ISDA briefing on 'frontloading' of contracts (EMIR)

7 April 2011

Introduction

As previously mentioned in comments to the *17 March 2011 Hungarian Presidency revised EMIR* we welcome the progress that has been made in relation to backloading in successive Presidency drafts.

However, we believe that there are major practical problems that remain with the 'frontloading' approach that has been proposed in the 17 March paper.

While this approach may deliver what some see as a political imperative, based on their interpretation of the G20 conclusions, we persist in our belief that the practical problems we refer to will – most importantly – make it very challenging to comply with these requirements. Unfortunately, in this instance, a willingness to comply and to prepare for compliance may not be enough, because of the bilaterally negotiated nature of OTC derivatives. This would become a problem for firms willing to comply but unable to do so. It would also ultimately become a problem for competent authorities in each Member State who could be overrun by cases of non-compliance.

We add that (a) favourable regulatory capital treatment and (b) the fact that as more new trades enter clearing clients' trades may become more unbalanced mean that there will be commercial incentive for clients to clear voluntarily. We believe that capital requirements will motivate dealers to clear existing contracts as CCPs begin to provide clearing offers.

Recap of 17 March 2011 proposals

The Hungarian Presidency text of 17 March said (in Article 3) that '*The clearing obligation shall apply to all derivative contracts which are entered into on and after the date of entry into force of this Regulation.*'[1]

Furthermore, Article 3 goes on to say that '*derivative contracts, entered into on and after the date of entry into force of this Regulation, but before the date from which the clearing obligation takes effect and for which the remaining maturity is less than the minimum*

[1] This section of Article 3 (1a) should probably be amended to reflect that the obligation would obviously not fall on contracts that are not eligible for clearing.

remaining maturity determined by the Commission' (subject to advice by ESMA), should be cleared.

The procedure set out in Article 4 will determine which contracts will be deemed eligible for clearing.

Practical problems with this approach

1. **Legal uncertainty**

Our concern naturally relates to the legal situation pertaining to contracts that are entered into after the date of application of EMIR, but which at the date they are entered into, have not been deemed eligible by ESMA, and ultimately, the European Commission.

These contracts will be agreed bilaterally, and their pricing will be contingent upon market conditions at the time, credit quality of the counterparties, collateral posted etc. Even if some recognition of the possibility of a future clearing requirement could be reflected in relevant documentation, pricing would be dependent to a significant degree on factors unique to the relevant CCP(s) – and these factors will not be known to the counterparties at the time of entering into the contract.

2. **Possibility of legal challenge**

We remain concerned that a retroactive clearing requirement could be open to legal challenge (and we believe that frontloading still implies retroactivity).

3. **It is impossible for a single market participant to comply without agreement from their counterparty on the terms of compliance**

We believe this is the ***key practical problem*** with this proposal. It is a consideration that is unique to bilateral negotiated derivatives, and it may differentiate this case from other cases where retroactivity may be practically possible.

Even if one of the counterparties to the contract wants to comply with the clearing requirement, there is no mechanism facilitating this if that's counterparty's counterparty will not agree terms (e.g. because of (new) pricing conditions and disagreement over which CCP to use)).

We believe that this may cause hundreds of cases of non-compliance, even if counterparties wish to comply. Ultimately, this will be a major problem for the competent authorities.

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