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*Practice Group(s):*

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## ISDA 2013 EMIR NFC Representation Protocol: Factors to consider in deciding whether to adhere

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On 8 March 2013, The International Swaps and Derivatives Association, Inc (“ISDA”) published the ISDA 2013 EMIR NFC Representation Protocol (the “Protocol”). Adherence to the Protocol provides parties to ISDA Master Agreements with a way of confirming their status for the purpose of European Union (“E.U.”) rules on the clearing of standardised derivatives. End-users in particular may find their counterparties requesting that they sign the Protocol. In this alert we examine the factors to be taken into account in deciding whether to adhere to the Protocol. We explain the background to the clearing obligation and to the Protocol, how parties can adhere to the Protocol and the effect of adherence. We also look at particular considerations for asset managers, investment advisors and agents in adhering to the Protocol.

### Background

Regulation (EU) 648/2012 of the European Parliament and the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (otherwise known as the European Market and Infrastructure Regulation or as EMIR) categorises counterparties to OTC derivative transactions as either “financial counterparties” or as “non-financial counterparties.” The distinction is relevant in relation to the obligation to clear derivatives through a recognised central counterparty (or “CCP”) established by Article 4 of EMIR (the clearing obligation) and the risk-mitigation techniques for OTC derivative contracts not cleared by a CCP established by Article 11 of EMIR. The term “financial counterparty” comprises investment firms authorised under MiFID;<sup>1</sup> authorised credit institutions; authorised insurance, assurance and reinsurance undertakings; UCITs funds and their related management companies; institutions for occupation retirement provision and alternative investment funds managed by investment managers authorised or registered under AIFMD<sup>2</sup> (all as defined in the relevant E.U. legislation).

The term “non-financial counterparty” comprises any undertaking<sup>3</sup> established in the European Union which is not a financial counterparty or a CCP.

EMIR further distinguishes between non-financial counterparties depending on whether their OTC derivative positions in designated categories of transaction exceed a limit referred to as the “clearing threshold” on the basis of their rolling average position over 30 working days. In ISDA’s terminology, non-financial counterparties that exceed the clearing threshold are

<sup>1</sup> Directive 2004/39/EC on markets in financial instruments.

<sup>2</sup> Directive 2011/61/EU on Alternative Investment Fund Managers.

<sup>3</sup> The term “undertaking” is undefined but it would be prudent to assume that any party to an ISDA Master Agreement will fall within the term “undertaking” (and will therefore be a non-financial counterparty unless it is either a financial counterparty or a CCP).

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referred to in the Protocol as "NFC+ Parties," and those which do not exceed the clearing threshold are "NFC- Parties."<sup>4</sup>

Broadly speaking, the clearing obligation only applies if each of the parties to an OTC derivative is either a financial counterparty or an NFC+ Party (or would fall into either of those two categories were it established in the European Union).<sup>5</sup> To put it another way, only financial counterparties, NFC+ Parties and their non-European equivalents<sup>6</sup> are subject to the clearing obligation.

EMIR requires financial counterparties and NFC+ Parties to mark to market the value of their uncleared OTC derivatives positions on a daily basis and to exchange collateral or hold capital against their uncleared derivative exposures.<sup>7</sup>

Therefore parties to ISDA Master Agreements will be interested to know whether their counterparties are financial counterparties, NFC+ Parties or NFC- Parties. They will also need to understand their own status.

### When does the Protocol apply?

The Protocol is voluntary. To adhere to the Protocol, a party must submit an adherence letter to ISDA<sup>8</sup> and pay a fee of U.S. \$500. ISDA will send the adhering party an email confirmation when it has accepted the adherence letter. In the adherence letter, the party must specify one of three options:

1. it can adhere as a party making the NFC Representation (for which see below);
2. it can adhere as a NFC+ Party making the NFC Representation; or
3. it can adhere to the Protocol as a party that does not make the NFC Representation.

In addition, the party may specify its DTCC Account number and any codes relevant to electronic matching and counterparty recognition (such as its LEI and CICI codes).

Once a party adheres to the Protocol, any existing ISDA Master Agreement it has with another party that has already adhered will be modified in accordance with the Protocol.<sup>9</sup> A

<sup>4</sup> The clearing threshold varies by type of derivative and is calculated on a consolidated basis. There are exceptions for certain intra-group transactions and certain transactions intended to hedge commercial or treasury risks (see further Article 10 of EMIR and the technical standards on OTC Derivatives, Reporting to Trade Repositories and Central Counterparties adapted by the European Parliament and the Council on 19 February 2013).

<sup>5</sup> If both counterparties are established outside the E.U., the relevant derivative transaction will only be subject to the clearing obligation if the contract has a direct, substantial and foreseeable effect within the European Union or where it is necessary or appropriate to impose the clearing obligation to prevent the evasion of any provision of EMIR. Given that the market for OTC derivatives is essentially a global market, it would be possible to argue that a great deal of activity within the market has a "direct, substantial and foreseeable effect" within the European Union. In any event, for a particular OTC derivative to be subject to the clearing obligation, it will also be necessary for it to belong to a class of derivative contract specified as being subject to clearing in a technical standard drafted by the European Securities and Markets Association ("ESMA") and adopted by the E.U. Commission.

<sup>6</sup> Note that certain categories of non-European entities are capable of falling within the definition of "financial counterparty". For example, a Cayman alternative investment fund managed by an alternative investment manager registered or authorised under AIFMD will constitute a "financial counterparty".

<sup>7</sup> There is an exception for certain intragroup transactions.

<sup>8</sup> The form of adherence letter is set out in the Protocol Management section of ISDA's website at [www.isda.org](http://www.isda.org). For the precise terms governing adherence, see paragraph 1 of the Protocol.

<sup>9</sup> ISDA Master Agreements entered into between two parties both of which have previously adhered to the Protocol will not be modified by the Protocol (subject to the express provisions of the ISDA Master Agreement itself). There is a limited exception for certain ISDA Master Agreements which are deemed to be created by two existing adhering parties by execution of a confirmation.

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party that has adhered to the Protocol can revoke its future adherence by serving a notice on ISDA during October in any calendar year; revocation is effective on 31 December in the same year, subject to modification for business days. Revocation does not affect any ISDA Master Agreements which have already been modified by the Protocol. ISDA has reserved for itself a right to declare a "Cut-off Date" on 30 calendar days' notice, following which no further parties will be permitted to adhere.

The Protocol provides that an adhering party will make certain representations under affected ISDA Master Agreements as at the date it adheres, including in relation to its status and power to adhere; that its obligations under the adherence letter and the affected ISDA Master Agreement are binding and it has obtained all necessary consents; that adherence does not conflict with applicable law, its constitutional documents or its contractual obligations; and that adherence does not adversely affect any credit support document relating to it.

### How does the Protocol modify an ISDA Master Agreement?

At the heart of the Protocol is the NFC Representation, which reads as follows:

*Each Representing Party represents to the other party on each date and at each time on which it enters into a Transaction (which representation will be, subject to sub-paragraph (ii) below,<sup>10</sup> deemed to be repeated by a Representing Party at all times while such Transaction remains outstanding) that:*

1. *it is either (A) a non-financial counterparty (as such term is defined in EMIR) or (B) an entity established outside the European Union that, to the best of its knowledge and belief, having given due and proper consideration to its status, would constitute a non-financial counterparty (as such term is defined in EMIR) if it were established in the European Union; and*
2. *it is not subject to a clearing obligation pursuant to EMIR (or, in respect of an entity under subparagraph (1)(B) above, would not be subject to the clearing obligation if it were established in the European Union) in respect of such Transaction. For the purposes of this subparagraph (2) of this representation, it is assumed that the Transaction is of a type that has been declared to be subject to the clearing obligation in accordance with Article 5 of EMIR and is subject to the clearing obligation in accordance with Article 4 of EMIR (whether or not in fact this is the case), and that any transitional provisions in EMIR are ignored.*

In other words, parties adhering to the Protocol and making the NFC Representation represent that they are non-financial counterparties (or would be so if they were established in the E.U.) and that they are not subject to the clearing obligation. Parties adhering to the Protocol as NFC+ Parties make the representation contained in sub-paragraph (1) of the NFC Representation, but not that contained sub-paragraph (2). In other words, they confirm that they are non-financial counterparties (or the non-European equivalent), but they do not make any representation as to whether the clearing obligation applies to them. These representations are given on a continuing basis (*i.e.*, at all times while the relevant transaction is outstanding).

A financial counterparty (or its non-E.U. equivalent) which wishes to adhere to the Protocol should, of course, do so as a "party that does not make the NFC Representation," as it is

<sup>10</sup> Sub-paragraph (ii) deals with the change of status notices referred to below.

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unable to confirm either sub-paragraph (1) or sub-paragraph (2). However, from a counterparty's perspective, the distinction between a financial counterparty and its non-E.U. equivalent can be relevant. For example, EMIR will require a bank in New York to clear if it deals with a U.K. bank (subject, of course, to the relevant OTC derivative having been designated as subject to the clearing obligation and to the rules governing EMIR's extra-territorial effect which are still being developed). However, EMIR will not require it to clear a transaction with another U.S. entity unless there is a "direct, substantial and foreseeable effect" on the E.U. or the transaction is entered into for the purpose of evading EMIR. Therefore, for the New York bank, the distinction between its counterparty being (a) a "financial counterparty" or (b) a non-E.U. entity that would be a financial counterparty were it established in the E.U. is material. The Protocol does not distinguish between these two situations. Therefore, market participants outside the E.U. may need to obtain additional representations from their counterparties.

The status of a non-financial counterparty as either an "NFC+ Party" or a "NFC- Party" can change according to the volume of derivatives business it undertakes. It is also possible that a party that is a financial counterparty when it signs the Protocol can later become a non-financial counterparty (and vice-versa). The Protocol therefore makes provision for parties to change their status by delivering a notice to their counterparties. Non-financial counterparties which become subject to clearing after they sign up to the Protocol (for example, because the volume of their derivatives business increases) are able to serve a Clearing Status Notice and thereby disapply sub-paragraph (2) of the NFC Representation. Similarly, non-financial counterparties which fall below the clearing threshold may elect to start to make sub-paragraph (2) of the NFC Representation by serving a Non-Clearing Status Notice.

The Protocol permits a party that becomes a financial counterparty after it signs up to give a "Non-representation Notice" and thereby cease to make the NFC Representation. Similarly, a party that does not make the NFC Representation when it adheres to the Protocol can elect to start to make either the whole of the NFC Representation (by delivering a NFC Representation Notice) or just sub-paragraph (1) of the NFC Representation by delivering a (NFC+ Representation Notice).

The Protocol permits parties to specify an address to which their counterparties can send notices in relation to a change of status (which can be different to their general address for delivery of notices under the ISDA Master Agreement). Parties can also specify "Counterparty Manager" in their adherence letter and, if both parties to an ISDA Master Agreement do so and are subscribers to the Markit Counterparty Manager Service, notices can be delivered through that service. This option may be useful for parties with a large number of ISDA Master Agreements in place.

### The consequences of a breach of the NFC Representation

If a party breaches sub-paragraph (2) of the NFC Representation in any material respect in relation to a transaction which is subject to the clearing obligation under EMIR (*e.g.*, if the party warrants that it is an NFC- Party when in fact it is subject to clearing) the consequences depend on whether the deadline for clearing the transaction under EMIR has passed or not. If it has not, the parties are required to negotiate in good faith and in a commercially reasonable manner to modify the transaction to make it clearable. This can involve the payment of a balancing payment by either party to reflect the difference in pricing between cleared and non-cleared trades. If the clearing deadline has passed, then an Additional Termination Event (as defined in the ISDA Master Agreement) will occur.

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If a party breaches sub-paragraph (2) in any material respect in relation to a trade that is subject to the risk mitigation techniques imposed by Article 11 of EMIR (*i.e.*, an OTC derivative trade which is not cleared) the parties must negotiate to ensure that the risk mitigation techniques are adhered to within six business days of the parties becoming aware of the breach (or, if later, the last day of any official transitional period in relation to the application of the risk mitigation techniques). Again, this can involve a payment by either party to reflect any difference in pricing between the trade as transacted and the trade as amended to adhere to the risk mitigation techniques.

If the transaction is not modified so that it is clearable or made subject to the risk mitigation techniques (as appropriate) within these time limits, an Additional Termination Event (as defined in the ISDA Master Agreement) will occur in relation to the transaction. It is worth noting that an Additional Termination Event will necessarily occur in relation to a transaction which should have been cleared under EMIR but was not before the clearing deadline had passed (although this in itself does not mean that the underlying Transaction will automatically terminate). The payment measure in relation to the Additional Termination Event will be "Loss" for transactions documented under the 1992 ISDA Master Agreement even if the applicable Schedule specifies "Market Quotation". The Protocol provides that neither a breach of the NFC Representation nor a failure to negotiate to amend the relevant transaction in the circumstances provided by the Protocol will constitute an Event of Default (without prejudice to any rights and remedies provided by law).

If an Additional Termination Event occurs, only the transaction which is the subject of the breach will be an "Affected Transaction," and therefore only this transaction can be terminated. The sole "Affected Party" will be the party which breached the NFC Representation, and therefore it will be the other party which determines the settlement amount on a close out. However, both parties are entitled to give a termination notice in relation to the affected transaction in order to close it out.<sup>11</sup> Parties considering whether to adhere to the Protocol should therefore note that their counterparty may be able to terminate a transaction, notwithstanding that it proves to be the counterparty's NFC Representation which is incorrect or misleading.

### Particular considerations for Asset Managers, Investment Advisors and other Agents

The Protocol allows an agent to adhere to the Protocol in one of three ways:

1. on behalf of all clients represented by the agent;
2. on behalf of those clients specifically referred to in the adherence letter;
3. on behalf of all clients represented by the agent other than those specifically agreed on a bilateral basis between the agent and any counterparty.

This provision will be of particular interest to asset managers or investment advisors entering into ISDA Master Agreements on behalf of separate managed accounts or funds. The term "client" in this context includes funds on whose behalf the asset manager or investment adviser acts. This provision is therefore capable of applying to ISDA Master Agreements

<sup>11</sup> This is because both parties are deemed to be Affected Parties for the sole purpose of Section 6(b)(iv). Section 6(b)(iv) specifies that where there are two Affected Parties in relation to an Additional Termination Event, both have the right to terminate.



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entered into between, for example, a bank and an asset manager or investment advisor acting on behalf of a number of funds.

UCITS funds are financial counterparties, as are alternative investment funds managed by alternative investment managers authorised or registered in accordance with AIFMD. Therefore, once the authorisation/registration requirements of AIFMD become compulsory, virtually all funds in the European Union will constitute financial counterparties. On the face of it, funds established outside the European Union will therefore be "entities that would be subject to the clearing obligation if they were established in the Union" (at least at the point in time at which the authorisation/registration provisions of AIFMD become compulsory) and will therefore be potentially subject to clearing. Regulatory technical standards on the extra-territorial effect of EMIR are anticipated, and so there may be further clarification on this point.

Because the authorisation and registration requirements of AIFMD are not yet in effect, it appears that alternative investment funds could currently give the NFC representation (either as NFC+ Parties or NFC- Parties depending on their circumstances). However, they will become financial counterparties as and when their related investment managers become authorised or registered under AIFMD. Therefore, alternative investment managers adhering to the Protocol on behalf of alternative investment funds may wish to do so as "Non-Representing Parties" to avoid the need to give a Non-representation Notice in due course.

The situation is more complex in relation to managed accounts, as they could constitute non-financial counterparties under EMIR depending on the circumstances of the account owner. Asset managers or investment advisors should consider with care whether their managed account clients may be eligible to make the NFC Representation and should ensure that they obtain appropriate authority from their clients in order to make the NFC Representation on their behalf if required to do so.

The Protocol also provides that any new fund (or indeed any client) added to an umbrella ISDA Master Agreement will be subject to the Protocol unless the ISDA Master Agreement provides otherwise.

### Factors to be taken in to account in deciding whether to sign up to the Protocol

Financial counterparties and NFC+ Parties, as well as their non-European equivalents, will need to know the status of their counterparties before the clearing obligation takes effect. In relation to the clearing obligation there is still time to consider how to achieve this because mandatory clearing is not expected to come into effect in Europe in relation to any class of OTC derivative before summer 2014 at the earliest.<sup>12</sup> However, it is advisable that parties plan the appropriate diligence well in advance of the mandatory clearing deadline.

Adherence to the Protocol represents a relatively straightforward way of modifying agreements without the need to undertake the time consuming exercise of amending agreements bilaterally. It provides a mechanism for modifying transactions which should be cleared or collateralised in circumstances in which a party has incorrectly represented its EMIR status and where it is still possible to remedy the failure within the relevant time limits.

<sup>12</sup> However, note that EMIR's requirement that parties have in place appropriate procedures in relation to the timely confirmation of non-cleared OTC derivative contracts is already in force; the time limits specified in the relevant technical standard depend in part on whether the counterparty is a financial counterparty, an NFC+ Party or an NFC- Party, and therefore an understanding of a counterparty's status is already relevant for the purpose of compliance in relation to the timely confirmation of trades.

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The inclusion of an Additional Termination Event also provides the ability to unwind trades which cannot be modified to comply with EMIR in a timely manner.

It will generally be clear whether a party considering adhering to the Protocol is a financial counterparty, an NFC+ Party or an NFC- Party. However, there are circumstances in which categorising a party for this purpose may be problematic. Not all non-European entities will have direct equivalents under European financial services regulation, and therefore it will not always be possible to say with certainty whether a party established outside the European Union would be subject to the clearing obligation were it established in the European Union.<sup>13</sup> Determining whether a non-financial counterparty is an NFC+ Party or an NFC- Party may also be problematic in certain cases, particularly given the difficulty in interpreting the hedging exemption to the clearing obligation and the application of the 30-day rolling average test. In certain circumstances, it may also be difficult to assess which entities should be consolidated with the party to the ISDA Master Agreement for the purpose of calculating compliance with the clearing threshold. Aside from the interpretational issues, there is also a risk that the NFC Representation could be breached inadvertently if a non-financial counterparty's trading volume took it above the clearing threshold, especially as the NFC Representation is a continuing representation.

These issues are the inevitable result of a lack of clarity in EMIR itself on certain points. Parties considering giving all or part of the NFC Representation under the Protocol should, of course, take account of the potential consequences of a breach. Those consequences can include an Additional Termination Event. From the financial counterparty or NFC+ Party's perspective this may be attractive (although those considering adhering to the Protocol should bear in mind that the right to terminate is given to both parties). Parties requesting that their counterparties give all or part of the NFC Representation will also make the point that the occurrence of an Additional Termination Event will not necessarily result in termination, but rather is intended to "bring the parties to the table." End-users considering whether or not to adhere to the Protocol as NFC-Parties will note that the immediate termination of a trade is a possible consequence of non-compliance with the NFC Representation.

Potential alternatives to adherence to the Protocol include financial counterparties and NFC+ Parties obtaining information relevant to their client's EMIR clearing status as part of their KYC process (although this in itself will not necessarily provide a mechanism for dealing with situations in which that information proves to be incorrect) and the bilateral amendment of ISDA Master Agreements. NFC- Parties considering bilateral amendment should ensure that a breach of any additional representation they make in relation to their clearing status will not result in an Event of Default in relation to the whole of the ISDA Master Agreement (an important protection given in the Protocol itself).

### Conclusion

The Protocol represents ISDA's efforts to respond to complex regulatory provisions affecting OTC derivatives transactions which are still in the process of change. In a manner which is similar to the Dodd-Frank Protocol in the United States, the Protocol is a tool that is designed to permit market participants to confirm their clearing status without the need to undertake the exercise of making bilateral amendments. If experience with the Dodd-Frank Protocol is a guide, dealers (and possibly other financial counterparties and NFC+ Parties) will insist that their counterparties adhere to the Protocol and make the appropriate resolutions. However,

<sup>13</sup> As discussed above, further regulatory technical standards on the extra-territorial application of EMIR are due to be published, and this may give some clarification.

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alternative solutions, including bilateral amendment, are available, and the take-up of the Protocol will also depend on whether market participants believe that the Protocol will achieve widespread acceptance. While the Protocol is a positive step, the consequences of adherence must be considered with care by market participants and their professional advisors, particularly in cases where the market participant's clearing status is not obvious.

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