

ISDA EMIR CLASSIFICATION LETTER – GUIDE FOR THE BUY-SIDE

On 13 July 2015, ISDA published the ISDA EMIR Classification Letter (the "**Classification Letter**"). The Classification Letter allows users of derivatives which are themselves subject to EMIR or which trade with entities which are, to notify their counterparties of the new layer of counterparty classifications arising out of the regulatory technical standards implementing the first clearing obligation in Europe. These classification categories are new and additional to the familiar FC/NFC classifications. This briefing note is relevant to all derivatives users impacted by the EMIR clearing obligation, including EU and non-EU funds, asset managers, pension funds and insurance companies.

What does the Classification Letter do?

The [Classification Letter](#) sets out two types of classification – the EMIR clearing categorisation and the EMIR counterparty classification.

Appendix I contains the new EMIR classification categories used in the draft regulatory technical standards on the clearing obligation on interest rate swaps (the "**Draft IRS RTS**"). The Draft IRS RTS are not yet finalised and are awaiting endorsement and adoption by the European Commission. However, in recognition of these new EMIR counterparty classifications created by the Draft IRS RTS and the practical challenges of obtaining classifications from relevant counterparties, ISDA has published the Classification Letter ahead of the Draft IRS RTS being adopted in order that market participants may prepare for this next stage of EMIR counterparty classification, although most entities will be unable to complete the Classification Letter at this stage because the relevant dates for determining classifications occur in the future.

Appendix II contains the EMIR counterparty classifications which are already required for EMIR compliance. For example, Appendix II covers whether the entity is EU or non-EU and whether it is a FC or NFC.

The Classification Letter allows counterparties to bilaterally notify each other of their classification. An online version of the Classification Letter is also available via the "ISDA Amend" tool. However, counterparties are not required to use the Classification Letter or ISDA Amend and may provide confirmation to their counterparties using other formats.

ISDA has produced an [explanatory memorandum](#) to accompany the Classification Letter, also available via [ISDA's website](#).

Who may be asked to complete the Classification Letter?

Buy-side entities which are themselves subject to the clearing obligation are likely to be asked to complete the Classification Letter (or the electronic equivalent on ISDA Amend). These buy-side entities will

also need to receive equivalent confirmations of status (using the Classification Letter/ISDA Amend or

Glossary

CRR: Capital Requirements Regulation

CVA: Credit Valuation Adjustment

FC: financial counterparty as defined in EMIR, i.e. an investment firm, credit institution, insurance/reinsurance undertaking, UCITS, pension scheme or AIF managed by an alternative investment manager, in each case where authorised or registered in accordance with the relevant EU directive

NFC: non-financial counterparty as defined in EMIR, i.e. an undertaking established in the EU which is not a financial counterparty or a central counterparty

NFC+: an NFC whose positions in OTC derivatives exceed the clearing threshold

NFC-: an NFC whose positions in OTC derivatives do not exceed the clearing threshold

ESMA: the European Securities and Markets Authority

AIF: alternative investment fund, as defined in the Alternative Investment Fund Managers Directive

EMIR: EU regulation on OTC derivatives, central counterparties and trade repositories

other formats) from their counterparties so that the application of the EMIR clearing obligation can be accurately identified with respect to a particular OTC derivatives trading relationship.

Non-EU buy-side firms which are not directly subject to the EMIR clearing obligation should nonetheless expect to be asked to complete the Classification Letter by EU counterparties in order to assist compliance by their EU counterparties with the EMIR clearing obligation, much like non-EU entities have already been asked by EU counterparties to classify themselves as third country entity equivalents of an FC/NFC+/NFC-, on the basis of what the non-EU entity would have been if established in the EU.

As mentioned above, the Classification Letter is not the only permissible format for providing the relevant confirmations of status for the purposes of the Draft IRS RTS. Indeed, there is no obligation on EU or non-EU entities to give any confirmation at all, although failure to confirm could risk the counterparty deeming the entity into a higher category than would otherwise have been the case.

As usual, entities should consider the liability issues arising from any status confirmation when using the Classification Letter, ISDA Amend or other formats. It should be noted that, under the Classification Letter, entities undertake to notify their counterparty if their status changes in the future and entities should monitor accordingly.

Why are these additional classifications important?

For users of OTC derivatives which are themselves subject to the EMIR clearing obligation, or which trade with a counterparty which will be required to clear OTC derivatives

traded with such a user, the new classifications determine the time from when the EMIR clearing obligation will apply to them and, separately, whether "frontloading" will apply.

What is OTC frontloading?

OTC derivatives in-scope for the clearing obligation which are traded before the relevant start date of a clearing obligation but after the frontloading period commences may need to be either cleared or terminated by the start date for clearing (see Table 1 on the following page for the application of and timings for frontloading). This is likely to affect the pricing of these derivatives (notwithstanding that initially the transactions may not be cleared) and counterparties may wish to include the recently published ISDA frontloading additional termination event in case transactions have not been cleared by the relevant deadline.

What are the new classification categories?

Question 1 of Appendix I of the Classification Letter relates to the entity's clearing category under the Draft IRS RTS. NFC-s (and non-EU equivalents of NFC-s) do not need to complete this question as OTC derivatives they enter into are not subject to the clearing obligation. Question 1 asks entities to classify

themselves into one of four categories (reflecting the categories in the Draft IRS RTS). Details of these categories are set out in Table 1 on the following page. Broadly, the higher the category, the sooner the clearing obligation will apply. Only Category 1 and Category 2 entities trading with other Category 1 and Category 2 entities will be subject to frontloading. Where one or both of the parties to an in-scope OTC derivatives trading relationship is an NFC+, the transaction will not be subject to frontloading.

Why will an entity need to know the notional amount of their uncleared derivatives portfolio?

Determination of Category 1 status should be relatively straightforward. Indeed, ESMA has already prepared a template register to identify the clearing members in Category 1, which ESMA may make public if there is sufficient take-up by CCPs and clearing members.

Determination of the remaining categories depends partly on whether the entity has FC or NFC+ status, whether the entity is an AIF and whether the entity belongs to a group whose aggregate month-end gross average notional amount of uncleared derivatives is above or below EUR 8 billion. This figure is calculated over

In-scope classes and timing

As of today, no classes of OTC derivatives are subject to the EMIR clearing obligation.

Draft technical standards have been published covering certain types of liquid interest rate derivatives, iTraxx index credit default swaps and FX non-deliverable forwards, although in a feedback statement ESMA has indicated that it does not propose a clearing obligation for FX non-deliverable forwards at this stage.

Timing for the clearing obligation remains uncertain. The current best guess is that the clearing obligation for in-scope interest rate derivatives will apply to Category 1 from Q2 2016, to Category 2 from Q4 2016, to Category 3 from Q2 2017 and to Category 4 from Q4 2018. Please see Table 1 on the following page for an explanation of the categories.

the 3 months following the publication in the Official Journal of the final technical standards for interest rate swaps (excluding the month of publication), so is unlikely to be capable of determination prior to Q1 2016. As is the trend with EMIR implementation, the metric used is the *notional amount* of the uncleared portfolio. Depending on the types of transactions a particular entity trades, this may bring more funds, insurance companies and other global buy-side entities into Category 2 than initially anticipated. There is also a question as to whether intra-group derivative transactions are included in the EUR8 billion notional amount calculation. If included, intra-group derivative transactions will broaden the potential application of Category 2 further.

How should third country entities answer the questions in Appendix I?

A third country entity which has chosen to use the Classification Letter should answer the questions in Appendix 1 on the basis of the categorisation which would have applied to it if it were established in

the EU. If the third country entity is an entity out of scope for EMIR, it should not answer any questions in Appendix 1.

Does the Classification Letter apply to asset classes other than IRS?

The Classification Letter has been drafted with the Draft IRS RTS in mind. However, ISDA has indicated that the Classification Letter will be expanded to cover other classes of OTC derivatives that become subject to the EMIR clearing obligation, if that proves necessary. In the meantime, an entity's category election in Appendix 1 of the Classification Letter will be deemed to apply to further mandated classes of OTC derivatives (and the associated regulatory technical standards) unless notice to the contrary is given and entities will therefore need to monitor the on-going accuracy of their status confirmation.

Pension Scheme Arrangements

Questions 3 and 4 of Appendix I relate only to pension scheme

arrangements (and should not be completed by third country entities). Article 89 of EMIR provides a temporary exemption from the clearing obligation for certain contracts entered into by pension scheme arrangements (the Pension Scheme Arrangement Exemption). Questions 3 and 4 track the two key conditions which must be satisfied in order for an OTC derivative entered into by a pension scheme arrangement to benefit from the temporary exemption from clearing.

These questions have also been designed with the CVA exemption under the Capital Requirements Regulation (CRR) in mind and are therefore significant in relation to regulatory capital requirements for banks and, indirectly, whether those costs will be passed to pension scheme arrangements. For further detail on the temporary exemption for pension scheme arrangements, please see our client briefing [available here](#).

Table 1 – EMIR clearing categories under Draft IRS RTS

Category	Counterparties covered	Phase-in period	Eligible for Frontloading
1	Counterparties which, on the date of entry into force of the IRS RTS, are clearing members for at least one of the classes of OTC derivatives listed in Annex 1 of the IRS RTS, of at least one of the CCPs authorised or recognised before that date to clear at least one of those classes	6 months	Yes* From 2 months after the entry into force of the IRS RTS
2	FCs and NFC+ AIFs which are not included in Category 1 which belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for [3 months following the publication in the Official Journal of the IRS RTS, excluding the month of publication] is above EUR 8 billion	12 months	Yes* From 5 months after the entry into force of the IRS RTS
3	FCs and NFC+ AIFs which are not included in Categories 1 or 2	18 months	No
4	NFC+s which are not included in Categories 1, 2 or 3	3 years	No

* Transactions with an NFC+ (regardless of their category) will not be subject to frontloading.

Contacts



Christopher Bates
Partner, London
T: +44 20 7006 1041
E: chris.bates@cliffordchance.com



Simon Crown
Partner, London
T: +44 20 7006 2944
E: simon.crown@cliffordchance.com



Paget Dare Bryan
Partner, London
T: +44 20 7006 2461
E: paget.darebryan@cliffordchance.com



Caroline Dawson
Senior Associate, London
T: +44 20 7006 4355
E: caroline.dawson@cliffordchance.com



Daniel Deacon
Lawyer, London
T: +44 20 7006 4852
E: daniel.deacon@cliffordchance.com



Owen Lysak
Senior Associate, London
T: +44 20 7006 2904
E: owen.lysak@cliffordchance.com



Habib Motani
Partner, London
T: +44 20 7006 1718
E: habib.motani@cliffordchance.com



Stephanie Peacock
Lawyer, London
T: +44 20 7006 4387
E: stephanie.peacock@cliffordchance.com



Monica Sah
Partner, London
T: +44 20 7006 1103
E: monica.sah@cliffordchance.com



Will Winterton
Senior Associate, London
T: +44 20 7006 4386
E: will.winterton@cliffordchance.com

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*Linda Widyati & Partners in association with Clifford Chance.