2016
Category 2	Table 1 or Table 2		50 years for contracts entered into or novated before 21 May 2016	Table 1	15 years for contracts entered into or novated before 9 October 2016
	Table 3 or Table 4		3 years for contracts entered into or novated before 21 May 2016	Table 2	3 years for contracts entered into or novated before 9 October 2016
	Table 1 or Table 4		6 months for contracts entered into or novated on or after 21 May 2016	Table 1 or Table 2	6 months for contracts entered into or novated before 9 October 2016
Category 3	Table 1 or Table 2		50 years	Table 1	15 years
	Table 3 or Table 4		3 years	Table 2	3 years

It is very unlikely that frontloading will apply to any Category 3 entity as the minimum remaining maturities are rather long. In any case, NFCs are not subject to frontloading.

#### Credit Default Swaps

##### Category 1

Date of OTC contract or novation	Minimum remaining maturity
Before 9 October 2016	5 years and 3 months
On or after 9 October 2016	6 months

##### Category 2

Date of OTC contract or novation	Minimum remaining maturity
Before 9 October 2016	5 years and 3 months
On or after 9 October 2016	6 months (for contracts that belong to the CDS classes as set out in the Annex hereto)

### Category 3

Date of OTC contract or novation	Minimum remaining maturity
N/A	5 years and 3 months, for FCs and intra-group transactions only

### Foreign Exchange and Equity Swaps

To date, no specific legislation on these classes of swaps has been passed but consultation papers have already been published for non-deliverable forwards and equity swaps.

#### ANNEX

OTC derivatives classes subject to the EMIR clearing obligation

#### *G4 Interest Rate Derivatives Classes*

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
<b>Table 1 - Basis swaps classes</b>						
Basis	Euribor	EUR	28D-50Y	Single currency	No	Constant or variable
Basis	LIBOR	GBP	28D-50Y	Single currency	No	Constant or variable
Basis	LIBOR	JPY	28D-30Y	Single currency	No	Constant or variable
Basis	LIBOR	USD	28D-50Y	Single currency	No	Constant or variable
<b>Table 2 - Fixed-to-float interest rate swaps classes</b>						
Fixed-to-float	Euribor	EUR	28D-50Y	Single currency	No	Constant or variable
Fixed-to-float	LIBOR	GBP	28D-50Y	Single currency	No	Constant or variable
Fixed-to-float	LIBOR	JPY	28D-30Y	Single currency	No	Constant or variable
Fixed-to-float	LIBOR	USD	28D-50Y	Single currency	No	Constant or variable
<b>Table 3 - Forward rate agreement classes</b>						
FRA	Euribor	EUR	3D-3Y	Single currency	No	Constant or variable
FRA	LIBOR	GBP	3D-3Y	Single currency	No	Constant or variable
FRA	LIBOR	USD	3D-3Y	Single currency	No	Constant or variable
<b>Table 4 - Overnight index swaps classes</b>						
OIS	EONIA	EUR	7D-3Y	Single currency	No	Constant or variable
OIS	Fed Funds	USD	7D-3Y	Single currency	No	Constant or variable
OIS	SONIA	GBP	7D-3Y	Single currency	No	Constant or variable



*Non G-4 Interest Rate Derivatives Classes*

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
<b>Fixed-to-float interest rate swaps classes</b>						
Fixed- to- Float	NIBOR	NOK	28D-10Y	Single currency	No	Constant or Variable
Fixed- to- Float	WIBOR	PLN	28D-10Y	Single currency	No	Constant or Variable
Fixed- to- Float	STIBOR	SEK	28D-15Y	Single currency	No	Constant or Variable
<b>Forward rate agreement classes</b>						
FRA	NIBOR	NOK	3D-2Y	Single currency	No	Constant or Variable
FRA	WIBOR	PLN	3D-2Y	Single currency	No	Constant or Variable
FRA	STIBOR	SEK	3D-3Y	Single currency	No	Constant or Variable

*Credit Default Derivative Classes*

Type	Sub-type	Geographical Zone	Reference Index	Settlement Currency	Series	Tenor
Index CDS	Untranching Index	Europe	iTraxx Europe Main	EUR	17 onwards	5Y
Index CDS	Untranching Index	Europe	iTraxx Europe Crossover	EUR	17 onwards	5Y

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