Guidelines on the selection of OTC counterparties for ETHENEA Independent Investors S.A.

As at: 29/10/2024

The selection of counterparties for EMIR relevant "OTC" transactions, such as iTraxx CDS/CDX, FX Forwards or FX Options, is subject to the following criteria within ETHENEA Independent Investors S.A. (hereinafter "ETHENEA"):

1. The counterparty's country of establishment may only be one of the countries of the European Economic Area or the G10 states.
2. The counterparties must be authorized by a state supervisory authority and subject to state supervision.
3. The counterparties must be specialized in OTC transactions and fulfill the agreed delegated reporting obligations
4. Each counterparty must have at least an investment grade rating from a reputable credit agency.
5. The counterparties must not be "U.S. persons" as defined below.
6. For counterparties with a rating of AAA, no collateral management agreement is required. Furthermore, OTC transactions with the fund's custodian bank are also exempt from the collateral management requirement.
7. For counterparties with a rating of at least A-, a procedure must be established which provides for at least monthly settlement payments of outstanding amounts.
8. With counterparties that have a rating worse than A-, collateral management in the form of a credit support annex must be agreed and established.
9. The custodian bank must approve all counterparties that meet these criteria in advance and after its own review.

ETHENEA requests the relevant International SWAPS and Derivatives Association (ISDA) framework agreements for review from the potential OTC counterparty and, after processing and review, makes them available to the custodian bank for their independent review.

After completion of the checks and if there is agreement between ETHENEA, the custodian bank and the OTC counterparty, the contracts are signed and the respective internal procedures for establishing a business relationship are activated.

The depositary bank is exempt from this procedure in its capacity as counterparty for OTC FX forwards of the funds; due to the special contractual relationship, collateral management is generally waived here.

Definitions:

Over-the-counter (OTC) is the trading of securities between two counterparties executed outside of formal exchanges and without the supervision of an exchange regulator. OTC trading is done in over-the-counter markets (a decentralized place with no physical location), through dealer networks.

OTC dealers convey their bid and ask quotes and negotiate execution prices by telephone, mass e-mail messages, and, increasingly, text messaging. The process is often enhanced through electronic bulletin boards where dealers post their quotes.

Role of derivatives

Derivatives play an important role in the economy, but they also bring certain risks. We saw this clearly during the 2008 financial crisis, when significant weaknesses in the OTC derivatives markets became evident.

In 2012 the EU adopted the European market infrastructure regulation (EMIR). The aim was to

- increase transparency in the OTC derivatives markets
- mitigate credit risk
- reduce operational risk

What is EMIR?

Based on the experiences of the 2008 financial market crisis, the heads of state and government of the leading industrial nations at the 2009 G20 summit in Pittsburgh decided to increase the transparency and safety of OTC (over-the-counter) derivatives trading. The G20 leaders specifically decided that in future any standardised OTC derivatives would have to be cleared through central counterparties and that OTC derivatives must be reported to trade repositories.

Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (European Market Infrastructure Regulation – EMIR) has been in force since August 2012 to implement these objectives and create a uniform supervisory framework regarding central counterparties (CCPs). EMIR has been revised in the EMIR Regulatory Fitness and Performance programme (EMIR Refit) and came into force on 17 June 2019.

Who is affected?

The EU Regulation contains requirements for the parties to derivative transactions. In this respect, the Regulation differentiates between financial counterparties and non-financial counterparties. Pursuant to Article 2(8) of EMIR, a financial counterparty is defined as:

- any investment firm authorised in accordance with Directive 2014/65/EC;
- any credit institution authorised in accordance with Directive 2013/36/EC;
- any insurance undertaking or reinsurance undertaking authorised in accordance with Directive 2009/138/EC;
- any UCITS and, where relevant, its management company, authorised in accordance with Directive 2009/65/EC, unless that UCITS is set up exclusively for the purpose of serving one or more employee share purchase plans;
- any institution for occupational retirement provision (IORP) as defined in point (1) of Article 6 of Directive (EU) 2016/2341 of the European Parliament and of the Council;
- any alternative investment fund (AIF), as defined in point (a) of Article 4(1) of Directive 2011/61/EU which is either established in the Union or managed by an alternative investment fund manager (AIFM) authorised or registered in accordance with Directive 2011/61/EU, unless that AIF is set up exclusively for the purpose of serving one or more employee share purchase plans, or unless that AIF is a securitisation special purpose entity as referred to in point (g) of Article 2(3) of Directive 2011/61/EU, and, where relevant, its AIFM established in the Union.
- any central securities depository in accordance with Regulation 909/2014/EU

For purposes of the Regulation, all other entities established in the EU are to be classified as non-financial counterparties (see also non-financial counterparties).

What is governed by the Regulation?

The Regulation contains the following elements in particular:

A clearing obligation applies to standardised OTC derivatives.

The additions to EMIR Refit mean that from now on not only non-financial counterparties but also financial counterparties will be classified according to whether the aggregate gross notional volume of the OTC derivative transactions of the FCs and NFCs consolidated within the group is below or above the clearing threshold, whereby the latter will result in the following notification requirements:

Under Article 4a of EMIR, financial counterparties are required to notify BaFin and ESMA if they exceed the clearing threshold or if they do not calculate their positions. Financial counterparties that do not calculate their positions, or do calculate their positions and exceed the clearing threshold, are subject to the clearing obligation for all classes of OTC derivatives.

Under Article 10 of EMIR, non-financial counterparties are required to notify BaFin and ESMA if they exceed the clearing threshold or if they do not calculate their positions. Non-financial counterparties that

do not calculate their positions are subject to the clearing obligation for all classes of OTC derivatives. Non-financial counterparties that do calculate their positions and exceed the clearing threshold are only subject to the clearing obligation for the classes of derivatives in which the clearing threshold was exceeded. Moreover, non-financial counterparties can exclude from the calculation OTC derivative contracts that are objectively measurable as reducing risks relating to their commercial activity.

If the results of the calculation show that the clearing threshold has not been exceeded, a notification to BaFin and ESMA is not required. However, after a year the entities are required to review whether their positions are still below the clearing thresholds. But even then, a notification is only necessary if this review leads to a change in the status (subject to the clearing obligation/not subject to the clearing obligation).

The contracting parties must also comply with special risk-management requirements in the case of transactions which, as a result of their structure, are not suitable for central clearing.

In order to increase transparency, derivative transactions must be reported to a trade repository. The EU Regulation also governs the requirements for the authorisation and continuous monitoring of central counterparties and provides for closer cooperation between the supervisory authorities. The responsibility for supervising the trade repositories has been therefore transferred to the European Securities and Markets Authority (ESMA). The provisions of the EU Regulation are directly applicable in Germany.

To which financial instruments does the Regulation apply?

OTC derivatives are derivatives within the meaning of points (4) to (10) of Section C of Annex I to Directive 2004/39/EU (Markets in Financial Instruments Directive – MiFID), which are not executed on a regulated market within the meaning of Article 4(1)(14) of Directive 2004/39/EC or on a third-country market considered equivalent to a regulated market in accordance with Article 19(6) of Directive 2004/39/EC. However, the requirement regarding reporting to trade repositories applies to all derivatives within the meaning of the aforementioned Directive.

What obligations must financial and non-financial counterparties comply with?

When the clearing obligation for certain groups of derivative contracts is imposed, subject to potential transitional periods, financial counterparties and non-financial counterparties whose OTC derivative volume exceeds a certain threshold are obliged to clear such OTC derivative contracts via a CCP.

To date, the following legal acts have been adopted by the Commission:

- Commission Delegated Regulation (EU) No 2015/2205 (OJ of 1 December 2015, L 314/18);
- Commission Delegated Regulation (EU) No 2016/592 (OJ of 19 April 2016, L 103/5);
- Commission Delegated Regulation (EU) No 2016/1178 (OJ of 20 July 2016, L 195/3);
- Commission Delegated Regulation (EU) No 2017/751 (OJ L 113/15).

The current situation with regard to the interest rate, equity, credit and foreign exchange derivative classes can be accessed on the ESMA website.

Moreover, financial and non-financial counterparties have the obligation to monitor whether they are exceeding the clearing thresholds set out in EMIR and in the technical standards and are thus subject to the clearing obligation and further risk-management requirements regarding bilaterally traded contracts.

EMIR imposes special risk-management requirements regarding bilaterally traded OTC derivative contracts. The technical standards define these requirements in greater detail. In particular, the technical standards lay down the requirement that transactions in OTC derivatives be confirmed by the counterparties – preferably by electronic means – within a certain period.

Financial counterparties and non-financial counterparties that have exceeded the threshold referred to in Article 10 of EMIR must fulfil additional risk-management requirements. This also includes the collateralisation of OTC derivatives that are not centrally cleared. The details are stipulated in Commission Delegated Regulation (EU) No 2016/2251.

Furthermore, financial counterparties and non-financial counterparties are required to report all transactions in derivatives (including exchange-traded derivatives) to trade repositories (see "Reporting obligation").

What action is required?

Clearing and margin requirements

Option regarding calculation or non-calculation of the clearing threshold

Under EMIR Refit, financial counterparties and non-financial counterparties are able to choose whether to calculate their positions to determine whether they exceed the clearing threshold. Counterparties that do not carry out this calculation promptly after the changes come into force must inform BaFin and ESMA of this without undue delay (case 1). They will then be subject to the clearing obligation for all asset classes.

If counterparties decide to calculate their positions against the clearing thresholds, the aggregate month-end average positions for the previous 12 months in the respective derivative classes named below are to be used. The calculation must be carried out at whole-group level. BaFin and ESMA are to be informed without undue delay if the clearing threshold is exceeded (case 2).

The clearing thresholds are set out in Article 11 of Commission Delegated Regulation (EU) No 149/2013. These are EUR 1 billion for OTC credit derivative contracts, EUR 1 billion for OTC equity derivative contracts, EUR 3 billion for OTC interest rate derivative contracts, EUR 3 billion for OTC foreign exchange derivative contracts and EUR 3 billion for OTC commodity derivative contracts and other OTC derivative contracts (all values in terms of gross notional value). Non-financial counterparties are only to take into account positions of non-financial counterparties in the group and are not to take into account OTC derivative contracts that are objectively measurable as reducing risks (“hedging”). Financial counterparties are to take into account positions of financial and non-financial counterparties in the group.

If the results of the calculation show that the clearing threshold has not been exceeded, a notification to BaFin and ESMA is not required.

Scope of the clearing obligation for financial and non-financial counterparties

Financial counterparties that do not calculate their positions are subject to the clearing obligation for all classes of OTC derivatives (case 1). Financial counterparties that do calculate their positions and exceed the clearing threshold are also subject to the clearing obligation for all classes of OTC derivatives (case 2).

Non-financial counterparties that do not calculate their positions are subject to the clearing obligation for all classes of OTC derivatives (case 1). Non-financial counterparties that do calculate their positions and exceed the clearing threshold are only subject to the clearing obligation for the classes of derivatives in which the clearing threshold was exceeded (case 2). Moreover, non-financial counterparties (unlike financial counterparties) can exclude from the calculation OTC derivative contracts that are objectively measurable as reducing risks relating to their commercial activity ("hedging").

The non-financial counterparties that exceed the thresholds should note that exceeding these thresholds also means that the requirements under Article 11 of EMIR, including the collateralisation requirement, are to be met for OTC derivatives in all asset classes. Financial counterparties are always required to meet the requirements under Article 11 of EMIR for OTC derivatives, regardless of any exemptions from the clearing obligation.

Deadline for compliance with the clearing and collateralisation requirement, recalculation before deadline for compliance

Counterparties are required to comply with the clearing obligation within four months after submitting the above notification to the supervisory authorities (case 1 or case 2) if they are subject to the clearing obligation for the first time. Counterparties that were already subject to the clearing obligation remain so.

These counterparties have a period of four months in which they have the option of providing evidence to BaFin and ESMA that they have dropped back below the clearing threshold. If such evidence is provided, the clearing obligation no longer applies.

In this context, these counterparties must be in a position to demonstrate to BaFin and ESMA (at any time) that the calculation does not result in a systematic underestimation of the positions. This would be the case, for example, if the counterparty systematically made adjustments shortly before determining the month-end position such that it was under the clearing threshold.

Frequency of calculations and notifications to BaFin and ESMA

No calculation (case 1):

The notification stating that no calculation has been carried out applies until further notice and does not need to be submitted annually. However, BaFin is to be notified of any changes, e.g. new subsidiaries, without undue delay.

Calculation (case 2):

The calculation is to be carried out annually. The results are to be sent to BaFin and ESMA if there are any changes relating to the group's status with regard to the clearing obligation. In principle, the calculation has to applied on 17th June (reference date). Devitations can occur by falling below the threshold within the one year reference period.

If the counterparty falls below the clearing threshold later in the year, this can be reported during the year. Supporting evidence is to be provided.

In accordance with the principles specified above, the notifications are also to be submitted to ESMA. ESMA has updated its Q&As on this topic.

Reporting to trade repositories

Moreover, counterparties are obliged, since 12 February 2014, to report any new derivative contract.

See Reporting obligation under Article 9 of EMIR.

Risk mitigation techniques

In addition, as of 15 March 2013, the risk-mitigation techniques laid out under Article 11 of EMIR must be applied to new as well as existing contracts. These include the obligation to confirm in a timely manner and to regularly mark-to-market the derivative contracts, to reconcile and compress portfolios, and to resolve disputes.

BaFin believes that, in order for these obligations to be met, contractual agreements with banks and other counterparties are always to be tested for compliance with the requirements set out by EMIR.

Special Arrangements and LEI

Please note that different entities have drafted special agreements for this purpose. If existing or future derivative contracts were entered into under an International Swaps and Derivatives Association (ISDA) Master Agreement, it is possible to sign a corresponding ISDA-EMIR protocol.

A special EMIR annex was developed for contracts entered into under the German Master Agreement. In addition, under certain circumstances, it may be necessary to examine a collateral annex for compatibility with the obligations under EMIR.

BaFin recommends that counterparties consider signing these or other, including bilateral, agreements in order to meet the EMIR obligations.

Entities need a unique legal entity identifier (LEI) in order to fulfil the EMIR reporting obligations. Information on the identification of parties subject to the reporting obligation can be found under "Reporting obligation". Entities which do not have a LEI yet should apply for their LEI immediately if they are subject to the reporting obligation of Article 9 of EMIR.

BaFin advises that a contravention of the EMIR obligations is an administrative offence and may result in proceedings for the imposition of fines.

Confirmation is the process by which, either through electronic messaging or through the use of paper confirmations, the parties legally memorialize the terms of the trade. Confirmation is typically performed on T, or as soon as practical thereafter.

In short, **"US persons"** are legal entities that are based in the United States and their branches abroad (e.g. Citibank New York and Citibank London Branch). Legal entities that have their "principal place of business" – i.e. the majority of their business activities – in the United States, regardless of their country of residence, are also classified as "US persons".

"Special Entities" represent a subset of "U.S. Persons" and are government entities, such as a federal agency, a state, a federal agency, a city, a county, or similar, or companies in which one of the aforementioned government entities has a direct or indirect interest.