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Mr. Rodrigo Buenaventura,
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Mrs. Isabelle Vaillant,
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26 June 2012

Dear Mr. Pearson,

Dear Mr. Buenaventura,

Dear Mrs. Vaillant,

Concerns regarding application of Article 11 EMIR

Article 11 of EMIR[1] sets out the risk-mitigation techniques that counterparties are required to put in place in relation to OTC derivative contracts not cleared by a CCP.

However, there are a number of points in relation to the scope of application of Article 11 and the timing for implementation which are still unclear. It will be essential for firms preparing for implementation of EMIR to understand the scope of the obligations under Article 11, and we urge the Commission and the European Supervisory Authorities (ESAs) to address these issues and to issue clarifications or provide some other solution to the problems raised.

For example, although the text of the Regulation may not have been drafted with the intention of having immediate effect upon entry into force (for aspects of the text not covered by recital 93), we are concerned that the intention of the legislators may not be so clear to the competent authorities focusing on ensuring timely implementation of the Regulation (and not all of whom may have been directly involved in the final stages of negotiation at 'level 1).

[1] All references in this note are to the 15 June 2012 text of EMIR

We are concerned that this lack of certainty may create difficulties for regulated firms and their competent authorities alike (and may already be doing so).

As such we do not believe that this situation should await clarification until the regulatory and implementing technical standards have been adopted.

Scope of application:

Types of contracts: The heading of article 11 states that it covers risk-mitigation techniques for OTC derivative contracts not cleared by a CCP. Similarly, recitals 24 and 25 refer to risk mitigation techniques for OTC derivative contracts not cleared by a CCP, and the joint discussion paper on risk mitigation techniques issued by the ESAs on 6 March 2012 reiterates that risk mitigation techniques are necessary in relation to transactions which are not centrally cleared. However, the various provisions of article 11 are not consistent in the way they refer to the contracts which are covered. Article 11(1) refers to "OTC derivative contracts not cleared by a CCP", but article 11(2) refers to "outstanding contracts" and article 11(3) refers to "OTC derivative contracts" and Article 11(4) does not explicitly identify its scope. *We ask the Commission or ESMA to confirm that these differences in terminology are not intended to reflect differences in scope of application and that all the obligations under Article 11 are limited to OTC derivative contracts not cleared by a CCP.*

Similarly, it is unclear whether the references to a "CCP" in article 11 are references to a CCP authorised under article 14 or recognised under article 25, or whether they are references to any CCP. In contrast, article 4(3) clearly states that OTC derivative contracts subject to the clearing obligation must be cleared in a CCP which is authorised or recognised under EMIR. As a result, we consider that the better view would be that the references to a "CCP" in article 11 are references to any CCP, regardless of whether it is authorised or recognised under EMIR. As a result, the obligations under article 11 would only apply to OTC derivatives contracts which are not cleared by any CCP. If a contract is cleared by a CCP authorised or recognised under EMIR, or a CCP authorised or recognised under national law during the transitional period, the risk mitigation obligations of Article 11 will not apply. This will be particularly important during the transitional period as there are some CCPs which clear OTC derivatives that are currently authorised or recognised under national law which will not be authorised or recognised under EMIR for several months. *We ask the Commission or ESMA to confirm that this is how Article 11 should be applied and to determine how the NFC thresholds will be monitored and communicated.*

Parties: The joint discussion paper issued by the ESAs on 6 March 2012 (on risk mitigation techniques for OTC derivatives not cleared by a CCP) indicates at paragraph 52 that the mandate for draft regulatory technical standards (RTS) does not leave room for outlining a third country regime for the exchange of collateral. We understand that this is because the ESAs interpret article 11(3) only to impose obligations on financial counterparties (FCs) and on non-financial counterparties above the clearing threshold (NFC+s) to exchange collateral when they enter into transactions with one another. As a result, we understand that there is no obligation on FCs or NFC+s to exchange collateral under article 11(3) with other counterparties, in particular counterparties not established in the EU (although non-EU counterparties may be subject to obligations to exchange collateral under Article 11(12) when they enter into transactions with each other). *We ask the Commission and the ESAs to make clear how Article 11(3) applies in this regard.*

Similar issues arise in relation to Article 11(1) which also appears only to apply where FCs and non-financial counterparties (NFCs) enter into transactions with one another. Indeed, there would be practical issues for firms in complying with Article 11(1) if their counterparties were not subject to a corresponding obligation. *Again, we ask the Commission and ESMA to make this clear.*

We note that article 11(3) currently refers to "non-financial counterparties referred to in Article 10". Article 10 makes clear that NFCs which meet the conditions referred to in Article 10(1) only become subject to the clearing obligation after four months and Article 10(2) specifies how such an NFC can establish that the clearing obligation no longer applies. We consider that the risk mitigation obligations in Article 11(3) should begin and cease to apply to NFCs at the same time as the clearing obligation. *We ask the Commission and the ESAs to make it clear that this is how Article 11(3) should be applied.*

<u>Timing issues</u>:

Entry into force: Recital 93 states that any obligation imposed by EMIR and which is to be further developed by means of acts adopted under Articles 290 and 291 TFEU should be understood as applying only from the date on which those acts take effect. However, in contrast to other provisions in Title II (such as Articles 5 and 9), Article 11 does not include any provisions providing for RTS to specify an effective date or phase-in of the risk mitigation obligations. It would obviously be impractical if the risk mitigation obligations were to come into force (by virtue of Article 91) before the relevant technical standards have been adopted (e.g., firms could be subject to an obligation to exchange collateral without knowing the levels and type of collateral required for compliance with Article 11(3)).

We ask the Commission and the ESAs to confirm that none of the risk mitigation obligations under Article 11 will apply until all relevant technical standards under Article 11 have been adopted and have come into effect.

Retrospectivity: As mentioned above, in contrast to the provisions in relation to the clearing obligation, the scope of the regulatory technical standards to be drafted by the ESAs in relation to the risk mitigation obligation does not include power to specify an effective date or phase-in for application of the risk mitigation obligation.

As a result, it appears to be possible that the risk mitigation obligations under article 11 could be applied retrospectively to OTC derivative contracts entered into after the entry into force of EMIR, but before the relevant regulatory technical standards take effect. For example, Article 11 (2) applies to "outstanding contracts", and 11(3) applies "with respect to OTC derivative contracts that are entered into on or after the entry into force of [EMIR]".

This potential "front-margining" requirement raises similar concerns to those which ISDA has raised previously regarding "frontloading" of contracts under the clearing obligation:

- **Legal uncertainty**: retrospective application of the risk mitigation obligations to contracts which were entered into before the relevant regulatory technical standards take effect clearly has the potential to create significant uncertainty for counterparties entering in to OTC derivatives contracts after the entry into force of EMIR.

  At the time that the counterparties enter into an OTC derivatives contract, they will agree on the amounts and types of collateral that they are prepared to post or accept under the contract, as well as other issues in relation to the collateral (e.g., method for calculating the amount of collateral to be posted, frequency of collateral calls and the counterparties' rights in relation to collateral). This will also be taken into account when the counterparties negotiate other aspects of the agreement.

  If retrospective margin requirements are imposed on the counterparties, this is likely to fundamentally alter the agreement between them, amending the underlying economics (pricing) of the transaction, as well as potentially increasing the costs associated with the transaction. As a result, the risk of having margin requirements imposed upon them after the transaction has been agreed creates significant uncertainty for counterparties.

- **Difficulties in compliance**: if the obligation under Article 11(3) may apply to transactions between an FC or NFC+ and a non-EU counterparty which is not subject to EMIR (although the statement of the ESAs in the joint discussion paper indicates that this will not be the case), this may cause difficulties for the EU counterparties in complying with their obligations. For example, if an EU counterparty is required under EMIR to change the terms of the agreement in respect of margin requirements, the non-EU counterparty may not agree to this, particularly where the change may result in increased costs to the non-EU counterparty. This may make it impossible for the EU counterparty to comply with its obligations under EMIR unless it terminates the agreement.

We believe an appropriate solution could be developed to address these issues, for example, by specifying a date in the RTS from which counterparties entering into new contracts will be required to comply with the risk mitigation obligations under article 11 (or by specifying that the level of collateral required for prior transactions is zero).

Intragroup transactions: *We would also welcome confirmation from the Commission and the ESAs that the risk mitigation and disclosure obligations under article 11 will not apply until the technical standards necessary for the operation of the intra-group exemption have also been adopted*. It would undermine the purpose of providing for an intra-group exemption if transactions which should benefit from the exemption are brought within the margin and reporting/disclosure requirements for an indefinite period, pending adoption of the necessary technical standards.

ISDA Safe, Efficient Markets

Yours sincerely,

George Handjinicolaou,

Deputy Chief Executive Officer and Head of Europe, Middle East and Africa

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