CLIFFORD CHANCE

Briefing note

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Documentation Impact of EMIR Client Clearing for Funds and Asset Managers

One of the milestones in the implementation of EMIR will be the introduction of the first clearing obligation, which will require certain OTC derivatives to be cleared through a CCP, probably from early 2015. Funds and asset managers which will be subject to EMIR's clearing obligation should be preparing now.

Which trades will be subject to the clearing obligation? Trades between FCs and NFC+s and trades between FCs or NFC+s and certain TCEs will be subject to the clearing obligation. In limited circumstances, the clearing obligation will also apply to trades between TCEs. As yet, there is no clearing obligation, but, with eight CCPs now authorised under EMIR (and with more authorisations expected), the first clearing obligation is likely to become effective early next year.

The application of the clearing obligation to different OTC derivatives and users will develop over time. Vanilla derivatives such as plain interest rate and certain index credit default products are likely to be the first to become subject to the clearing obligation.

Will a fund be subject to the clearing obligation? Depending on the fund, the answer is likely yes.

The most obvious way for a fund to be caught is by falling within the definition of "FC". This captures UCITS and (where relevant) UCITS managers and alternative investment funds (irrespective of their location) which are managed by an alternative investment fund manager authorised or registered under AIFMD. This means that all UCITS and most alternative investments funds which are managed by a European manager are already FCs or will become FCs by the time the first clearing obligation comes into force next year. It is also possible for a fund to become subject to the clearing obligation by falling into the NFC+ or TCE categories.

As a fund subject to the clearing obligation, how do you clear? EMIR provides three ways for derivatives counterparties subject to the clearing obligation to clear:

Glossary

- **AIFMD:** Alternative Investment Fund Managers Directive
- **Clearing member**: a member of a CCP through which non-members may gain access to the clearing provided by that CCP.
- **Clearing obligation**: over time, FCs and NFC+s will be required to clear OTC derivatives subject to the clearing obligation through a CCP when they trade with each other or with TCEs.
- **CCP**: a central counterparty/clearing house which is authorised or recognised under EMIR.
- **EMIR**: European Market Infrastructure Regulation.
- **ETD**: Exchange traded derivatives.
- **FC (financial counterparty)**: An undertaking which is an investment firm, credit institution, insurance/reinsurance undertaking, UCITS/UCITS manager, pension scheme or alternative investment fund managed by an alternative investment fund manager, in each case where authorised or registered in accordance with the relevant EU directive.
- **NFC (non-financial counterparty)**: An undertaking established in the EU which is not an FC or CCP.
- **NFC+**: A non-financial counterparty whose positions in OTC derivatives (excluding hedging positions) exceed the specified clearing threshold.
- **TCE (third country entity)**: an entity not established in the EU that would be subject to the clearing obligation if established in the EU.

become a clearing member of a CCP, become a client of a clearing member of a CCP or enter into EMIR-compliant indirect clearing arrangements. Becoming a clearing member of a CCP is not a realistic option for most funds, and the legal and practical aspects of indirect clearing remain under development. Consequently, at this point, becoming a client of a clearing member of a CCP ("**client clearing**") is the realistic option for most.

For funds entering into client clearing, how will their documentation be affected? For OTC derivatives, there is a documentation package that will need to be agreed between the fund (or its asset manager) and the clearing member. Some basic questions will determine the broad content of this documentation package. First, will the fund and the clearing member continue to use their existing ISDA Master Agreement as the underlying trading document for cleared OTC derivatives, or will a set of trading terms (similar to exchange traded derivative client documentation) be used? Secondly, what form of document will be used to make the necessary supplements to the underlying trading document to make it compatible with clearing? On this second question, there are currently two main choices in the European market (depending on the type of underlying trading document to be used): the ISDA/FOA Client Cleared OTC Derivatives Addendum (the "**Addendum**") and the FOA Clearing Module (the "**Module**").

Why is a clearing supplement such as the Addendum or Module necessary?

The ISDA Master Agreement is a bilateral framework document so does not envisage the existence of CCPs and clearing. While trading terms may well include clearing-related provisions, they are unlikely to reflect the segregation models which CCPs and clearing members are required to offer under EMIR. So, irrespective of the type of underlying trading document, it will need to be supplemented through an Addendum or a Module.

Are the Addendum and Module negotiable documents? Yes, in part. The Addendum and Module can be roughly divided into three parts. First, the negotiable commercial terms to be agreed between the fund and the clearing member. Secondly, the structural changes to underlying trading document to reflect the realities of clearing. These structural provisions are largely non-negotiable, but it is important that funds and their asset managers understand their implications. Thirdly, both the Addendum and the Module incorporate by reference parts of the CCP rules. The CCP rules are not open to negotiation but do impact on the client clearing documentation.

What about ETD documentation? ETD are already cleared. However, funds already trading ETD should expect to receive amending documentation from their dealers, which amends existing ETD documentation to make it EMIR-compliant. This documentation may be in the form of the Module, or something similar, so many of the issues which arise in respect of OTC derivatives clearing documentation apply also to ETD documentation.

What should funds and asset managers be doing now? For those that will become subject to the clearing obligation and intend to enter into client clearing, now is the time to begin the process, if you have not done so already. The on-boarding process involves not only the agreement of the documentation package, but also requires significant operational input.

How can we help? As a member of the Working Group involved in the drafting of the Addendum and as drafting counsel for the Module, we are ideally placed to advise Clearing Users on this complex documentation. We have experience in assisting a range of funds, asset managers and other buy-side entities with the structuring and negotiation of their client clearing documentation. This is all done with the benefit of our long-established and market-leading derivative clearing practice which encompasses work with CCPs, clearing members and end-users.

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