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ISDA EMIR Classification Letter

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Do you need to take action?

Yes, over the coming months each buy side entity will be required to classify itself so that it – and its counterparty – can determine when mandatory clearing of interest rate swaps will apply as between those two counterparties.

In our July AB Briefs, we summarised the forthcoming clearing obligations under the European Market Infrastructure Regulation (EMIR), which the first wave of market participants will be required to comply with from as early as April 2016.

The Classification Letter

In July, ISDA published the ISDA EMIR Classification Letter (the "Classification Letter"), a standard form document which can be used for notifying counterparties of the new counterparty classifications arising out of the regulatory technical standards (RTS) for the first clearing obligations for interest rate swaps under EMIR.

In other words, the Classification Letter allows parties to inform each other of their status for determining when (i.e. in which phase) the clearing obligation will apply, as between those two parties, in relation to interest rate swaps.

These classification categories are new and additional to the financial counterparty (FC) and non-financial counterparty (NFC) classifications which have been required thus far in relation to EMIR (used, for example, in the ISDA 2013 EMIR NFC Representation Protocol).

To recap, EMIR defines FCs to include investment firms, credit institutions, insurance/reinsurance undertakings, UCITS, pension schemes or AIFs managed by alternative investment managers. EMIR defines NFCs to mean undertakings established in the EU which are not financial counterparties or central counterparties. NFCs are then further categorised into NFC+ (meaning an NFC whose positions in OTC derivatives exceed the clearing threshold) and NFC- (meaning an NFC whose positions in OTC derivatives do not exceed the clearing threshold).

Who needs to sign the Classification Letter?

Buy side entities subject to the clearing obligation will need to complete the Classification Letter (or the equivalent on ISDA's online portal, ISDA Amend) and will also need to receive equivalent confirmations of status from their EU trading counterparties, in order for the EMIR clearing obligation as between those two counterparties to be correctly ascertained. Non-EU entities not directly subject to the EMIR clearing obligation are very likely to be asked by their EU trading counterparties to complete the Classification Letter (or the equivalent on ISDA Amend) in order to allow the EU counterparties to correctly ascertain status.

When will the Classification Letter need to be completed?

Parties can expect to complete this new classification process at any time prior to the first clearing obligation coming into effect (i.e. prior to April 2016). Many entities will be unable to complete the Classification Letter now because relevant dates for determining classifications occur in the future.

Different methods of notification

There is no prescribed method under EMIR by which notification of classification must be made.

Parties may incorporate classification details in their ISDA Master Agreements or in statements through ISDA Amend instead of using the Classification Letter.

However, parties must be careful to ensure that one of these forms takes precedence in case of duplication. Parties can elect in the Classification Letter that, in the event of inconsistencies between the Classification Letter and corresponding statements through ISDA Amend, one of them is specified to prevail over the other.

As a general statement, using either the Classification Letter or ISDA Amend is to be preferred over incorporating classification details in ISDA Master Agreements, in order to avoid inconsistencies.

What does the Classification Letter do?

The Classification Letter covers two types of classification: the EMIR clearing categorisation and the EMIR counterparty classification. Appendix I contains the new EMIR classification categories used in the RTS on the clearing obligation on interest rate swaps. 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.

Clearing categorisation

Appendix I of the Classification Letter requires each party to state whether it is a Category 1 Entity, Category 2 Entity, Category 3 Entity or Category 4 Entity. As a general rule, the clearing obligation is to apply first to Category 1 Entities, working down to Category 4 Entities, in a phased manner.

Category 1 is for clearing members. As set out in our July AB Briefs, membership of the remaining categories depends on whether the entity is a FC or a NFC+, whether it 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 (to be calculated over the three months following the publication of the final RTS for interest rate swaps). This notional figure is unlikely to be capable of determination before the beginning of 2016.

Will there be more classification letters in future?

Yes. The Classification Letter has been drafted to cover the RTS in relation to the first clearing obligations for interest rate swaps. However, it is likely that ISDA will release similar classification letters to cover OTC derivatives which in future become subject to mandatory clearing, or else the existing form of Classification Letter may be expanded to include those OTC derivatives. In any event, an entity's category election in Appendix 1 of the Classification Letter will be deemed to apply to further mandated classes of OTC derivatives unless notice to the contrary is given.