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FINANCIAL MARKETS LAW COMMITTEE

*Response to the European Securities and Markets Authority Consultation Paper on the Clearing
Obligation under EMIR (no. 3)*



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FINANCIAL MARKETS LAW COMMITTEE

This paper has been prepared by the FMLC Secretariat.¹ In preparing this paper, the Secretariat drew on meetings and discussions with stakeholders in the UK and US.²

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1. EXECUTIVE SUMMARY AND INTRODUCTION

Executive Summary

- 1.1 The role of the Financial Markets Law Committee (the “FMLC” or the “Committee”) is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets, which might give rise to material risks, and to consider how such issues should be addressed.
- 1.2 This paper highlights issues of legal uncertainty which arise from the draft regulatory technical standards (“Draft RTS”) set out in a consultation paper published by the European Securities and Markets Authority (“ESMA”) dated 1 October 2014 (“the CP”) on the clearing obligation under the Regulation (EU) No. 648/2012 of the European Parliament and the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (“EMIR”) as it pertains to the class of foreign-exchange non-deliverable forward (“FX NDF”) over-the-counter (“OTC”) derivatives.³

Introduction

- 1.3 EMIR introduces a mandatory obligation requiring certain classes of OTC derivatives to be subject to clearing by authorised central counterparties (“CCPs”). The CP is the latest of three related consultation papers on the mandatory clearing obligation. It asks for stakeholders’ views on the Draft RTS on FX NDF OTC Derivatives. The Draft RTS follow the publication of: (i) a discussion paper on the clearing obligation under EMIR;⁴ (ii) consultation papers on the clearing obligation on interest classes⁵ and credit classes; and (iii) a Final Report on the clearing obligation on interest rate classes.⁶
- 1.4 The FMLC welcomes ESMA’s proposals but remains concerned that certain provisions may give rise to legal uncertainty which would have a negative impact on wholesale financial markets. Specifically, this paper addresses uncertainties arising with regard to:
 - a. harmonisation in the NDF clearing obligations between the EU and other jurisdictions;

³ The European Securities and Markets Authority (“ESMA”) “Consultation Paper Clearing Obligation under EMIR (no. 3)”, 1 October 2014 (ESMA/2014/1185) (“the CP”).

⁴ “Discussion Paper—The Clearing Obligation under EMIR”, 12 July 2013 (ESMA/2013/925).

⁵ “Consultation Paper—Clearing Obligation under EMIR (no. 1)”, 11 July 2014 (ESMA/2014/799) and “Consultation Paper—Clearing Obligation under EMIR (no. 2)”, 11 July 2014, (ESMA/2014/800), respectively.

⁶ “Final Report Draft technical standards on Clearing Obligation—Interest Rate OTC Derivatives”, 1 October 2014 (ESMA/2014/1184).

- b. the obligation to clear OTC derivative contracts that are entered into after the notification provided in Article 5(1) of EMIR and before the date of application of the clearing obligation (“frontloading”);
- c. the inclusion of certain maturities in the scope of clearing obligations; and
- d. the risks associated with CCP withdrawal.

The sections below examine these uncertainties in greater detail.

2. HARMONISATION

- 2.1 The Draft RTS provide for a clearing obligation on certain classes of FX NDFs. They stipulate that 11 classes in total should be subject to the mandatory clearing obligation. All classes have tenors which range from three days to two years. The Draft RTS provide that four counterparty categories are required to clear trades once the RTS come into force, following an associated phase-in period.
- 2.2 A lack of harmonisation in the NDF clearing obligations between the EU and other jurisdictions such as the United States could result in fragmentation of global liquidity, distortions and conflicting rules which may give rise to considerable legal uncertainty. The first criterion for the mandatory clearing of NDFs addressed in the CP is the degree of standardisation achieved in the market. The CP sets out the criteria for determining the degree of standardisation of NDF contracts at section 3.2.1.
- 2.3 In this regard, ESMA relies on the prevalence of standard market terms in the form of the Emerging Markets Trade Association (“EMTA”) Master Agreement to conclude that the standardisation criterion is satisfied across European jurisdictions. The CP refers to EMTA’s recommended template terms for NDFs in 21 currencies (of which 11 are covered by the CP as noted above), which have enabled a degree of standardisation in the market.⁷ The CP also provides that NDFs are “relatively simple products which

⁷ The CP (*ibid.*) notes that the Master Agreement includes, among others, the following standardised terms:

- The reference currency
- The settlement currency
- 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

include few characteristics that can be customised by market participants”.⁸ It does not explain, however, that the EMTA terms which are prevalent in Third Country jurisdictions (e.g. the United States) are modified in significant and relevant ways. These inter-jurisdictional differences, which are replicated in clearing house rules, risk crystallising market fragmentation. Unless the clearing obligation for FX NDF transactions is applied only to standard contracts which incorporate unmodified currency templates currently published by EMTA, fragmentation, exacerbated by a degree of confusion and uncertainty as to the forms on which derivatives are cleared, is likely to occur within the EU. The FMLC recommends that the clearing obligation is restricted to contracts on standard terms.

- 2.4 Alternatively, where clearing is not required in major jurisdictions at the same time as the EU, the global liquidity pool could equally be subject to fragmentation and, in the EU, to a loss of liquidity. While it is not for the FMLC to comment on issues of policy, it does take the view that coordination and consistency in respect of the products to be cleared, counterparty categories, and timelines for mandatory clearing is highly desirable in the cross-border context.

3. FRONTLOADING

- 3.1 A “frontloading requirement”, as anticipated in Article 4(1)(b)(ii) of EMIR, is the obligation to clear OTC derivative contracts that are entered into after the notification provided in Article 5(1) of EMIR and before the date of application of the clearing obligation. This requirement allows regulators to accelerate the speed at which volumes of trades move from the bilateral to the centrally-cleared environment. The Draft RTS propose that specific counterparties (identified through defined categories as noted above) be required to “frontload” contracts concluded between the date of publication of the RTS in the Official Journal of the EU and the start date of the clearing obligation. There is a lack of clarity, however, as to when the frontloading obligation will begin for some counterparties as the publication date of the RTS will not be known in advance.⁹ Counterparties will not be able to predict the exact date of

⁸ See page 15, para.29 of the CP, *op. cit.*

⁹ That is, uncertainty for counterparties falling within category one which, in accordance with the Draft Regulatory Technical Standards (“Draft RTS”) set out in the CP *op. cit.*, requires clearing from six months of entry into force of RTS; and counterparties within category 2 within 12 months of entry into force of RTS.

publication with any degree of certainty and are likely, therefore, to draft their contracts on a “to be cleared” basis.

- 3.2 Furthermore, it may not be possible for some counterparties to clear their trades within the required period. In particular, as many of the trades will have short term maturities, counterparties will need to submit their contracts for clearing immediately. Large volumes of FX NDF transactions may, therefore, be subject to clearing at the same point in time yet only one CCP is currently offering to clear FX NDF trades.¹⁰ It is conceivable that the CCP will be under considerable pressure to clear very large volumes of trades at the same point in time, as soon as the clearing obligation comes into force. Uncertainty arises as to what the ramifications will be in the event that trades cannot be cleared. One possibility, should the CCP be unable to clear certain trades, is that they may be terminated. Should large volumes of trades be terminated at the same point in time, this may have a negative impact on the stability of the wholesale financial markets.
- 3.3 On 8 December 2014, the European Commission wrote to ESMA to confirm that it endorsed, subject to certain amendments, ESMA’s draft technical standards on clearing obligations for OTC interest rate derivatives, published in a final report dated 1 October 2014.¹¹ The FMLC takes the view that the transposition of the frontloading requirements discussed in the context of interest rate swaps to FX NDF clearing obligations—in particular ESMA’s proposal that frontloading requirements should be applied only to contracts concluded by counterparties falling within certain categories of financial institutions from the date of publication of the RTS in the Official Journal of the EU—would ameliorate many of the uncertainties discussed above.

4. MATURITY

- 4.1 The question of which maturities should be included in the scope of the clearing obligation is examined in section 3.2 of the CP. Under this section, ESMA stipulates that although there is evidence to suggest that the concentration of liquidity lies in the shortest maturities, the longer dated contracts bear more risks and there are, therefore, incentives for including longer term maturities within the scope of the clearing

¹⁰ The FMLC is given to understand, however, that it is to be expected that at least one additional CCP will launch an FX clearing service (including the clearing of NDF transactions) in 2015.

¹¹ “Final Report Draft technical standards on Clearing Obligation—Interest Rate OTC Derivatives”, *op. cit.*

obligation. Should longer term maturities (of up to two years) be included in the scope of the RTS, material uncertainty may arise owing to the limited liquidity in those maturities.¹² It is not clear whether the CCP authorised to clear FX NDFs will be able to manage in the event of default of a clearing member responsible for those transactions. This risk is exacerbated by the fact that, as noted above, only one CCP is currently authorised to clear FX NDF trades. Analysis of the risk of CCP withdrawal is provided in section 5.

5. THE RISKS ASSOCIATED WITH CCP WITHDRAWAL

- 5.1 At the time of writing, only one CCP is offering to clear FX NDFs and the FMLC considers that market concentration of this kind could give rise to material uncertainty.¹³ In particular, should the CCP decide to withdraw its clearing services in respect of certain products, despite it being authorised to do so, this would not remove the clearing obligation even if no other CCP was authorised to clear the transactions in question. Article 5(6) of EMIR does not stipulate whether there are any measures which could be adopted to remedy such a situation. The article only applies where a class of OTC derivatives no longer has a CCP which is “authorised or recognised” to clear the contracts. It does not apply where a CCP continues to be authorised to clear a specific class of contract but simply chooses to withdraw these services. Furthermore, if the CCP withdraws its clearing services during the frontloading period, it is not clear how counterparties might take steps to remedy this problem whilst ensuring compliance with the RTS other than by terminating their contracts.
- 5.2 It is noted that the CP stipulates that further CCPs are likely to gain authorisation in the future, and whilst this may provide some comfort to markets, it would be desirable for further guidance to be provided in the interim.

¹² The FMLC notes that the voluntary clearing of NDFs is very much in its infancy when compared with the voluntary clearing of interest rate swaps and credit default swaps. There are a limited number of clearing members that clear NDF contracts in the EU and there is currently no client clearing of NDF contracts in the EU.

¹³ See also n.5 above. In fact, further concentration arises because, the FMLC understands, the liquidity in NDF contracts (which comprises a very small percentage of trading in FX products) is far lower than it is for other derivative asset classes that are currently subject to mandatory clearing consultations (i.e. interest rate swaps and credit default swaps).

6. CONCLUSION

- 6.1 The objective of this paper has been to identify and, where appropriate, suggest potential solutions or improvements to issues of legal uncertainty affecting the wholesale financial markets arising from the Draft RTS on FX NDF OTC derivatives. The FMLC has drawn attention to issues of legal uncertainty arising from, in particular (i) the need for further harmonisation in the NDF clearing obligations between the EU and other jurisdictions; (ii) the frontloading requirements in the FX NDF market;¹⁴ (iii) the scope of the clearing obligation with regard to certain maturities; and (iii) the risks posed by market concentration and the consequent potential damage of CCP withdrawal. Where appropriate, this paper suggests solutions. It is the view of the FMLC that whilst expected amendments and market developments may mitigate some of the issues of legal uncertainty highlighted in this paper, coordination and consistency in respect of the products to be cleared, counterparty categories, and timelines for mandatory clearing would be highly desirable in the cross-border context.

¹⁴ The FMLC is, however, given to understand that they may be mitigated by the application of frontloading requirements as expressed in respect of the interest rate swaps market.

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