



AFME-BBA-ISDA Response to
1st ESMA-DISCUSSION PAPER (dated 16 February 2012):
Draft Technical Standards for the Regulation on OTC
Derivatives, CCPs and Trade Repositories.

20 March 2012

Executive Summary

The signatory associations welcome the opportunity to respond to the 1st ESMA Discussion Paper on EMIR.

The associations would like to underline their commitment to a safe and efficient OTC derivatives business, and high regulatory standards for clearing houses. We support the direction of regulatory change for both cleared and non-cleared OTC derivatives, as evidenced by the progress made in the upgrade of industry infrastructure in recent years, e.g.

- 51% of the global interest rate swap market (which itself makes up over 80% of the gross notional volume of the total OTC derivatives market) is now cleared;
- clearing and tear-ups have reduced the gross notional value of the CDS market in excess of 75% since its peak;
- trade repositories are established and operational - or close to being operational – for all of the 5 main OTC derivatives asset classes, giving regulators increased visibility on risk in the OTC derivatives business.

Our priority in addressing requirements for CCPs is to ensure that they are both safe and efficient, given the level of risk concentration they imply.

The associations make the following comments on key themes covered the Discussion Paper, and in our response:

- We welcome the recognition of the **global nature of the OTC derivatives business** in EMIR, as underlined by the EMIR mechanisms to deal with conflicts and underlaps between EU and 3rd country regulation of OTC derivatives, as well as the scope permitted for 3rd country CCPs and trade repositories to provide their services to EU market participants. We believe it is important to clarify what the perimeters of EU regulation are before ESMA can tackle

mandates addressing contracts with ‘direct, substantial and foreseeable effect’ in the EU that are not covered by EU regulation, or contracts transacted as such with the purpose of evasion of EU regulation. Legal uncertainty about extraterritorial application of such rules to contracts (and hence the potential for legal conflicts) will hamper markets that are the most global in nature. As the mandate to ESMA in Article 3.2a was a late addition to EMIR Level 1, (as acknowledged by ESMA), we ask that ESMA consult with industry as its thinking develops (so that issues pertaining to ‘evasion’ and ‘direct, substantial and foreseeable effect’ are subject to exhaustive consideration). In general, we feel that EU regulators should feel that they can defer regulation to 3rd country regulators where regulation in those countries delivers equivalent regulatory outcomes to those in the EU.

- The recognition of the need for **indirect clearing** in EMIR is welcome, facilitating access to clearing and increasing competition in derivatives clearing business. We raise a number of issues that need further consideration herein in this regard (appropriate segregation options, capital implications, appropriate legal documentation, bankruptcy implications, client choice and tax and accounting considerations, inter alia).
- Concerning the clearing obligation, we raise a number of concerns in relation to **frontloading** herein, in particular pertaining to the need for consideration of the systemic risk implications of mandatory frontloading, competition implications (where CCPs seek to be first to market), and the need for market participants to be made aware as soon as possible of the possibility that frontloading could be required (in order to avoid the operational, legal and funding difficulties ensuing from key terms of the transactions being changed retroactively).
- We believe that the **notification to ESMA by the competent authority should include a focus on legal and contractual standardization** in the relevant class of derivatives, in order to promote legal certainty in the market. Where a submission by a competent authority regarding eligibility for clearing of a class of derivatives is rejected, we make some suggestions herein to ensure enough rigour regarding risk management capabilities of the CCP is maintained.
- We believe that the definition of hedging instruments – for the purpose of determination of measurement versus the clearing threshold of **non-financial counterparties’** participation in derivatives business – should look current beyond hedge accounting rules. We are concerned that the list of types of derivative that can be used for commercial reasons in the Discussion Paper is too restrictive - failing to pay heed, for example, of the valid commercial hedging uses of equity derivatives, inter alia. We further believe that anticipatory hedging, dynamic macro-hedging and portfolio hedging strategies should be recognised by ESMA. In addition, we believe that it should be clarified that Special Purpose Vehicles (SPVs) should benefit from the exemption from clearing, in recognition of the hedging of debt issuance enabled by SPVs’ use of OTC derivatives.
- We have a number of concerns about the some of the proposals tested in the Discussion Paper on **bilateral risk mitigation**, and feel that further consideration of current OTC derivatives risk mitigation practices and business capabilities, as well as existing regulatory commitments at international level across different asset classes, would provide further insights. In this regard
 - ISDA would recommend conduct of a study on the scope for more ambitious timetables for electronic confirmation;

- We believe that the ESMA approach on conditions for marking to market/model should be consistent with EU accounting rules (please see the relevant answer for further precision);
 - Consideration is needed of the two-way process and responsibilities involved in portfolio reconciliation and the challenges in applying stringent rules therein in some asset classes;
 - We recommend – an alternative to mandatory requirements – that ESMA consider issuing best practice guidelines on an asset-class specific basis on portfolio compression;
 - A more flexible approach is needed on Dispute Resolution, considering the needs and priorities of the different parties, and specificities of different disputes.
- The **intragroup transaction exemption** (from clearing and/or bilateral margining) is vital to the industry. We appeal to ESMA to use the flexibility afforded it in the EMIR level 1 text to phase Regulatory Technical Standards addressing the exemption in such a way that market participants do not have to collateralise transactions while awaiting regulatory approval of exemptions. If this situation can be avoided – while ensuring regulatory review of validity of application for exemption - it will prevent the creation of a misleading and excessive snapshot of bilateral risk and will also avoid a needless drain of liquidity at a time when liquidity is scarce. We also believe that it would be sensible to grant the exemption for ‘kinds’ of intragroup transaction (e.g. between certain counterparties) and not on a case-by-case basis (which would seem very demanding for regulators).
 - We are concerned about the impact of **intra-day margin requirements** in what seems likely to be a fragmented clearing market. We estimate a cost of around US\$20 billion in overnight funding from each clearing member or US\$300-500 billion in aggregate. We provide a link to a recent ISDA paper on this issue, also detailing potential solutions.
 - We express broad support for **CCP governance structures** as set out in EMIR, which we believe should act as a further bulwark against any potential conflicts of interest at CCPs. We stress the importance of CCP transparency and provide detailed recommendations therein. **CCP transparency** is key to the ability of market participants to conduct their own due diligence.
 - We would welcome further clarification as to whether Article 41a of EMIR (addressing **liquidity risk controls**) relates to intra-day liquidity. This issue has serious cost and efficiency implications for CCPs and clearing members.
 - We stress that **collateral accepted at CCPs** should be of high credit quality; frequently/heavily traded and liquid; characterised by low volatility and should not be highly correlated with the exposure being collateralised. These principles inform our other answers on CCP collateral.
 - We believe a **CCP’s investment policy** should be more restrictive than its policies regarding the eligible collateral which it accepts from clearing members and their clients. We provide detailed views of what that policy should entail.
 - We are broadly in agreement – with some additional comments – with the ideas addressed in the Discussion Paper on CCP **back and stress testing**.

- In relation to **trade repositories**, we welcome the contents of the Discussion Paper, but express concerns that in certain instances the standards provide insufficient detail e.g. the standards are silent on reporting timeframes and whether such reporting should be done in single or multiple reports. We also set out detailed thoughts on trade repository registration requirements, and recommend that – in relation to public disclosure of trade repository data - ESMA institutes a procedure where any new public report that a Trade Repository proposes to produce is subject to a consultation process prior to approval and implementation (in order to protect the integrity of financial market participants’ trading information). We look forward to assisting ESMA in delivering an efficient and value-adding reporting framework.

We have not been able – in the time allowed by this ESMA consultation – to elaborate a market-wide industry position regarding **CCP margin rules** - that we can be sure is representative of consensus. We will be able to provide ESMA with more detailed views on this issue in the coming weeks.

Lastly we hope that – while we understand the disproportionate time constraints that ESMA itself is faced with, and the fact that the current consultation is ‘pre-consultation’ prior to further formal consultation on the technical standards later this year – future consultations with interested parties will allow more time for industry consideration and feedback.

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Responses to Discussion Paper Questions

Clearing Obligation (Article 3)

Q1: In your views, how should ESMA specify contracts that are considered to have a direct, substantial and foreseeable effect within the EU?

Q2: In your views, how should ESMA specify cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR for contracts entered into between counterparties located in a third country?

Importance of international regulatory cooperation

This is a complex issue. We urge ESMA to coordinate with relevant parties in other jurisdictions to avoid duplication and uncertainty over clearing obligations, and their application regionally.

We believe that any clearing obligation must be transparent, clear and publicly disclosed. Furthermore, ESMA should have the flexibility to change the parameters around clearing obligations if required to quickly respond as a result of global discussions and/or market conditions. Again, these changes should be transparent, clear and publicly disclosed.

International regulatory cooperation is key to prevention of opportunities for regulatory arbitrage, and avoidance of conflicts between regimes for cross border business. The associations even believe that harmonisation of timing of implementation of regulation by international regulators is crucial in this regard.

Uncertain territorial scope

We observe that the territorial scope of the EMIR Regulation is not clear, and as such a focus on regulatory evasion may seem misplaced. For example, it is not clear that two branches of EU banks doing business with each other in a third country jurisdiction would actually be out of the territorial scope of EMIR – no such clarification has been made as yet.

We believe, in general, that EMIR should not apply to non-EU branches of EU banks, if subject to local rules (article 9a of the EMIR text stipulates the conditions under which such branches could be exempted from EMIR).

Similarly, it is not yet clear whether branches of non-EU incorporated credit institutions located within the EU would be treated as “third country entities” for this and other purposes under EMIR, or alternatively whether they would be treated as “financial counterparties”. Such clarification is essential if counterparties are to know whether the “direct effect” criterion applies to their contracts with other counterparties. We believe that EMIR should apply to the EU branches of non-EU banks, but not to the non-EU branches of the legal entity, whose activities would be regulated elsewhere.

We believe the clarifications mentioned above are a necessary starting point in any RTS seeking to address “direct effect” contracts or contracts which may be subject to any “anti-evasion” measures.

Avoidance of overlaps and underlaps

Overlaps become more likely in the absence of mutual recognition of infrastructures such as CCPs and data repositories. EU entities dealing with non-EU counterparties are in danger of conflicts between EMIR and local regulation in the jurisdiction of the counterparty in relation to cross-border transactions. Examples include circumstances where a swap is required to be cleared in two different places at once. This emphasizes the importance of recognition of CCPs established in third countries and coordination and cooperation between the EU and non-EU countries. Failure to do so will result in fragmentation of markets resulting in loss of liquidity, inability of market participants in one jurisdiction to have access to the full range of risk mitigation products traded in other jurisdictions and thus increased costs and risk for derivatives end users and lost business opportunities for all market participants. We are encouraged by the provisions of EMIR permitting recognition of non-EU CCPs, TRs and overseas derivatives regimes.

'Direct, substantial and foreseeable effect'

EMIR proposals seek to apply clearing and collateral requirements for uncleared trades to transactions between two non-EU counterparties who would be subject to EMIR were they in the EU where those transactions have a "direct, substantial and foreseeable" effect in the EU. Any lack of clarity on this point (and potential conflicts arising as a result) will be a key issue that will hold up many decisions for the purpose of implementation of and compliance with new derivatives requirements in what is the most global of markets and should be addressed by ESMA in consultation with overseas regulators as soon as possible.

We would remark that it is difficult to see how a transaction can have a "direct" effect in the EU where there is no EU counterparty.

We don't believe that the participation of European investors in a company or investment vehicle (e.g. a fund) based in a third country should imply that derivatives entered into by that fund constitute a 'direct, substantial and foreseeable effect' within the EU. Taking such an approach would prohibit European investors from investing outside Europe (as these entities would be subject to both European and local regulation), with negative effects on European savings and pensions inter alia.

Evasion

We further comment that a branch or affiliate, based in a third country, of an EMIR-regulated firm dealing with another entity in that third country should not be assumed to be 'evading' EU regulation. Many European companies have branches or affiliates in third countries, for legitimate business reasons, such as the need to build local relationships with customers.

Overseas branches and affiliates of entities have long engaged in a range of derivatives and non-derivatives financial services activities for local and international clients and have separate strategic, business and legal reasons for their existence and organizational structure. For example, in many jurisdictions, branches or affiliates are established because certain activities may only be conducted by entities licensed or organized under local law. Such branches and affiliates often manage the risk from financial exposures incurred in such jurisdictions in the local financial markets. Subjecting such branches and affiliates to EMIR requirements could effectively preclude them from, or significantly increase the cost of, managing their risk in the local financial markets, since local financial institutions may be required to comply with EMIR to provide those services.

As the mandate to ESMA in Article 3.2a was added to the EMIR text quite late (as acknowledged by ESMA in paragraph 9), we ask that ESMA consult with industry as its thinking develops on this mandate (so that all issues pertaining to 'evasion' and 'direct, substantial and foreseeable effect' are subject to exhaustive consideration).

Equivalence and avoidance of conflicts and underlaps

We believe, in general, that EU regulators should rely on the regulation applicable in third country jurisdictions to the extent to which regulation in those third countries deliver results which are 'equivalent' to regulatory outcomes in Europe. Article 9a – aiming to avoid conflicting or duplicative regulation - has this aim (subject to certain conditions). The application of this test should be pragmatic, and focus on broad outcomes (rather than methods of regulation used).

Types of Indirect Clearing Arrangements

Q3: In your views, what should be the characteristics of these indirect contractual arrangements?

Before responding directly to the question, we wish to state that we welcome the recognition of indirect clearing in EMIR and will briefly describe the possible users of indirect clearing.

As we have said previously, the indirect clearing model allows financial institutions in the EU that do not wish to become clearing members (CMs) of a particular CCP themselves to pass on the benefits of clearing to their own clients. If this were not possible, institutions (such as generally large regional banks in the EU) would be forced to pass clients to their larger, global competitors. This unintended consequence will lead to poor competition, restricted access to clearing services and delay the implementation of central clearing for OTC markets. Smaller or more focussed institutions will lose the ability to service their clients effectively, and those clients without credit relationships with the clearing member's global banks might find themselves unable to access clearing at a reasonable cost.

Therefore a viable indirect clearing model is key to providing appropriate protections and the benefits of clearing to the breadth of the OTC market. We note that the existing segregation, portability and default procedures have been designed to provide protections to those clients accessing clearing directly through a clearing member. Industry participants (from all sides of the market) are considering how indirect clearing arrangements can deliver these benefits – including options in terms of different levels of protection (as provided in the direct clearing model) – and issues associated.

Industry participants are currently evaluating the potential applicability of indirect clearing to certain transaction cases, as recognized by EMIR. Therefore, at this juncture, the industry feels that taking an approach of putting a detailed strawman together and iterating around this "target" may not be appropriate due to the considerations outlined below, the complexity of which cannot be underestimated. Instead, we would welcome the opportunity to develop some of the issues and ideas we see as most pertinent herein, to ensure the next level of principles are well articulated and form a firm foundation for moving forward on this topic.

The following are some of the considerations we feel most relevant at this time:

- Segregation options available to indirect clients need to ensure default implications for all parties are fully considered, including the extent to which it is appropriate for a CCP to have a relationship with an extended set of market participants, and as a result, may be need to be limited.
- There needs to be consistency between the approach on segregation for the indirect model and the capital implications, respecting the ability of non-regulated clients to participate and absorb liquidity shocks arising from clearing member, CCP or regulated client default.
- We would expect that any indirect clearer must provide "risk break" protections to the member that parallel those the member gives to the CCP, specifically underwrite the client risk, have KYC and anti-money laundering responsibility and manage the default procedure of their clients. Risk multipliers / extended close-out periods may be necessary for the indirect clearer and end clients to allow for the additional complexity in a default scenario
- Standardised legal documentation is critical to provide a scalable solution and ensure portability is viable.
- Significant legal review is needed to understand the implications of extending the protection framework to the end customers, encompassing both the challenges of differing protection and insolvency regimes within Europe, plus the cross border bankruptcy implications where Clearing Member and Indirect Clearer, and indeed Client are in different jurisdictions.
- Indirect clearing should allow indirect clients the freedom to access competitive execution with the counterparties of their choosing.
- ESMA may wish to consider the extent to which it can work with tax and accounting regulators to ensure that tax and accounting rules incentivize and do not obstruct retrospective clearing through indirect clearing arrangements. Many market participants will have a natural incentive to backload eligible trades to benefit from portfolio margining at the CCP, rather than keeping separate portfolios of uncleared and cleared eligible trades, but changes in tax and accounting treatment could undermine these incentives. This issue should be considered in conjunction with deliberations on frontloading.
- In addition, indirect clearing models may be used to facilitate access of EU entities to derivatives products cleared only outside the EU, and of third country entities to derivatives products cleared only in the EU. It is essential to ongoing cross border business of this nature, and the maintenance of access to appropriate risk management tools, that solutions can be found to these currently problematic issues

Clearing Obligation Procedure (Article 4)

We make the observation that neither the EMIR Level 1 text nor the Discussion paper appear to give thought to the situation where a previously liquid class of derivatives - that had been deemed subject to mandatory clearing - becomes very illiquid. While Article 4.6 and Article 4a.3 of EMIR address a situation where a CCP is no longer authorised to clear a certain class of derivatives, and therefore provides for removal of the mandatory clearing requirement, as well as removal of the class from the ESMA register, it may be appropriate to consider whether the CCP should continue to be authorised to clear that class if the contract has become so illiquid (in consideration of the pricing information availability and liquidity tests required under EMIR and applied at the time ESMA decided that the class should be subject to mandatory clearing). EMIR does not seem to address whether/how a CCP's continued authorisation to clear the class of derivatives should be re-considered. This may be a question ESMA may wish to consider.

Q4: What are your views on the required information? Do you have specific recommendations of specific information useful for any of the criteria? Would you recommend considering other information?

We believe it is important that the notifying competent authority make a recommendation to ESMA as to whether **frontloading** under Article 3 (1) (b)(ii) for the relevant derivative class is appropriate for this class, and if so, relevant maturities for affected contracts and any phasing-in of the 'frontloading' obligation. Careful consideration must be given to the appropriateness of frontloading, especially in light of competent authorities' consideration of the ability of a CCP to handle expected volume (see item 16c of ESMA paper), and pricing and liquidity impact of any frontloading on the relevant market.

We further note that ESMA is supposed to consider (for purpose of drafting Regulatory Technical Standards) a number of matters referred to in Article 4.4 of the EMIR in addition to the so-called clearing criteria, namely **'level of interconnectedness' between counterparties using the class of derivatives in question, and impact on levels of counterparty risk therein.**

One important systemic impact of EMIR – and clearing obligations in general – is that it will shift segments of the derivatives universe from previously quite 'flat' netting sets between financial market participants, and into clearing houses. The effect of this will be to open counterparty exposures where previously positions were balanced. The impact herein will vary by counterparty and class of derivatives.

We believe it makes sense (at least for contracts that could be potentially 'frontloaded' (and that are therefore already part of the portfolio of regulated firms)) – irrespective of the political demand for application of the clearing requirement – for ESMA to consider these issues and leave it flexibility to act to limit counterparty risk in other ways for this subset of contracts, where it feels that clearing requirements have the potential to increase counterparty risk in that class as a result of frontloading of that class.

In this regard, we believe it would be helpful for ESMA to be provided information on such considerations in the notification.

In considering any notification, ESMA should take account of competition and market issues as part of its assessment as to the timing of any resulting clearing obligation. Bringing the clearing obligation into effect in relation to a class of derivatives at a point in time where there may be only one CCP available to provide services (effectively delivering a regulatory-driven monopoly), particularly where that CCP's service does not align with market practice and CCP memberships, distorts the incentives for CCPs to seek to launch new cleared offerings. It risks hurried development which puts proper risk models and testing under strain and is likely to result in dealers and clients being forced to become members of a potentially very broad range of CCPs, with knock-on effects for netting efficiencies and other key benefits of CCP clearing. This could be avoided if timing of clearing obligation implementation is factored in scope for ESMA to consider and allow for appropriate market development.

ESMA may also wish to consider whether it would be more prudent to require more granularity from competent authorities and CCPs in notifications as to the classes of derivatives that would be cleared in the first phase of the move to clearing. There should be no complacency that a CCP is well-equipped to clear a specific *broad* class of derivatives, and as such, there should not be an assumption that large variations in economic terms within that class can be easily risk-managed.

We support an emphasis on information on level of '**standardization**' in the notification, in particular – in order to promote legal certainty for market participants as to the type and features of a clearable contract - detailed description of the precise legal terms and conditions of any contract which they notify for clearing, by reference to the published rules or procedures of any affected CCPs, as well as other information pertaining to legal and contractual standardization (such as type of documentation used (e.g. ISDA Master Agreement) and percentage of standard tenors traded versus bespoke contracts traded in the class or classes of derivatives).

Other information that should also be provided (and taken into account by ESMA) could include the **balance of financial participants and non-financial end users** active in a particular class of derivatives (hedging non-financials not will not want to see liquidity in a class of derivatives disappear as dealers in that class are forced onto clearing houses).

The extent to which some of the 'relevant market information' referred to in paragraph 17 is relevant and informative to the regulator will vary from class to class (and hence will be of varying utility). Secondary trading is not the norm for a majority of the OTC derivatives business.

We support the move to central clearing as the norm, with the caveat that clearing houses should be able to risk manage cleared contracts on an extremely safe basis. As such, we stress prudence, above all else, in addressing the question of information that needs to be provided to ESMA by CCPs and competent authorities.

Lastly, we believe that it is important that market participants be given an opportunity to comment in relation to notifications provided to ESMA. Market participants, as users of these products, and clients and clearing members of CCPs, will be able to provide important insights and data to ESMA.

Q5: For a reasonable assessment by ESMA on the basis of the information provided in the notification, what period of time should historical data cover?

Minimum rules are required on this issue, to ensure that CCPs have a clear understanding of liquidity in a class of derivatives and fluctuations therein over a sufficient length of lookback period. This could detail a fixed amount of time e.g. 12 months – or could be tied to the lookback period stipulated by ESMA (if ESMA so stipulates) or by the CCP in calculation of margin requirements.

We may revert to ESMA to elaborate further on this question in due course.

Q6: What are your views on the review process following a negative assessment?

We support the approach as set out in the Discussion Paper.

However we further suggest that

- A minimum timeframe should be set before CCPs can resubmit (to give CCPs the opportunity to address concerns raised by regulators) information, once a notification has been rejected by the regulators.
- Re-submissions should include an explanation of any changes in data from previous submissions.
- ESMA should immediately inform the market of any negative assessment of this information.

Q7: What are your views regarding the specifications for assessing standardisation, volume and liquidity, availability of pricing information?

We support the approach as set out in the Discussion Paper. Further thoughts on issues pertaining to these criteria have been set out in our answer to questions 4 and 5.

Q8: What are your views, regarding the details to be included in ESMA Register of classes of derivatives subject to the clearing obligation (Article 4b)?

We believe that ESMA should include on the public register details of any notification made by a competent authority to ESMA pursuant to Article 4(1), and such details should be added immediately upon receipt by ESMA of such Notification.

It is very important that market participants be made aware of the competent authority's notification of ESMA at the time it is made, if it is to assess pricing or liquidity effects on the affected derivative class in the period up to the ESMA decision as to whether that class should be subject to mandatory clearing. If market participants are not made aware of this notification, they could enter into derivatives contracts based on completely different pricing considerations than those that they would subsequently be required to take into account when fulfilling a clearing requirement. Market

participants must be able to ensure that sufficient mechanics are in place to allow for an orderly close out and/or re-pricing of OTC trades that become wholly or partially subject to a mandatory clearing requirement part way through their term.

For commodity derivatives, item 24c of the Discussion Paper should include a reference to 'commodity'. Item 24 should also include details of where it is traded/or the region to which it relates (an issue for commodity derivatives that are globally traded/fungible such as oil, coal and products) and pricing norms/conventions.

ESMA may also like to consider whether information on CCPs providing clearing services for the class of derivatives in question should be provided in the Register.

Furthermore, ESMA may wish to consider whether Unique Product Identifiers for relevant products/classes should be included in the Register.

Q9: Do you consider that the data above sufficiently identify a class of derivatives subject to the clearing obligation and the CCPs authorised or recognised to clear the classes of derivatives subject to the clearing obligation?

Please note our comment regarding granularity under question 4.

In some asset classes e.g. commodity derivative markets (which can be both regional or global), ESMA could consider clarifying the region/market to which it is applying the clearing obligation. Thus, a reference should also be made to the specifications sought in the notification, as set out in the second last paragraph of our response to question 8.

Non-financial counterparties (Article 5/7)

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

We agree that ESMA's definition of legitimate hedging activities is a useful and comprehensive start.

We underline however, that while transactions qualifying for hedge accounting treatment should not count towards the clearing threshold, these transactions are only a subset of the transactions of non-financial firms that should not count towards the clearing threshold. We provide further detail in this regard below.

Further to this point, we maintain some concerns that the definitions in paragraphs 27 – 31 do not appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to commercial or treasury financing activity (valid economic hedge). The current wording does not appropriately capture the intention of EMIR of requiring only non-financials whose activity could be labelled largely as investing or trading to clear OTC derivative contracts.

For paragraph 29, our chief concerns relate to the need for clarification of the current ESMA wording and that the current wording excludes some valid hedging arrangements as follows:

- ISDA would argue that the risks listed in paragraph 29a of the Discussion Paper should not be considered as exhaustive. For example, there are a number of commercial activities, including but not limited to freight, transport, capacity, storage and emissions that are legitimately hedged with derivatives. Exposure management to volatility in cash flows, revenues and commodity prices is another example of a key risk in the energy sector that requires hedging. Risk on asset classes such as equity and credit can also be legitimately hedged as part of a firm's commercial or treasury activity.
- We would underline the point partly addressed in paragraph 29a, and believe that it should be clear that the definition should be inclusive of anticipatory hedging of future risks and commercial activities that may arise in the course of any particular business (i.e. that the definition is not limited to risks that have crystallised). Such hedging activities will of course have to be subject to appropriate time horizons and take into account the fact that any business' decision as to when and how to hedge a commercial risk will in practice depend upon the liquidity and pricing of the available hedging instruments.
- Recital 16a of EMIR expressly recognises that due account should be taken of a non-financial counterparty's overall hedging and risk mitigation strategy. This is important because a number of large non-financials often employ sophisticated hedging techniques, undertaken on a dynamic, portfolio basis rather than on a static, transaction by transaction basis. This permits firms to optimise their hedging strategy and benefit from risk reduction techniques such as netting and offsetting. Accordingly, the use of dynamic portfolio or macro-hedging techniques should be expressly recognised by ESMA. It seems clear to us that the list of instruments referred to herein is non-exhaustive and simply refers to examples of potential hedge instruments.
- While we elaborate our concerns on the use of hedge accounting related to determining whether a hedge is a valid economic hedge or not above, a specific accounting related question we have in relation to paragraph 29 is when mentioning "European accounting rules", it is not clear whether this paragraph is saying that hedge accounting under what we presume is local country GAAP is one way to demonstrate hedging, or it is just saying that (similar to most local GAAPs) that the hedge's objective is to reduce risk. If the intent is not to require achieving local GAAP hedge accounting, but rather to ensure in principle the reduction of risk, the reference to "European accounting rules" should be removed. Also, we would like clarity on what ESMA means by European accounting standards (local GAAP?) and whether they must meet this as well as IFRS accounting requirements, or just one or the other.
- Regarding equity derivatives, many examples can be given to demonstrate that they can also be used as good hedging instruments:
 - ***Diluting Instrument hedging share option plans:*** Companies have a commercial need to retain qualified staff through the offer of competitive remuneration plans grant stock options, free shares, or issue convertible bonds/loans for the exclusive benefit of their staff. At maturity the company may potentially need to issue new shares to be delivered to stock options or bond holders. This issue of new shares increases dilution. To avoid or reduce dilution, the company may decide to purchase call options or enter into derivatives instruments paying cash or delivering shares upon exercise of the stock options or conversion of the bonds. This typical

transaction is described in some local regulators' guidelines in relation to share buybacks using derivatives.

- **Access to cheap financing:** A holding company may have equity in its portfolio of assets. Depending upon market conditions, the holding company may finance itself at a competitive price in issuing bonds exchangeable with the equity and in purchasing call options or any other similar derivative instrument delivering the same equity upon exercise. This type of structure may optimize the cost of the financing and avoid also the dilution in the relevant equity.
- **Hedging and Financing Equity Stake:** A company may own Equity or Equity linked products. A sale may not be possible but the company is willing to protect its position. The company may thereafter enter into various derivatives transactions (purchase of puts combined with sale of call, sale of options, purchase of option) to reduce its exposure to the risk held. As an example, a company may sell part of its business with a payment in kind. The company will receive equity from another company, and sometimes also specific instruments (like CVRs serving as hedge against the decrease in value of the equity). The company may be prevented from selling the equity stake (for tax, accounting, regulatory reasons etc) but may also be committed to cover and hedge this new exposure, according to a comprehensive and prudent risk mitigation strategy. Accordingly, the company may enter into collars, even prepaid, where they receive upfront cheap financing and hedge the equity exposure. If the company received CVRs, it is possible to sell an OTC derivatives contracts enabling it to freeze the value of the instrument at a predetermined level. Derivatives reduces thereafter the uncertainty linked to the market variations.
- **Macro Hedging in order to hedge a "commercial risk":** Companies whose activity is closely linked to specific market items may enter into equity derivatives (generally on Indices) hedging the business of the company (but not hedging a specific asset/liability of it). Even if it can be seen as a speculative transaction, this transaction pay off enables the company to receive a certain amount of cash in case of a deterioration of its core business.

In paragraph 30 of the Discussion Paper, ESMA addresses the accounting treatment of derivatives contracts, that is, hedging contracts pursuant to IFRS principles as referred to in IAS 39 paragraph 71-102 on hedge accounting as endorsed by the European Commission. The use of hedge accounting is an issue on which our members have strong views. ISDA recommends that hedge accounting should not be used as the sole determinant for establishing which derivative contracts are objectively measurable as reducing risk, and that ESMA should not be overly prescriptive in this regard. It is crucial to recognise that among the universe of economically valid hedges, deals that qualify for hedge accounting are just a subset. Therefore, basing the requirement on meeting hedge accounting criteria would inadvertently exclude many valid economic hedges, which in our view is contrary to the stated policy intention of EMIR. Examples of non-financial counterparties entering into valid economic hedges which would not qualify for hedge accounting are many, including:

- **The purpose of hedge accounting is not to validate whether or not a transaction constitutes a valid hedge, but to eliminate any P&L measurement mismatch that occurs. As a result, there are many instances where hedge accounting is not applied to derivatives that are valid hedges,**

because it is not needed when a natural P&L offset already occurs. This is a very routine approach for FX transactions that are hedging on-balance sheet items such as payables and receivables, where the mark-to-market of the FX deal naturally offsets quite well the P&L recognised from translating the foreign payable and receivable into functional currency through P&L.

- Additionally, there are several issues with the rules based approach to applying hedge accounting in that hedges which are universally accepted as economic hedges do not meet the strict rules to apply hedge accounting of IFRS. Significant examples of this include utilities and other companies swapping fixed rate debt into inflation linked, when pre-hedging interest rates of an upcoming bond issuance in a different currency than the bond itself (as a cross currency swap will be entered into at the time of issuance), and in some cases where the hedges are cancellable at the counterparties' option. In these cases, especially where it involves long dated interest rate or inflation derivatives, the ramifications of being forced to clear even though they are valid economic hedges would be immense.

We would also observe that existing IFRS hedge accounting rules are restrictive in that, for instance, non-financial items may only be designated as a hedged item in their entirety or for their foreign exchange risk. It is therefore not possible to obtain hedge accounting for the interest rate risk or the inflation risk of non-financial items such as many "service, inputs, products, commodities". The changes in hedge accounting expected to be introduced by IFRS 9 will go some way to address this problem, although the new standard will not be issued until later this year and will not be mandatory until at least 2015 and subject to EU endorsement. As such, we continue to maintain that hedge accounting should not be a criterion to verify whether a derivative is a valid economic hedge or not. If, for some reason, there is a decision to require hedge accounting, we recommend that non-financial entities be permitted to determine whether their use of derivatives reduces risk by applying the hedge accounting provisions of IFRS 9 for this purpose as soon as they are issued as a standard.

- In many cases, where larger corporates use treasury centres (TC), they will net internal derivatives with external derivatives as there is a natural mark to market offset. Applying hedge accounting to some for these external deals solely at the TC level without considering the transactions more broadly would lead to P&L volatility, while also being unattainable.
- Still, there are instances where corporates may elect not to seek hedge accounting due to administrative cost considerations, although still hedged on an economic basis. In such circumstances, the corporate would accept the P&L volatility and frequently disclose the nature of such volatility in their financial statements. We have heard from many corporates that investors typically understand this, and as such do not view the P&L volatility overly negatively.

There have also been significant queries raised from by members on the applicability of the regulations to SPVs and other legal entities:

- The treatment of OTC derivatives entered into by special purpose companies or equivalent structured finance vehicles used in securitisations and as structured note issuance vehicles requires particular clarification. Many of these vehicles will not meet the definition of a financial counterparty in EMIR (noting that there is no express exemption in EMIR, unlike the AIFMD, for securitisation vehicles) nor benefit from the intra-group exemption from the mandatory clearing and bilateral collateralisation obligations and will, therefore, be treated as non-financial counterparties. Such entities will enter into OTC derivatives as part of their commercial activity and such derivatives will be objectively measurable as reducing its risks directly related to such activity. Specifically, such vehicles would not be able to execute their normal business (debt

issuance) without such hedges being put in place; the OTC derivative will typically provide the primary source of funds to service the vehicle's debt obligations and other liabilities. In ISDA's view, such vehicles should be able to avail themselves of the hedging exemption for non-financial counterparties, as they are not using the derivative for the purpose of speculation, investing or trading. Failure to address this with certainty will risk the viability of the European securitisation and structured debt markets.

- It should be made clear that this exclusion should not be based on the specific circumstances of the legal entity in question, but more the ultimate parent. This would avoid inadvertently requiring the clearing of entities such as Special Purpose Vehicles as well as financial counterparty-like entities such as treasury centres.
- For the reasons described above, we also believe that SPVs should be exempted from EMIR bilateral collateralisation rules (just as other non-financials falling below the clearing threshold would also be exempted from bilateral collateralisation rules).

Regarding the general requirement that hedges must be objectively measured, we would advocate this relates more to qualitative conceptual criteria rather than the rules based accounting approach, otherwise you will face some of the issues described. ESMA may wish to consider allowing management attestation, verifiable by auditors, akin to requirements in Sarbanes Oxley.

Also, it should be made clear that it is the requirement of the non-financial counterparty, and not the bank or financial trading party, to ensure compliance with the regulations.

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

We agree with ESMA's recommendation in paragraph 33 that the clearing threshold for non-financials should be simple to implement. We understand the merits – in particular from the point of view of regulators¹ - of a clear "bright line" test based on a clear parameter, but it is not altogether clear that such a bright line test should be based (as proposed by ESMA) upon the notional value of OTC derivatives entered into. We believe that using notional as a measure of exposure is inappropriate given that the actual level of financial exposure could be radically different for two deals with different maturities but the same notional. Also, the same concept can apply two deals with the same notional, with one being an interest rate swap and the other a cross-currency interest rate swap, which does not seem the intended outcome. Instead the clearing threshold could be measured against:

¹ We note many non-financial corporates are concerned at the prospect of a low fixed threshold as – in their view - it could leave little buffer for trading/accounting mismatches in hedging or proxy and portfolio hedges (depending, of course, on how the threshold is set) which could emerge when hedging large commercial risk. They would prefer a relative value instead of a fixed one (e.g. based on turnover or balance sheet size (measures which would have the further value of appropriate proportionate capture of SMEs)).

- Market values (as also CFTC proposes). From the viewpoint of a financial institution, only negative market values are risky ones, as this is when the counterparty owes the financial in case it defaults. We therefore suggest focusing on negative market values only for non-financial companies.
- Negative market values plus a form of mark-to-market sensitivity, either through a value-at-risk type calculation, or (recognising a VaR approach could be complex), basic sensitivity calculations as specified by ESMA.

It is also not entirely clear to us that it would be appropriate to adopt a low threshold as opposed to a systemically significant level. In this regard, we would draw ESMA's attention to the current debates in the United States and the CFTC discussions regarding an increase in the Dodd-Frank thresholds from USD100 million to USD 2 billion for so-called "rate swaps" and USD 1 billion for other types of swaps. We urge ESMA to consider the US approach on clearing thresholds in this context and seek convergence to the extent possible.

We also agree that it may be detrimental to calibrate the threshold with reference to asset class. We agree that, in the interests of clarity, it would make sense to distinguish between the thresholds applicable to individual legal entities and the group as a whole, although in practice clearing arrangements would need to be entered into by legal entities individually, so the Level 1 text should not be interpreted as requiring all legal entities in the group to clear their transactions once a group-wide threshold has been passed. We would note that there are potential anomalies that may arise when group level thresholds are set, particularly where some members of the group fall outside the scope of EMIR (for instance, a group headquartered in HK whose main markets are in Asia, but has a single UK subsidiary). There may also be monitoring issues, particularly where local requirements for entities outside EU do not have reporting requirements.

Consideration also needs to be given to the application of the thresholds to third country counterparties. It is unclear how this concept will work given there is no means by which the third country counterparty can be compelled to disclose the relevant information to even attempt to make any such assessment, and indeed it may not wish to do so. Uncertainties may also arise in determining whether a third country counterparty would have been a "financial counterparty" if it was established in the EU. These uncertainties make it difficult for EU entities to determine with certainty which areas of EMIR may apply in relation to their dealings with such counterparties. The references to hedge accounting under EU accounting rules will also need to be widened out to contemplate equivalent third country GAAP.

We strongly agree with ESMA - in paragraph 36 - that additional information should be gathered to determine the threshold level.

Risk mitigation for non-CCP cleared contracts (Article 6/8)

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

It is generally acknowledged that, in most cases, a trade that is electronically executed and/or electronically confirmed is capable, given the greater standardisation of contracts and automation of the confirmation process for such trades, of being confirmed more quickly than one that is not. Please note our reference to electronically confirmed rather than electronically processed (a term that is unclear and should be avoided). There are however a number of concerns relating to the ability of parties to meet the suggested time frames for trade confirmation cited in paras 38 and 39 of the Discussion Paper (“DP”):

- i. The DP does not appear to reflect the potentially distinct nature of the two parties to a given transaction. It suggests certain performance requirements for counterparties exceeding the clearing threshold but different requirements for other parties, without acknowledging that the confirmation process may well take place between one party which exceeds the clearing threshold on the one hand, and one that does not on the other.
- ii. As industry infrastructure around electronic execution and confirmation is still developing and improving, it is difficult to determine conclusive timelines for confirmation processing until such infrastructure has been more fully developed and tested and the ability of the different categories of firm to interact with such infrastructures is better understood. For example, until OTFs are implemented under MIFID II, there are currently no EU trading venues that qualify as “electronic execution” and therefore the impact of electronic execution on confirmation timeliness is not fully understood. For this reason ISDA recommends that Technical Standards be implemented in a phased manner.
- iii. There are other factors that may delay confirmation cycle times or the overall ability of the transaction to actually be confirmed on a platform at all. These include:
 - a. Allocations – where investment managers may need to follow compliance processes and / or receive instructions from their clients, who may be subject to different timing constraints, which could take much longer than the proposed 15 or 30 minutes and in some cases may even take longer than a day.
 - b. Client connectivity – It may be the case that for a trade which would otherwise be capable of being confirmed on an electronic platform is traded with a client which has not subscribed to the given platform. Therefore the confirmation will need to be processed on paper. Efforts continue across the asset classes to onboard clients onto appropriate electronic platforms but there is still a significant proportion of the client base which is resisting such efforts.
 - c. Post- execution information – there are occasions when certain terms required in a confirmation are not known at the time of execution or indeed for some time after, e.g. initial fixing rates and prices, or those relating to forward starting OTC, and therefore it is not possible to process the confirmation electronically within the proposed timelines. Furthermore, for some derivatives, certain aspects of the deal are still subject to discussion after execution and full confirmation cannot be sent until this has been concluded. There may, in addition, be technical and/or administrative limitations of some parties within the market that may be a factor.

- iv. Where transactions are not capable of being confirmed on existing electronic confirmation platforms, such transactions are typically confirmed via paper. In many cases the primary driver for this is the bespoke nature of the transaction which is necessary to enable clients to tailor the transactions to their specific needs. Such transactions can range in complexity, and often require significant legal liaison and discussion meaning dispatch times of a number of days are not uncommon although this can vary significantly across asset classes. Full execution of such confirmations may not be achieved for a number of days following dispatch and therefore, implementing the proposed timelines that place time pressures on these review processes may unnecessarily prioritise speed of confirmation over accuracy and thereby increase systemic risk. Some transactions may require paper confirmations for reasons other than complexity or “bespokeness”. We have already noted above that some parties do not currently subscribe to existing electronic confirmation platforms and in other cases it may be that industry has not agreed to the exact form of documentation for the product in question. As regards this latter point ISDA continues to facilitate discussion and develop standard forms of documentation where possible. Furthermore, the proposed timelines for non-electronically confirmed transactions do not cater for processes around booking, check-out and affirmation of the trade that are essential for effective risk management. In addition it is important to note the potential impact of the proposed timelines for non-electronic confirmations on clients and end users of OTC derivatives. For, instance there will very likely be an increased cost in additional resources and legal input. Many end users may employ utilities to facilitate their operations functions which inevitably increase the timeline for paper trades. The proposed timelines could limit the usefulness of such utilities and make it more difficult to manage their infrastructure costs efficiently.

It is also important to recognise that processing times generally, but specifically for confirmation processing, should avoid reference to terms such as “on the same calendar day”. Such a term does not reflect the fact that transactions may be executed at, or additional information not available until, close or near to close of business. As a related point such requirement does not consider trades where limited time zone overlap of the two parties exists, for example trades done with a non-EU counterpart where time zone limitations can frequently add at least 24 hours to allocation and confirmation cycles. Moreover, as noted previously, for exotic trades the full confirmation process can take a number of days or more. We suggest that Technical Standards should reflect this and proposed timelines should be based on a time period starting at point of execution. Additionally, Technical Standards should include a clear and globally-consistent definition of “execution time”.

ISDA believes that it would be prudent to conduct a study in order to (i) better understand the potential barriers to complying with any specific timeline in each asset class and therefore the ability of participants to comply with the suggested standards and (ii) define “x” in para 39 b) of the DP. We would also suggest reviewing the existing quarterly metrics as published by Markit in order to develop a better understanding of industry progression in recent years as well as current performance levels. Related to this we would encourage ESMA to adopt the existing ODSG commitment framework as it relates to confirmation processing and timeliness in order to incrementally drive improvements over time. Examples of current ODSG targets for submission and matching for Credit, Equity and Interest Rates are included in the table below for reference. It is important to note that these are performance targets and whilst generally achieved by the G15 firms who subscribe to the industry commitments there are exceptions. Moreover, the G15 firms would likely be at the more technologically advanced end of the spectrum and therefore more able to

comply with the target timelines noted below whereas many other market participants would find this a significant challenge.

Table showing current industry commitments relating to submission and matching of electronic confirmations.

Asset Class	Industry Commitment
Credit	90% T+0 submission - all electronically eligible transactions
Credit	94% T+2 matching - all electronically eligible transactions
Equity	95% T+1 submission - All Electronically Eligible Confirmations processed on an electronic platform
Equity	95% T+4 matching - All Electronically Eligible Confirmations processed on an electronic platform.
Interest Rates	95% T+0 submission – G15/G15 electronic confirmations
Interest Rates	80% T+0 submission G15/Non G15 electronic confirmations
Interest Rates	98% T+2 matching - G15/G15 electronic confirmations.
Interest Rates	90% T+2 matching - G15/Non G15 electronic confirmations.

Furthermore, over recent years industry has made significant improvements to confirmation processing infrastructure and continues to work with vendors to improve the infrastructure further. Such improvement has delivered high levels of electronic confirmation, in some asset classes, which in turn has reduced and in some cases virtually eliminated aged confirmation backlogs as indicated in the following table:

Table showing levels of Electronic Confirmation processing against aged outstanding confirmations. Data derived from industry metrics as at end Quarter 4 2011.

	Electronic Confirmed as a % of Total Volume	Outstanding Confirmations >30 days (expressed as number of Business Days Outstanding ¹)
Credit Derivatives	98%	0.02
Equity Derivatives	40%	0.54
Interest Rate Derivatives	87%	0.07

¹ Business Days Outstanding is a measure that expresses outstandings in terms of days' worth of business and is derived by multiplying the number of outstanding confirmations by a standard number of twenty-two business days and dividing by monthly event volume.

The above are general comments relating to issues associated with timeliness of confirmation processing for OTC derivative confirmations in the context of the anticipated Technical Standards. It should be noted that the points raised may apply to a greater or lesser degree to each asset class. These differences may be based on the extent of common market infrastructure available but are also determined by the size of the market in terms of number and diversity of client base. For example, the credit derivatives market tends to be limited to banks and sophisticated multinationals whereas the FX market is actively used by any organisation that has cross border flows. Therefore, when setting final Technical Standards, ISDA would encourage a flexible approach where confirmation standards should vary based on asset type, trade type, counterparty type, event type and surrounding circumstances.

As a final point ISDA believe it is important that the final Technical Standards provide a clear definition of the term “confirmation” as it relates to various market practices and processes, i.e. a trade matched electronically versus a confirmation physically signed.

Q13: What period of time should we consider for reporting unconfirmed OTC derivatives to the competent authorities?

The current industry standard for reporting unexecuted confirmations, where such reporting is required, is 30 days after trade date and relates to a trade count of unexecuted confirmations aged greater than 30 days. Provided that the proposed reporting requirement relates to the number of trades only and does not require any additional information relating to confirmation content or specifics then it would be appropriate to retain the 30 day threshold initially with intent to review and adjust over time. However, if more granularity around trade attributes and or other classification and criteria relating to the outstanding confirmation is required then further analysis around timelines would be required. Such analysis would need to be informed by the exact requirements and content related to the reporting requirement. Where reporting is not currently required there may be different confirmation conventions, such as for certain commodity derivative transactions, and introducing reporting would represent a significant step change for firms. Consideration should be given to the scale of impact and appropriateness of any reporting window and a cost-benefit analysis should be performed. Should such analysis identify a tangible benefit we would recommend a phase-in timeline, which recognises the degree of change to current market practice, be adopted.

Marking-to-market and marking-to-model

Q14: In your views, is the definition of market conditions preventing marking-to market complete? How should European accounting rules be used for this purpose?

ISDA believes that the ESMA definition of market conditions preventing marking-to-market is reasonable when considering the appropriate European accounting rules related to situations where Level 3 inputs are used.

However, in order to avoid multiple definitions and guidance to assess whether a market has become inactive, ISDA believes that ESMA should align its guidance with paragraph B37 of IFRS13 (indeed, consistency should be sought with the whole fair value hierarchy approach in paragraphs 67-90 and B36 to B47 of IFRS13 and its US equivalent FASB 157).

Q15: Do you think additional criteria for marking-to-model should be added?

ISDA believes that no additional criteria are required . The valuation techniques used by prudentially regulated institutions are already subject to significant oversight as they form the basis of the inputs to the Basel II/III calculations. However, ISDA does not agree that “the marking to model valuation technique” is a matter for board approval, but rather for an appropriate internal valuation control oversight body.

To be clear, in a bi-lateral OTC derivative market, ESMA should understand that on some fundamental level, all OTC derivative trades are marked to model. The pricing model inputs for plain vanilla products that trade in liquid, active markets are easily obtainable from market data sources such as Thomson Reuters, Bloomberg, brokers, actual transactions, Markit or other data providers while some of the inputs for complex, bespoke transactions that trade in illiquid markets are more likely to be based on assumptions derived from more liquid proxy instruments, market intelligence, historical traded levels and so on.

Reconciliation of non-cleared OTC derivative contracts

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

Conceptually, the ESMA discussion paper reflects what ISDA considers to be a meaningful and appropriate view of "reconciliation". ISDA appreciates that ESMA has considered the existing ODSG portfolio reconciliation process in its discussion paper. We feel the ODSG process has the advantage of providing an internationally consistent standard defined exclusive of counterparty type. We also feel that the ODSG process, developed as a result of public and private sector collaboration, more readily lends itself to evolution as circumstances require. The ESMA Discussion Paper proposes daily reconciliation when counterparties have 300 or more OTC derivatives with each other and an as yet to be defined frequency for portfolios with lower numbers of trades.

ISDA supports the widespread adoption of portfolio reconciliations. As such, we would support lowering the reconciliation commitment from the current 500 trade level within the ODSG process to a daily frequency of portfolios with 300 trades or more as long as the commitment a) excluded fx

spot and short-dated forward trades², non-collateralized trades and intra-company trades and the reconciliation was able to be performed on either counterparty to the trades 3rd party reconciliation vendor of choice. The key terms to be reconciled must also include mark-to-market (mtm).

The benefit relating to reconciliation of portfolios of less than 300 trades is primarily a function of the risk profile of the counterparty and the frequency of trading within that portfolio. As such, ISDA recommends that the decision to regularly reconcile portfolios with less than 300 trades remain with individual firms and be based on their individual tolerance for counterparty risk.

It must be recognized the portfolio reconciliation is an inherently two-sided process - both parties need to provide their data, otherwise there is nothing to reconcile. Given the fact that unregulated entities may not be subject to any statutory or regulatory requirement to exchange portfolio data, it would be impossible to compel such a party to provide their portfolio data in order to perform a reconciliation. Therefore, the rules applicable to regulated firms must recognize that compliance is not fully within the control of those firms, and therefore that <100% compliance will be achieved. It is, however, appropriate that they make a good faith and commercially reasonable effort to procure the cooperation of their counterparties in the portfolio reconciliation process.

Q17: What are your views regarding the threshold to mandate portfolio compression and the frequency for performing portfolio compression?

ISDA recognises the benefits of portfolio compression, but would emphasize that the current process has taken a number of years to develop and is asset class specific. Furthermore, the success of the current process is due primarily to it being limited to a relatively small and homogenous group of participants. Expanding this to additional asset classes and products could be extremely costly and further expanding to a broader set of participants would require such participants to invest in additional processing tools which they do not currently have access to. Such investments could be costly for limited return particularly in light of the move to clearing of swaps which will reduce the need for bilateral/uncleared portfolio compression. In addition it should be noted that the effectiveness of portfolio compression is dependent on the differential of net to gross risk ratio. Where a portfolio consists entirely or with the majority of transactions in the same market risk direction there would be very limited benefit, if any, to participating in a portfolio compression cycle. Therefore, ISDA believes that the specifics around portfolio compression are best left to market participants, instead of being prescribed by regulation.

Alternatively, rather than mandating portfolio compression, ESMA should consider issuing best practice guidelines. Such guidelines should consider the comments made below.

Should ESMA decide otherwise ISDA would request a careful approach in determining which industry participants should be required to participate in compression cycles and indeed which products should be subject to the requirement. We believe that a participation criterion based on

² For example, trades with an original maturity under [3] days. Any issues with these trades that would be detected by portfolio reconciliation will in any case be rapidly detected during the trade settlement process and resolved accordingly. Further subjecting these short dated trades to daily portfolio reconciliation seems like an unnecessary burden that reduces focus on other longer dated trades where difference detection and resolution via the portfolio reconciliation process is of greater importance because settlement events may be distant in the future.

total size of non centrally cleared swaps is an inappropriate measure in this regard and any frequency should be determined by cost benefit analysis. Furthermore, the participation criterion should be specific to an asset class and reflect the participants and nature of the transactions within that asset class. Irrespective of which criterion is used we would note that portfolio compression is only feasible for certain asset classes where the asset class is standardised, global and liquid. Moreover, we believe that the following asset classes and products should be specifically excluded from the proposed portfolio compression requirement for the reasons noted:

- i. Foreign Exchange Swaps: As opposed to other asset classes (e.g., credit and interest rate derivatives), where the tenor is measured in years, the average tenor for foreign exchange and currency derivatives is between three and six months (and for foreign exchange forward contracts, as little as three to five days). Given the short tenor of these trades, their non-standardized, bilateral nature and the considerable preparation time associated with the compression process, there is minimal benefit to be gained from compression in this context.
- ii. Equity derivatives: This market is broadly positional in nature and, as a result, there is little opportunity for compression and netting. In addition, as the equity OTC market is broadly hedged with physical securities and/or listed derivatives, the justification for the Proposed Compression Requirement is diminished and could in fact increase risks by disrupting hedged positions. A lack of product standardization in this area also weighs in favor of an exclusion from the compression requirement.
- iii. Commodities: The notional amounts are comparatively low within this asset class and compression yields will only be worthwhile across a limited subset of products (primarily oil and precious metals). As an alternative to the imposition of the Proposed Compression Requirement to the entire asset class, we propose that so long as market participants and compression vendors can continue to define compression opportunities where the returns outweigh the costs, subjecting a consistently limited subset of commodity products to the Proposed Compression Requirement could be feasible.

Finally, given the considerable administrative and logistical obstacles that market participants will encounter in complying with any compression requirements, ISDA urges ESMA to consider a suitable phase-in period that will allow such parties to abide by the requirements within a reasonable timeframe, yet avoid disruption to the markets.

Dispute resolution

Q18: What are your views regarding the procedure counterparties shall have in place for resolving disputes?

The ESMA dispute paper references the need for firms to maintain detailed procedures for investigating, recording and resolving collateral disputes in a timely manner. We believe that it is important to view the answers to questions 18, 19 and 20 regarding the resolution of collateral disputes in the context of the overarching regulatory objective of reducing systemic risk to the global

financial system and that the appropriate balance exist between the need to reduce systemic risk while enabling firms to retain the essential ability to meet clients' risk mitigation needs utilizing sound business practice. We consider the mandatory resolution of collateral disputes in any specific timeframe by any specific mandated resolution method to be impractical and quite possibly unenforceable³. Counterparties to a private OTC derivative contract have the right to mutually resolve their differences with respect to any transaction between them in the manner and timeframe that they see fit. That being said, ISDA has worked with the industry for the last two years to document the process and options for resolution to make the process more predictable and to provide multiple avenues for resolution. Based on the collective work we have done, we believe that disputes should be able to be settled in 30 days.

ISDA supports the need for these procedures where they are focused on dispute resolution at the portfolio level, in line with ODSG reporting commitments. Over the last two years, OTC market participants have collaborated to draft the Convention on Portfolio Reconciliation and the Investigation of Disputed Margin Calls and Formal Market Polling Procedure, the Dispute Resolution Protocol (DRP). These documents are designed to serve as the industry suggested methodology for resolving collateral disputes. The DRP puts forth a specific, step-by-step process for resolving collateral disputes which can expand, when necessary, to a 30 day timetable. ISDA supports the most rapid collateral dispute resolution possible, but in practice, mandated resolution on a 5 day timeframe is infeasible. Experience with the DRP shows that it is hard to resolve some disputes in 5 days, and also hard to come up with a protocol that covers 100% of the disputes before they occur. Some reasons for allowing more time to resolve a dispute include:

- The portfolio reconciliation results must be analyzed to determine the root causes of the dispute. This can take time to accomplish. If the process is conducted across different time zones, all aspects of the resolution process will take longer.
- Some disputes require trader-to-trader discussion to resolve. Others may need to be escalated to senior management for further discussion.
- A small number of disputes prove to be intractable throughout the foregoing process, and must be resolved via an independent reference process such as a market poll or another agreed upon dispute resolution methodology. The Formal Market Polling Process referenced in the DR Drafts is one example of a polling process, but others are also possible. However, all polling processes require time to prepare, execute and then assess results. Depending on the product involved, substantial effort may be required to price transactions. The time to execute a poll for a complex structured derivative may be measured in hours or even days as time is required to build and populate a valuation model.

The DRP, when combined with other regulatory reporting initiatives (such as the Monthly Supervisory Dispute Reporting and Quarterly Dispute Market Average Report) already established under the existing ODSG process and data quality enhancements enabled by the implementation of counterparty ids (LEI) will provide Global Regulators with the tools to ensure that firms have the appropriate business process in place to resolve disputes in a timely manner and ensure that - when

³ In some jurisdictions it is important to avoid any kind of "agreement to agree", which may be considered to be unenforceable. A bilateral contract, even if under a government or regulatory mandate, in which the parties agree today that they will at the some future date agree to resolve a dispute may not be enforceable.

disputes do occur – regulators have the necessary transparency that enables them to quickly identify, question and escalate any potential systemic risk before it takes place.

Therefore, to be clear, we recommend that regulators require parties to have a mutually-agreed dispute resolution process, but avoid forcing them to agree to agree, or to resolve disputes in a prescribed timeframe. The quality of dispute resolution processes implemented in response to this requirement is something that can be assessed by prudential regulators during their firm review or horizontal review processes, and adjusted as necessary by discussion with market participants

Please see the answer to question 19 for ISDA comments to the ESMA discussion paper points regarding resolution via legal settlement, third party arbitration and/or a market polling mechanism.

Q19: Do you consider that legal settlement, third party arbitration and/or a market polling mechanism are sufficient to manage disputes?

ISDA does not consider legal settlement, third party arbitration and/or market polling as the only sufficient options to settle collateral disputes. In general, parties to a collateral dispute may view legal settlement as an option, but only after exhausting all potential remedies outside of a courtroom. Market participants view third party arbitration as similar to legal settlement in that the option is always available to two consenting firms, but only to be used after exhausting all other potential remedies. Moreover, market participants involved in crafting the DR drafts debated the practicalities of using a mandated third party arbiter to resolve collateral disputes, however, this alternative was deemed unacceptable due to many firms doubts about a third party's proficiency to accurately price a complex, bespoke transaction. The Market Polling Process was envisioned by the OTC market participants who created the DR drafts as the dispute resolution method of default, when firms couldn't agree to any other form of resolution.

ISDA believes that it would be impractical for two parties to a collateral dispute to proscribe a resolution method before they actually identified the cause of the difference. Moreover, the ESMA DP makes no mention of other perfectly valid dispute resolution options such as unwinding the dispute driving trade(s) or indentifying and eliminating a structural difference in disputing firms valuation models to name a few examples. They key to managing disputes is a robust and pro-active portfolio reconciliation process that is designed to identify and resolve issues before they turn into larger and longer dated disputes.

Q20: What are your views regarding the thresholds to report a dispute to the competent authority?

ISDA appreciates the approach to dispute reporting that ESMA has put forth and we support the dispute reporting thresholds of \$15mm or greater and 15 days or more outstanding as referenced in the ESMA discussion paper so long as they are intended to be reported on a) monthly frequency, b) at the portfolio (and not the trade) level, c) reflected in USD and d) reflect the cumulative age of the dispute (meaning the collateral dispute continues to age if the dispute swings from one disputing party to the other).

One additional note on the topic of international coordination: because portfolio reconciliation and dispute resolution necessarily require the interactive cooperation of both parties in real time, ISDA

believes it is vital that the relevant international rules be perfectly synchronized. This will avoid situations where two parties have a dispute but each is subject to rules that are mutually incompatible. Synchronization must extend to the content of the rules, the timing of actions under the rules and the implementation phasing thereof.

Intra-group exemptions

Q21: In your views, what are the details of the intragroup transactions that should be included in the notifications to the competent authority?

The purpose of this notification requirement is to enable competent authorities to assess compliance with (a) and (b) of the different sub-paragraphs.

In order to achieve this goal without unnecessarily overburdening the regulatory process or compromising each counterparties' need to maintain confidential group information,, we think that counterparties wishing to take advantage of the relevant exemptions should notify to regulatory authorities

- i. Their name;
- ii. The name of the other counterparty they wish to deal with and appropriate detail on the affiliation;
- iii. A generic description of the kind of derivative transactions for which they wish to take advantage of the exemption;
- iv. A description of their risk management procedures applying to these transactions;
- v. A statement that they meet the criteria developed by EBA, ESMA and EIOPA for there not to be an impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties.

We note that technical standards in relation to the criteria for 'practical and legal impediments' will be the subject of a separate discussion paper. We welcome the opportunity to provide input on those important issues.

Furthermore, In order to make this exemption practicable, we submit that the following needs to be taken into account:

- The exemption will need to apply for a certain class of transactions, which could encompass all transactions between specific group members. Given that the exemption will need to be available when a specific exposure arises, it would clearly be impracticable to decide about the exemption on a transaction-by-transaction basis. We think that the reference in Art. 8 (1j) d EMIR to "the details of the intragroup transaction concerned" is intended to refer to the kind of intragroup transactions that are covered by the exemption, not to specific single transactions.
- The procedure for granting the exemptions should be structured in a way so that the exemption can be granted by the time the relevant requirements enter into force. In so far as it will take some time for ESMA and regulatory authorities to develop the criteria under

which firms can take advantage of the exemption, “appropriate” collateralization should be defined with these timelines in mind, effectively allowing for a phasing-in, so that the requirements only apply in an intragroup context once the procedures, including the first batch of equivalence assessments for third countries, have been defined. A margining requirement for these contracts will provide an excessive and misleading picture of bilateral exposures in OTC derivatives, and will be a significant and often unnecessary liquidity drain.

Q22: In your views what details of the intragroup transactions should be included in the information to be publicly disclosed by counterparty of exempted intragroup transactions?

We take it that this publication requirement should enable the market to assess the extent to which the exemption is used. We think that for this purpose the following information to be published is appropriate

- i. The name of the counterparties to which the intragroup exemption refers;
- ii. A generic description of the kind of derivative transactions for which the exemption applies.

Art. 8 (1j) d EMIR specifies that counterparties should publicly disclose “information on the exemption”. We take it that this is meant to provide the market transparency which counterparties may profit from the intragroup exemption. We do not think that it is meant to provide the market information about specific transactions (as the wording of Q 22 of the discussion paper may be read to assume), as the widening of post-trade transparency to non-equity transactions involves complex trade-offs between liquidity and market information, which will be more appropriately addressed in MiFID.

Q23: What are your views on the notion of liquidity fragmentation?

We remain very concerned as to the systemic risk posed by intraday margin calls for OTC derivatives.

This fragmentation of the clearing market is likely to result in unbalanced netting sets in clearing members’ house and client accounts. In this context, the use of intraday margin calls for OTC derivatives cleared at multiple CCPs creates systemic risk as clearing members must make payment of net mark-to market losses on directional exposures to CCPs without the benefit of payment from CCPs for accounts with net mark-to-market gains. In the absence of refined standards for intraday margin practice, CMs are exposed to a serious liquidity risk as they risk-intermediate CCPs in distressed market conditions.

One preliminary estimate suggests that such Intraday margin calls may require USD\$20B in overnight funding from each CM or USD\$300B - \$500B in aggregate. This preliminary estimate gives a sense of the magnitude of the issue. As noted, clearing members cannot effectively control this risk, since it originates from fragmentation of the clearing market and client choice of clearing venue.

We have addressed this issue in more detail in a submission to CPSS-IOSCO, and have considered some potential solutions. Please see the document at the link below:

<http://www2.isda.org/attachment/Mzk2OA==/CPSSISOCO%20Final%20letter%202%2002%2012.pdf>

We would nevertheless make the further point that – in relation to access to trading venues – liquidity fragmentation concerns should not be used to unnecessarily block access to competitor CCPs and hence maintain vertical silos.

Q24: What are your views on the possible requirements that CCP governance arrangements should specify? In particular, what is your view on the need to clearly name a chief risk officer, a chief technology officer and a chief compliance officer?

We agree on the need to name a chief risk officer, a chief technology officer and a chief compliance officer. As more and more derivatives become subject to mandatory clearing, CCPs will take on more and more systemic importance. It is therefore crucial that the interest of regulators, CCP owners, clearing members and clients in stable and efficient (in risk and cost terms) CCPs are underpinned by sound governance practices, minimising the scope for potential conflicts of interest. The governance structure of a CCP should require higher or heightened governance or approval processes than followed in the normal course of business for the alteration of its rules, procedures or contracts. In addition, the discretion of the CCP to make substantive changes in these areas should be limited. CCP governance structures should take into account and balance the interests of its major stakeholders, including clearing members and clients of clearing members. It is not sufficient that the process is “fully disclosed” – clearing members and their clients have an interest in clear, comprehensible rule sets that are applied consistently, including in relation to Risk, Default Management and other Advisory committees. These should describe i) committee roles and responsibilities, ii) decision making authority/permissible actions , iii) composition and nomination process and requirements, iv) representative fiduciary responsibilities and v) frequency of meetings, among other governance issues and should be shared with members to ensure full transparency. These rules should cover any risk advisory committees, even if not formal Board committees.

We believe that where a CCP is part of a larger organisation, there should be dedicated resources for the management of the CCP (i.e. distinct staff for the CCP) which have the appropriate expertise to ensure a sound, prudent and efficient management.

We further believe that CCP governance needs to promote stability of the CCP and should be independent from the parent company and any influential stakeholder(s). CCP should be effectively ring-fenced from other activities and risks associated with their parent group (where they are part of a wider group). Any intra-group servicing/outsourcing arrangements should be on arms length commercial terms and risk with suitable back-up arrangements/contingencies in place.

Q25: Are potential conflicts of interests inherent to the organisation of CCPs appropriately addressed?

Evidence-based regulation

Due to the complexities of the market and the need to attract both capital and expertise, ISDA believes that the ESMA should engage in a robust review of the market and appropriate ownership and voting requirements for CCPs. Simply put, there should be a meaningful administrative review

that might support any proposal that could have the unintended effect of constricting capital formation in the new market entities. In other words, there should be findings supporting any rules that are adopted, and the authorities should not act without developing that basis.

On competition on risk

The G20 commitment to more clearing in OTC markets and related national legislation and implementing rules creates a major business opportunity for CCPs. It is also clear that the strong network effects for CCPs (value to a user is greatly increased by the access that is given to a wide range of counterparties and exposure netting benefits) mean that it is likely that there will be only a small number of winners in each asset class, perhaps only one. However, to the extent that competition does take place for a period, there are two obvious ways for CCPs to compete: lower initial margin, and accepting a wider range of collateral with lower haircuts. From a risk management perspective, both of these actions are undesirable.

Risk Committees, Board composition and conflicts (or otherwise) in CCP governance

Every CCP should be required to establish a risk committee or committees.

Should the CCP clear different types of assets, the Risk Committee should reflect the expertise of the various asset classes and the CCP should set up dedicated committees by types of assets

We note that EMIR Regulation stipulates that no one group on a Risk Committee (including the representatives of the clearing members and the representatives of clients of clearing members) can have a majority on this Risk Committee⁴. The potential for conflicts of interest in Risk Committees – as suggested by some market participants and commentators – would seem to be minimised by this level 1 provision.

The risk committee of a CCP should establish risk tolerance statements. These statements would establish the nature of the back tests and stress tests performed by the CCP, the assumptions and methodologies used in the tests, and the extent of mutualized loss exposure that clearing members would face if stress scenarios occurred.

Other matters that would be appropriate for a Risk Committee to vote on include the size and composition of the default fund and how CCP losses are allocated.

A CCP Risk Committee should report directly to its board. EMIR stipulates the Risk Committee's role as advisory to the board, but individual CCPs give Risk Committees a stronger (decisive) role in decision-making.

Where a CCP's board of directors overrules the Risk Committee (or indeed any other committee), the board should be required to notify the CCP's regulators and should provide a detailed analysis of the reasons that prompted the board of directors to make that decision. Further to this point, regulators are given the power – under the level 1 text – to attend Risk Committees if they wish.

⁴ The Risk Committee will also include independent members of the Board of the CCP, and can invite others to participate in a non-voting capacity, including employees of the CCP, and external independent experts

In general, disagreement between the CCP Risk Committee and the CCP Board is indicative of potentially unhealthy governance and risk management structures at a CCP.

We believe that board independence is best ensured by encouraging a balance of views being represented on the board. In our view, the desired balance between different interests can best be achieved by identifying different classes of interested parties and encouraging a diverse representation of those interests in the board, rather than prohibiting participant representation. This would be accomplished by prohibiting any single class of interested parties (clearing members, clients, other investors and infrastructure providers). These limitations would have the added benefit of promoting open access to CCPs.

On the potential outsourcing of clearing member default management to unaffiliated third parties

We would welcome ESMA examining issues therein, in order to ensure that neither clearing members nor clients are compromised through such outsourcing arrangements.

Q26: Do the reporting lines – as required – appropriately complement the organisation of the CCP so as to promote its sound and prudent management?

We think that a CCP's risk management function should be independent, reporting directly to senior management or Board of Directors; and that strong systems and procedures for controlling, monitoring and reporting risk, including transactions between an institution and its affiliates, should be implemented. Such systems will include segregation of client assets and a credit limit process.

We further believe it is critical that CCPs have a formal new business initiative approval process in line with what financial institutions have in place. Such a process (subjected to internal audit and regulatory oversight) would ensure all support/business functions evaluate costs/ benefits of a new/expansion of product for clearing.

Q27: Do the criteria to be applied in the CCP remuneration policy promote sound and prudent risk management? Which additional criteria should be applied, in particular for risk managers, senior management and board members?

We are generally in agreement with the contents of the Discussion Paper on this point.

We add further that

- Remuneration policy needs to be linked to key performance and risk metrics (TBA) and should be structured to encourage a long term view.
- Pay scales and compensation packages need to be competitive compared to the market (for risk professionals) and set at levels that attracts high quality skilled risk managers.

Q28: What are your views on the possible organisational requirements described above? What are the potential costs involved for implementing such requirements?

We are in large part in agreement with these requirements. However we add

- The statement in Paragraph 75(c-d) indicates that a CCP should consider “industry standards”. Currently there are initiatives seeking to standardise client clearing customer documentation. As and when there is further industry standardisation, these should be taken on board.
- We believe the point addressed in paragraph 75.g is particularly important. CCPs should be obliged to share all material relevant to properly monitoring exposures and Potential Future Exposure to CCPs for clearing members.
- Full ETE testing should involve any third party vendors involved in the clearing process (see paragraph 75).

Q29: Should a principle of full disclosure to the public of all information necessary to be able to understand whether and how the CCP meets its legal obligations be included in the RTS? If yes, which should be the exceptions of such disclosure requirements? Has the information CCP should disclose to clearing members been appropriately identified? Should clients, when known by the CCP, receive the same level of information?

Disclosure of CCP financial resource requirements will add to confidence in the financial markets. In addition, there must be regular CCP back-testing of its initial margin calculation and periodic disclosure by the CCP to its CMs and regulators of its back-testing methodology, its stress tests and results. There should also be disclosure of CCPs' exposures and balance sheets. Information appropriate for participants to manage their credit exposure to the CCP may not necessarily be suitable for public consumption, but in general CCPs should establish mechanisms for sharing information with members and clients of members as needed to allow for their ability to measure, monitor and report their CCP exposures. We summarise below some particular areas where we believe greater transparency of information is needed (noting that while full disclosure should be made to clearing members, full disclosure to the public may not be appropriate in all circumstances and care needs to be taken in relation to certain information which may need to be anonymised):

- Governance: rules, procedures and internal committee and terms of reference documents including composition of the board (members & their company) and of the shareholding of the CCP.
- evaluation/monitoring of clearing members (to : documentation and procedures covering internal credit rating methodology for new members and on a continuing basis; member level limits and measuring and actioning uncollateralised exposures; credit profile and composition of CCPs member base (e.g. weighted average credit rating across members).
- Initial margin; guarantee fund methodologies; standard reporting; regulatory capital calculations: details on IM methodology (e.g. VaR, SPAN, Monte Carlo) and relevant formulae (e.g. source code); independent IM review documentation; monthly back testing and stress testing reports; data supporting margin/GF calculations; calculations under new Basel 3 requirements.
- Composition/value of IM and guarantee fund: granularity of position and collateral data sufficient to allow members to estimate potential exposure to CCP.

- Default procedures : detailed disclosure of steps to be taken in managing a clearing member default, including auction procedures and parameters, hedging and liquidation timelines, consequences of auction failure, recourse to CCP in event of insufficiency of resources.
- Investment policy.
-

Legal opinions: disclosure of netting and collateral enforceability legal opinions, covering clearing member and CCP insolvency analysis; interoperability legal opinions where that CCP is offering such arrangements.

We further add that - with reference to the obligation for CCPs and its clearing members to “publicly disclose the prices and fees associated with the services provided” (as indicated in Article 36 of EMIR), we believe that there should be clear distinction between transparency requirements for an infrastructure, where membership is based on generic eligibility criteria, versus transparency in the context of commercial services, which are most often based on target market considerations (‘value proposition’) and risk parameters. We also believe that this would be against the principle of free competition amongst relevant market players. We believe that the mandatory disclosure requirement should be established only about maximum prices and for basic standard services (and comparable amongst different CCPs and different clearing members), thus leaving room for further bilateral arrangements.

Q30: What are your views on the possible records CCPs might be required to maintain?

We broadly agree. However we add

- Information should be provided – in records - to interested parties (clearing members and clients) regarding stress testing.
- Minutes of all relevant committees (including advisory committees) as well as any new business initiative process related docs (assuming process established per prior comment);

The pay-off description of the relevant derivative products should be added in paragraph 79b.

We disagree in relation to the second bullet point in paragraph 79 (page 22). The document here refers to positions built up from underlying transactions, in line with the exchange traded market. Unlike exchange traded derivatives, OTC contracts have variable tenors, so it will not be possible to create OTC positions from the underlying trade data. We encourage ESMA to work with the industry on the implementation of Universal Product Indicators (UPI) codes to allow regulators and CCPs to aggregate risk by classes of derivative products. Existing OTC CCPs prefer not to complete KYC on Clients, and do not request client details.

Q31: What are your view on the modality for maintaining and making available the above records? How does the modality of maintaining and making available the records impact the costs of record keeping?

While we welcome the principle in paragraph 84 - that no legal or technical impediment should prevent European regulators from promptly accessing data maintained by a CCP outside the EU, and that they should be able to access this data with the same modality and delay as if it was maintained in the EU – we believe that (at least in the near/medium term) this may be a challenge.

ISDA would make several additional observations:

- The proposed 10 year retention period allows for a retrieval of data. However given that backup data is taken to offsite storage, and would need to be retrieved and restored, ESMA should accept that the response time for regulatory queries could accordingly be days rather than hours. Other regulators (US) have specified 3 year retentions, and an expected SLA for retrieval.
- More specific requirements, such as those in the US which specify not only the retention period (3 years) but an expected SLA for retrieval and even the media type, would cost significantly more due to the need to implement specialized systems.
- We believe that an intra-EU location should not be specified as a requirement and welcome the position taken in the level 1 text in this regard.

Q32: What are your views on the possible requirements for the business continuity and disaster recovery plan and in particular on the requirements for the secondary site? Would it be appropriate to mandate the establishment of a third processing site, at least when the conditions described above apply? What are the potential costs and time necessary for the establishment of a third processing site and for immediate access to a secondary business site?

ISDA supports many of the proposed elements of these requirements including the policy framework, requirement for secondary processing sites and business recovery sites, regular testing, communication and awareness. However ISDA wishes to emphasize it is imperative that a comprehensive plan to address CCP stress is agreed ex ante. Such a plan might include consideration of whether an alternative CCP is able to clear a particular product and also the requirement for some level of interoperability across CCPs (including compatible operational systems and procedures) so that non-defaulting portfolios can be ported relatively seamlessly to another CCP rather than having to unwind large portfolios over the course of a relatively short period which could result in further market dislocation.

A credible CCP resolution plan is vital for financial stability, particularly given that a CCP may be the principal venue for clearing a product, and, in the absence of adequate continuity planning, CCP stress might preclude the functioning of the market for that product, while stress in a “systemically important” CCP might preclude the functioning of the entire financial system.

With regard to some of ESMA’s specific proposals:

- In terms of the third processing site, the costs of this strategy are significant and need to be set against the small risk that the backup site as well as the primary site are affected, given that these are geographically separated.
- We would emphasize importance of the secondary site being significantly geographically distant – we find that many CCP back sites are located too close to the primary site which would prove useless in event of natural disaster and/or disruption to locate.
- All business recovery plans, tests/results should be shared with both regulators and members and subject to CCP internal audit review.

Q33: Is the 2 hours maximum recovery time for critical functions a proportionate requirement? What are the potential costs associated with that requirement?

Assuming the plan is to have a back-up site that can be physically reached by people to man the site within the relevant time frame, it may be proportionate. Some firms say they have secondary sites within two hours reach and expect to recover their critical systems within 2-4 hours. We would expect CCPs to have similar arrangements in place.

However, if the plan is to rely on a purely technological solution, in our view the costs of such a solution would not be proportionate, particularly as the risks to the primary site where such a high tech solution is proposed may be at risk to force majeure scenarios. Also, the costs of any such highly resilient technology solutions would exponentially increase as the need to replicate those systems at multiple locations is required.

Q34: Are the criteria outlined above appropriate to ensure that the adequate percentage above 99 per cent is applied in CCP's margin models? Should a criteria based approach be complemented by an approach based on fixed percentages? If so, which percentages should be mandated and for which instruments?

Q35: Taking into account both the avoidance of procyclicality effects and the need to ensure a balance distribution of the financial resources at the CCP disposal, what is in your view the preferred option for the calculation of the lookback period.

Q36: Is in your view the approach described above for the calculation of the liquidation period the appropriate one? Should a table with the exact number of days be included in the technical standards? Should other criteria for determining the liquidation period be considered?

Q37: Is procyclicality duly taken into account in the definition of the margin requirements?

Q38: What is your view of the elements to be included in the framework for the definition of extreme but plausible market conditions?

Placeholder: Given the time allowed for response to this consultation, the associations do not feel that they have been able to develop detailed views on questions 34-38 that would be both (a) of interest and value to ESMA and (b) reflective of consensus market views.

The associations will revert to ESMA in detail on these points in the coming weeks.

Liquidity Risk Controls (Article 41a)

Note: The current modus operandi of equity-clearing CCPs is that they typically use a single payment bank for their **intra-day liquidity** needs in each market where they offer clearing services (only one per market). This is a practical, operational requirement based on how the settlement infrastructures work today.

Re-use of client margin is prohibited so a CCP still requires this funding. It is suggested that a limit of 25% be applied per clearing member, parent undertaking or subsidiary of the clearing member. Therefore the CCP would have to utilize someone who is not either a member, or subsidiary of their members, to provide this service. This may be possible but could mean the usage of smaller capitalized banks, thereby potentially increasing the CCP's risks, especially if they cannot secure the funding required. We consider it to be an inefficient, impractical and potentially more costly method of providing intra-day liquidity. These costs are likely to impact the end investor.

We understand that some CCPs already have this arrangement in place for their **overnight credit lines** and agree that this is a suitable and cautious arrangement. However, additional clarification to EMIR Article 41a that it does not relate to intra-day liquidity would be welcome.

Q39: Do you believe that the elements outlined above would rightly outline the framework for managing CCPs' liquidity risk?

The liquidity of the financial resources available to CCPs is critical. If a CCP does not have adequate liquid resources to manage the default of a large participant then any request for further contributions from participants will be a further liquidity drain on the system and may exacerbate the crisis by causing cascading defaults in other (otherwise solvent) participants. Further, the CCP's local supervisor should make the relevant assessment of the liquidity of the FMI's financial assets as self-assessment may give rise to an imprudent incentive structure, although we acknowledge that this may lead to disparity between CCPs should local assessments differ. A CCP's exposure to sovereign CDS spreads and credit ratings (internal and external) should also be taken into account when establishing whether a CCP's liquidity framework is low risk.

Q40: Do you consider that the liquid financial resources have been rightly identified? Should ESMA consider other type of assets, such as time deposits or money market funds? If so, please provide evidences of their liquidity and minimum market and credit risk.

Yes, although cash should prevail when considering collateral and liquid financial resources as it is easier than securities to liquidate quickly. We also consider LTRO and emergency facilities repos to be suitable.

We do not consider time deposits and money market funds to be appropriate liquid financial resources as time deposit are not sufficiently liquid while it may not be possible to liquidate money market funds may not be able to be liquidated without disrupting the market. Further clarification is needed on what constitutes an authorized credit institution if credit lines are to be properly considered.

Q41: Should the CCP maintain a minimum amount of liquid assets in cash? If so, how this minimum should be calculated?

We support the view that a CCP should have sufficiently liquid financial resources to enable the CCP to fulfill its obligations as a central counterparty during a one-day settlement cycle. We assume the intention of EMIR is that financial resources are available as cash within one day (and not that settlement in a default context must occur in one day). The liquidity of the financial resources available to the CCP is critical as if the CCP does not have adequate liquid resources to manage the default of a large CM then any request for further contributions from CMs will be a further liquidity drain on the system and may exacerbate the crisis by causing cascading defaults in other (otherwise solvent) CMs.

Any such amount should be calculated as a percentage of assets and informed by the results of CCPs stress testing.

ESMA should be aware that standard industry practice for equity-clearing CCPs involves the use of a single payment bank per market for intra-day liquidity needs This is a practical, operational requirement based on contemporary settlement practices.

Q42: What is your preferred option for the determination of the quantum of dedicated own resources of CCPs in the default waterfall? What is the appropriate percentage for the chosen option? Should in option a, the margins or the default fund have a different weight, if so how? Should different criteria or a combination of the above criteria be considered?

When considering the two options, we believe that option 1- *x% of the average of the margins and default fund contributions collected by the CCP over a one year period excluding margins posed by interoperable* will result in sounder market outcomes in terms of CCP accountability and risk minimization. We do believe that the inclusion of initial margin in the calculation is inappropriate, especially in light of the expectation that the initial margin of non-defaulting clearing members should not be at risk in the waterfall. Should a default occur, it is the defaulting clearing member's

margin which is available to the CCP, while the non-defaulting clearing member's collateral would not be mutualised and therefore would be unavailable to the CCP. This should be amended.

The size of this contribution to the default fund is a matter of debate however and should be proportionate to the CCP's level of activity and its risk profile. An approximate starting point would be 10%, with the CCPs contribution scalable according to these factors but incorporating a minimum floor based on percentage of capital resources/retained earnings. An appropriate figure for this floor would be 8%.

It is also important that ESMA define what exactly constitutes a CCPs' 'own funds' in this instance, keeping in mind the considerable requirements already surrounding the need for high quality collateral.

We would welcome greater clarity on the extent to which EMIR and associated technical standards address the sequence of events in the event of default of a clearing member – in particular how provisions for portability will be applied in the context of the default waterfall and – where reference is made to clearing members' margins in article 42 – whether this includes or is distinguished from collateral of that clearing member's clients.

Q43: What should be the appropriate frequency of calculation and adaptation of the skin in the game?

Should CCP contribution to the default fund fall below the required level, a CCP should be required to bring them to back to the required level within one month at a minimum, or in line with its member replenishment, whichever is lower.

In terms of the frequency of default CCPs calculations and in light of a CCP's systemically important role in market infrastructure, a CCP should be proactive and responsive to the level of activity and existing market conditions. In the event of a relatively stable level of activity, it is appropriate the CCPs should be required to calculate their contribution at least once a month. In addition, CCPs should be required to "replenish" their contribution, (in case it has been used during a default) to ensure "skin in the game" in line with member replenishment. We do not believe however that there should be an aggregate cap across contractually segregated segments if CCP contributions cannot be used cross segments.

Q44: Do you consider that financial instruments which are highly liquid have been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of cash of financial instruments? Do you consider that the bank guarantees or gold which is highly liquid has been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of bank guarantees or gold?

Q46: Do you consider that the proposed criteria regarding the currency of cash, financial instruments or bank guarantees accepted by a CCP have been rightly identified in the context of defining highly liquid collateral? Should ESMA consider other elements in defining the currency of cash, financial instruments or bank guarantees accepted by a CCP as collateral? Please justify your answer.

We believe that the overwhelming priority in the EMIR Regulation and associated technical standards is the stability of CCPs.

As such, we feel it is critical that ESMA, in considering acceptable collateral – and conditions therein - have this priority in mind. In this context, ESMA should approach this question by considering the circumstances in which such collateral would have to be liquidated:

- The default of a client of a clearing member.
- The default of a clearing member.
- The default/resolution of a CCP.

It is important that collateral accepted by a CCP can be quickly liquidated in these circumstances, maintaining, to a significant degree, its pre-default value.

If clearing members (or clients of clearing members) post margin in assets other than cash, the CCP can become undermargined due to changes in the value of the collateral. The risk of this undermargining depends on the volatility of the price of the collateral: the greater the volatility, the greater the risk of undermargining. It also depends on the correlation between the value of the collateral and the value of the collateralized positions. If the assets posted as collateral tend to decline in value when the associated position loses money, the risk of under-collateralization is greater. The risk also depends on the liquidity of the collateral. A CCP runs the risk of forcing down the price of collateral when it sells it to cover a defaulter's obligations: this risk is greater, the less liquid the collateral.

Accordingly, broadly speaking, we consider that “eligible collateral” should ideally have the following characteristics:

- high credit quality;
- demonstrable and measurable high market liquidity or trading volume (by objective and independent standards);
- low price volatility and high transparency of pricing; and
- have low correlation with the exposure being collateralised.

Collateral with these features, along with minimum cash thresholds and concentration limits by instrument/maturity/single issuer at both member and aggregate CCP level, would help ensure both adequate liquidity and loss coverage at the CCP in the event of a CM default. Examples of assets that have the above features include:

- cash in the currency in which the trades are settled or other G4 currency; and
- direct obligations of, or obligations guaranteed by the sovereign of the jurisdiction in which the CCP resides or other highly-rated sovereigns, i.e. A or above. (This would
- senior debt of certain government-sponsored entities assuming it met objective parameters noted above.)

There is a sliding scale in terms of optimality of the forms of collateral that can be considered liquid enough for the purpose of CCPs, beginning with cash and ending with commercial bank guarantees.

Conditions relating to permissibility of these types of collateral – to the extent that they are permissible- should become more stringent as we go down that sliding scale.

It is important, nevertheless, to acknowledge the significant liquidity reduction in certain non-cash assets if eligible collateral for every CCP was limited strictly to those non-cash assets of ‘demonstrable and measurable high market liquidity or trading volume (by objective and independent standards)’. Such liquidity strain may be further exacerbated by the competing and similar uses for such collateral pursuant to the rules for uncleared swap margin rules proposed in the United States and European Union and the Basel III reforms (including, notably, the Basel III liquidity ratio).

Certain CCPs also accept other non-cash assets with meaningful haircuts (for example, gold). Accordingly, expansion of eligible collateral types is an area that warrants further discussion so long as it is done in a risk appropriate manner subject to regulatory approval. We believe that discussion is warranted regarding the expansion of eligible collateral types, and we would encourage ESMA to provide clear guidance on this issue in the finalized principles.

In relation to commercial bank guarantees, we make the following observations:

- Our key risk-focused concern is the value of such a guarantee in a default situation. How quickly would it be liquidated? Clearly ESMA has considered this concern in paragraph 120
- We query the logic of the condition (condition 3(v), paragraph 120) suggested for their use by ESMA that they be full backed by collateral that is realizable on a same-day basis. Obviously, if such collateral were available there would be no need for the commercial bank guarantee anyway.

We believe that it would be useful for ESMA to draft a clear definition of ‘low credit risk’ (the Discussion Paper (paragraph 120.2) states that an asset could be deemed highly liquid for this purpose if ‘issued by an issuer with low credit risk.’

Q45: In respect of the proposed criteria regarding a CCP not accepting as collateral financial instruments issued by the clearing member seeking to lodge those financial instruments, is it appropriate to accept covered bonds as collateral issued by the clearing member?

We fear that covered bonds may not be sufficiently liquid for the purposes of a CCP (rapid management of a default). Certainly, covered bonds issued by clearing members – even if they are actually submitted as collateral by other clearing members – do represent a certain degree of wrong way risk.

A CCP should identify and mitigate any exposure that may give rise to specific wrong-way risk, where the value of a cleared product is likely to fall specifically because the creditworthiness of that counterparty is deteriorating. For example, CMs in a CCP clearing CDS should not be allowed to clear single-name CDS on their own name or their legal affiliates. A CCP should be required to review regularly its portfolio in order to identify and mitigate promptly any exposures that give rise to specific wrong-way risk and to monitor and measure exposures that give rise to general wrong-way risk. A wrong way risk methodology needs to address both measurement and thresholds with corresponding incremental margin charges paid by CMs exceeding them.

Q47: Do you consider that the elements outlined above would rightly outline the framework for determining haircuts? Should ESMA consider other elements?

ISDA is broadly supportive of the considerations set out in the DP, and supports an appropriate haircut for certain types of financial assets as determined by the regulators upon review of the relevant CCP. The appropriateness and level of any such haircut should also be impacted by the attributes of the CCP, its membership, and other criteria further to those in set out in the DP. We would emphasize that in determining appropriateness of haircuts, consideration as to performance in 'stressed periods' should be taken into account (i.e. volatility during stressed periods for a particular asset (eg 1987 financial crisis for equities)). Daily monitoring of haircuts should be required with formal review/updates monthly.

Consideration of potential for wrong way risk should also be part of the assessment regarding appropriate haircuts.

Q48: Do you believe that the elements outlined above would rightly outline the framework for assessing the adequacy of its haircuts? Should ESMA consider other elements?

Yes, broadly.

Q49: Do you consider that the elements outlined above would rightly outline the framework for determining concentration limits? Should ESMA consider other elements?

Yes, broadly.

Collateral with concentration limits by instrument would help ensure both adequate liquidity and loss coverage at the CCP in the event of a CM default. CCPs should continually monitor the risk associated with concentration in CMs' positions. If a CCP determines that a participant's cleared portfolio is so large that it could not be liquidated within the liquidation period assumed in the CCP's default management plan, then the CCP should have discretion to include an extra charge for concentration risk in the initial margin requirements of such CM – as is currently common practice.

Some consideration should be given to some of the issues that concentration limits can throw up vis-à-vis clearing rules for clearing members. For example

- Would CCPs be required to state CCP-wide concentration limits in their rules?
- Would CCPs be required to disclose all collateral holdings, as part of their concentration limits policy (and enforcement)?
- It should be clear exactly how such limits would work at the point of breaking of them e.g. would a trade breaching the limits be allowed, with all subsequent trades in the specific instrument or grouping (for the purpose of the limits) not to be allowed? How much delay, uncertainty would there be in clarifying the situation?

There may, as the paper suggests, be merit in application of sector concentration limits – though clarity is essential.

Q50: Should a CCP require that a minimum percentage of collateral received from a clearing member is provided in the form of cash? If yes, what factors should ESMA take into account in defining that minimum percentage? What would be the potential costs of that requirement?

Collateral with minimum cash thresholds could help ensure both adequate liquidity and loss coverage at the CCP in the event of a CM default. At the very least, holding a certain amount of cash could cover operations until less liquid collateral could be liquidated without significant loss.

Investment policy (Article 44)

CCP Investment policy (Article 44)

Q51: Do you consider that financial instruments and cash equivalent financial instruments which are highly liquid with minimal market and credit risk have been rightly identified? Should ESMA consider other elements in defining highly liquid financial instruments with minimal market and credit risk? What should be the timeframe for the maximum average duration of debt instrument investments?

Approach

We agree with a criteria-based approach to defining the relevant investments, but we also believe that a list of eligible financial instruments should be published by ESMA on its website and that that list should be subject to regular review and updating.

ESMA's criteria should also leave ESMA free to direct that CCP investment should be in cash form only, should market conditions so dictate for any period of time.

We also agree that the CCP's investment policy should be more restrictive than its policies regarding the eligible collateral which it accepts from clearing members and their clients. It should cover highly liquid financial instruments which are the subject of restricted repo arrangements entered into with eligible repo counterparties, as set out further below.

In our view, CCP cash should only be used in one of the following ways by the CCP: (i) placed on deposit with eligible central banks in its entirety if such facility is available to each CCP or, if such central bank facility is not so available, then placed on deposit with eligible commercial banks (provided the CCP Risk Committee is satisfied that the risks of the deposit are mitigated to the greatest extent possible), or (ii) repo'd out overnight by the CCP in exchange for eligible highly liquid and high quality collateral from eligible repo counterparties. In both instances, there should be clearly specified eligibility criteria and tenor profiles to ensure that investments are liquid. Eligibility in each case would be defined by ESMA, made publicly available on its website and updated frequently and in rapid response to changes in market conditions. Please see our responses to questions 52 and 54 for further granularity on eligibility criteria.

Frequent policy review and amendment

It is essential that the criteria and parameters used to identify highly liquid financial instruments are subject to regular review and updating by ESMA.

We urge ESMA to consider building a transparent, practical and publicly disclosed mechanism for (a) changing the parameters themselves and (b) varying the content of the parameters quickly in response to changes in market conditions. We envisage (a) having a far longer lead-in time than (b): for example, a decision by ESMA to change volatility risk as a parameter should be subject to public consultation and review over a longer period than a decision to amend the volatility levels currently set for that parameter, which may need urgent amendment in response to sudden changes in market conditions. ESMA should have authority to change both the parameters (after appropriate public consultation) and their content (which would require a rapid response mechanism with immediate practical effect).

ESMA's criteria for assessment of CCP investment policies should be transparent, as should the mechanism for changing them. We would suggest that any concerned market participant could propose changes in ESMA's parameters or their content to their national regulator for them in turn to raise it with ESMA. A CCP's investment policies should be subject to its Risk Committee approval (not just consultation) such that clearing members are aware of, and agreeable to, the proposed use of their collateral contributions. A mechanism to ensure speedy transmission to and reaction by ESMA should be established. It is also essential that ESMA should not be fettered by political sensitivities from acting quickly: ESMA should be able to focus solely on the criteria governing asset quality.

CCP policies on investment and investment activities should be similarly transparent to CCP clearing members and their clients. CCPs should keep their investment policy under review and ensure that it is always within the investment parameters set by ESMA. We would suggest quarterly review by CCPs, with more frequent reviews if market conditions and confidence dictate. CCPs should disclose their investment policy and activities publicly, as well as any changes to them as soon as they are made. CCPs should consult on their investment policy and activities and any changes to them with their Risk Committee. ESMA should publish a list of highly liquid financial instruments eligible for CCP investment (together with lists of or, where appropriate, criteria for) eligible commercial banks, eligible central banks and eligible repo counterparties), with CCPs able to restrict their investment to certain instruments, central banks, commercial banks and repo counterparties within those ESMA lists.

Clearing member collateral: CCP investment incentives

ESMA's investment criteria should not encourage CCPs to call clearing members purely for cash collateral. ESMA will also wish to consider the broader market liquidity implications of the parameters which it sets and to test their impact on and liquidity implications for the wider market.

CCPs should not be incentivised to take risks with clearing member collateral and ESMA should seek actively to discourage this as a policy matter. CCPs should not be permitted to make a profit from generating treasury revenue on clearing members' collateral. To the extent that the CCP makes investments, losses should be borne by the CCP and not passed on to its clearing members. CCP revenue should derive mainly from fees and its origin should be transparent to its members.

Any incentive for CCPs to take risks of this nature and to generate revenue on clearing member collateral would likely lead to a conflict of interest and increase counterparty risk. To the extent that CCPs make a profit from reposing clearing member collateral, this should be publicly disclosed. It should be reinvested in the CCP for the benefit of its members so that the CCP is disincentivised from relying on the generation of treasury revenue.

ESMA will no doubt also wish to consider the requirements of the Basel Committee on Banking Supervision in its latest consultation paper “Capitalisation of bank exposures to central counterparties”⁵ and the provisions of the proposed CRD IV reforms regarding collateral posted to CCPs to be “bankruptcy remote” in order for clearing members and their clients to benefit from favourable risk weightings. There should be no incentive for CCPs to act to prevent clearing members and their clients from benefiting from these provisions.

Criteria

In terms of the criteria themselves:

- Some of the criteria set out in paragraph 135 (1) are not sufficiently objective and will be difficult to assess (e.g. low credit risk (is this by reference to credit ratings?) and it may not be easy to determine that there is no “regulatory or legal constraint that impairs liquidation”). It is imperative for the criteria to be clear and certain. ESMA should be concerned to ensure that different CCPs are not able to make different determinations of its criteria, leading to variability in CCP investment standards and thresholds. If ESMA sets minimum criteria (such as (short term) credit rating requirements for eligible central banks, commercial banks, eligible repo counterparties and the highly liquid financial instruments they may invest in, then those lists should be made publicly available on its website and updated frequently and in rapid response to changes in market conditions (e.g. ESMA may decide in response to credit rating changes that certain sovereign instruments should be taken off that list for the time being).
- The lower the tenor of the instrument, the more liquid the investment. A short tenor is integral to high liquidity (as evidenced by the credit market immediately after the Lehman insolvency in September 2008). But ESMA’s overriding policy should cover the type of investment, to which duration should be secondary as a function of the investment profile. Duration should not supersede ESMA’s wider policy and criteria governing investment types. However short-term duration necessitating regular churning of investments would ensure that the CCP reviews its investment policy frequently as the instruments mature. We would suggest average tenor should not be more than 1 year and majority of the portfolio should be in overnight instruments or instruments that can be liquidated overnight to generate liquidity in the event of stress, unless ESMA considers at any time that market conditions would dictate otherwise. Examples would include short-term financial instruments or commercial paper issued by appropriate sovereigns or multilateral development banks or

⁵ <http://www.bis.org/publ/bcbs206.pdf>

multilateral financial institutions such as the European Investment Bank and the European Bank for Reconstruction and Development.

CCPs should have sufficiently liquid financial resources to enable the CCP to fulfill its obligations as a central counterparty during a one-day settlement cycle. We assume the intention of the regulation is that financial resources are available as cash within one day (and not that settlement in a default context must occur in one day). The liquidity of the financial resources available to the CCP is critical as if the CCP does not have adequate liquid resources to manage the default of a large CM then any request for further contributions from CMs will be a further liquidity drain on the system and may exacerbate the crisis by causing cascading defaults in other (otherwise solvent) CMs. That is why ESMA needs to determine, and publish on a regular basis, the type of eligible financial instruments which a CCP may invest in which would be strictly limited to a narrow range of very liquid and very safe instruments. The CCPs should then only be allowed to invest collateral monies received in these specified instruments. It is very important that ESMA make the relevant assessment of the liquidity of eligible financial instruments as each CCP's self-assessment may give rise to an imprudent incentive structure as well as huge variations which would inevitably lead to increased risks.

Q52: Do you think there should be limits on the amount of cash placed on an unsecured basis?

Cash: deposit with eligible central banks and commercial banks

This paper does not address the legal and jurisdictional complexities of placing cash on a secured basis. We would however propose that cash collateral should be deposited, on an unsecured basis, with the appropriate, "eligible" (as defined by ESMA) central bank for the relevant currency as far as possible (ESMA may wish to specify a minimum daily threshold). The rest should be either repo'd out in its entirety overnight for high quality, highly liquid non-cash collateral only with eligible repo counterparties or deposited with eligible commercial banks (provided that the relevant CCP's Risk Committee is satisfied that the risks of the deposit are mitigated to the greatest extent possible). Such non-cash collateral should fall within the parameters, criteria and list set by ESMA and disclosed on its website (e.g. selected sovereign debt, US Treasuries, AAA rated debt instruments, or instruments issued by multilateral development banks or multilateral financial institutions such as the European Investment Bank or the European Bank for Reconstruction and Development) and should be held in safe custody (preferably with the CCP's own CSD/ICSD accounts for immediate access).

Cash: commercial bank deposits & repo arrangements

Cash deposited with a commercial bank is exposed to the risk of that counterparty's default, whereas cash deposited with an eligible central bank ensures that this risk is minimised. Therefore to the extent that eligible central bank deposits are available then the CCPs should be mandated by ESMA to use that facility in respect of all of its cash collateral received. Alternatively ESMA may wish to consider proposing that CCPs seek the consent of their national regulator before putting cash on deposit at a specific eligible commercial bank instead of posting it to the relevant central bank. If CCP cash is allowed to be deposited with eligible commercial banks on an unsecured basis (where

the relevant CCP's Risk Committee is satisfied that the risks of the deposit are mitigated to the greatest extent possible), then ESMA and national regulators may wish to set minimal (e.g. 2% or less) limits on how much is held in this manner and to set parameters for bank eligibility, although consideration must be given to whether 2% may be insufficient considering the fact that there may be a limited universe of commercial banks with whom the CCP can place foreign currency/ currency where it does not have access to central bank deposits (however ESMA should recognise that clients are able to post non-cash collateral to clearing members for conversion into CCP-eligible collateral, which is a different issue from investments or deposits made by CCPs themselves).

An ability for CCPs holding cash collateral to repo it out means that ESMA should consider setting parameters to ensure the robustness of such repo arrangements. Repos should be for short term cash management purposes only and preferably limited to placement with eligible Central Banks. We agree that such repo arrangements should be entered into on a secured basis only; they should also be marked to market daily in order to ensure their robustness, and involve only eligible financial instruments, and where eligible Central banks are not available for these purposes eligible repo counterparties in accordance with ESMA's criteria. CCPs should be required to ensure that their contractual arrangements with eligible repo counterparties include suitable protections for the CCP so that CCPs have adequate contractual recourse against such repo counterparties.

This overnight repo risk also necessitates the specification by ESMA of criteria covering the creditworthiness of appropriate repo counterparties (even in circumstances where simultaneous exchange of cash for securities is assured via DVP (delivery versus payment) mechanisms). We would suggest that the factors specified by ESMA to cover repo counterparty selection should be linked to the relevant CCP's requirements for eligibility as a clearing member (e.g. appropriate capital, rating etc – though ESMA may consider that long-term ratings are not sensitive enough for this purpose), though ESMA may wish to specify a floor for each factor for repo counterparty purposes.

Cash: eligible central bank accounts

If ESMA accepts that CCPs should hold cash collateral then ESMA will no doubt wish to ensure that a CCP has appropriate eligible central bank accounts in which to hold cash on deposit. This does not mean that CCPs need to be licensed as banks. This is not related to the issue of CCP access to central bank liquidity, which is a separate question. It should be a fundamental principle that bank accounts at eligible central banks should be available to CCPs, who can choose whether or not to use them.

Q53: Do you consider that CCP should be allowed to invest in derivatives for hedging purposes? If so, under which conditions and limitations.

CCP use of derivatives should be permitted for the purposes of default management only (where ESMA should recognise that it is a necessity, not an option, in the management of a defaulting clearing member's open positions). CCP treasurers should not be permitted to enter into derivatives in the normal course of business.

Arguably, the only risk in the collateral pool which a CCP might need to hedge would be FX risk (so use of interest rate, credit, equity and commodity derivatives should not be permitted). However there is a strong argument that CCPs should already be taking a sufficient cross currency haircut on eligible currencies posted to them as part of their collateral management and risk management

model, and adjusting these haircuts when market conditions dictate, so as to eliminate the need for them to use FX hedging. CCP rules would usually specify OECD currencies with an appropriate eligible haircut for collateral posting – and if CCP risk models work properly and they hold a buffer amount and mark to market overnight then arguably CCPs should have no need to enter into FX hedges. Instead, they could simply increase their cross currency haircut to deal with FX risk.

Q54: Do you consider that the proposed criteria regarding the currency of financial instruments in which a CCP invests has been rightly identified in the context of defining highly liquid financial instruments with minimal market and credit risk? Should ESMA consider other elements in defining the currency of highly liquid financial instruments with minimal market and credit risk? Please justify your answer.

We would reiterate that CCP investment policy and the parameters set by ESMA should be subject to frequent review and scrutiny. It is not clear to us why para 138(ii) is needed: it is not sufficiently objective and allows CCPs more flexibility than they require. The main criterion is that the currencies should be highly liquid. We would propose that ESMA publishes a list of eligible currencies on its website, which is subject to frequent review and updating.

Q55: Do you consider that the elements outlined above would rightly outline the framework for determining the highly secured arrangements in respect of which financial instruments lodged by clearing members should be deposited? Should ESMA consider other elements? Please justify your answer.

Full protection of the instruments (per paragraph 139) should not just be for the CCP itself, but also for the benefit of its clearing members and their clients and should take into account the requirements of the Basel paper and CRDIV referred to above in relation to bankruptcy remoteness of clearing member and client collateral. The CCP must be certain that it can access the collateral quickly, but it should also protect the beneficial interest of the posting clearing member in that collateral and thus ensure bankruptcy remoteness for Basel III/CRDIV purposes.

As regards the safekeeping and protection of non-cash collateral, there should be no reason why a CCP should need to take it out of the custody account in which it is held and use it other than in the circumstances of a clearing member default.

A distinction should be made between custodian risk and counterparty (issuer/guarantor) risk. In the event of a custodian's insolvency, existing asset segregating and statutory or security/bankruptcy remoteness mechanisms mean that non-cash collateral is more protected and thus will be returned to the CCP. We agree with ESMA's approach in promoting a "risk-based" assessment by CCPs in selecting which highly secured arrangements for financial instruments satisfy the requirements of the Regulation. We understand those key requirements to be full protection on insolvency and timely access by the CCP (as per paragraph 139). As between the EU securities settlement systems and the other four systems listed in paragraphs 140(a)-(d), each system should be assessed by the CCP through its risk committee at the relevant time in light of the different depositary models and the legal and other protections available at that time. Where core CSD services are not ring-fenced from ancillary services that are risk-taking, such as the provision of credit (as has been suggested in relation to the recent EU proposed regulation on Central Securities Depositories), CSDs/ICSDs may

face typical custodian bank risks. We suggest that ESMA avoid a hierarchy among the five options (SSS, CSD, third country CSD, central bank & credit institution), and instead require CCPs to manage their custody risk for any of those arrangements against those key requirements in the Regulation on a security interest basis.

In addition, CCPs should be required to have non-cash collateral posted to them by clearing members delivered only by way of security interest and not by way of title transfer. CCPs must protect themselves from clearing member default by having immediate access to liquidity. They must also protect clearing members' interests from the CCP's own insolvency. The method of taking non-cash collateral from clearing members by way of security is robust enough both to protect the members' beneficial interest in the collateral and to facilitate CCP access to instant liquidity upon clearing member default. It is not necessary to take collateral from clearing members by way of title transfer: this could leave members exposed in CCP insolvency and could itself lead to the insolvency of non-defaulting clearing members, leading to systemic risk. Clearing Members must be protected from the insolvency of CCPs.

Further, CCPs should not be permitted to rehypothecate or re-use clearing member non-cash collateral except perhaps in the limited circumstances of a clearing member default in order to access central bank liquidity. However, even permitting this is arguable as if the CCP went insolvent after this rehypothecation then the securities would be at risk as the assets would form part of the CCP's insolvent estate and so endanger the solvency of its Clearing Members. Therefore no rehypothecation of non-cash collateral should be allowed. We consider that CCPs may also be permitted to rehypothecate clearing member non-cash collateral before clearing member default but only to appropriate eligible EU and third country central banks and solely for the restricted purpose of accessing and generating liquidity in order to facilitate intra-day settlement (and subject to the Basel/CRDIV requirements). For example, the TARGET2 mechanism should enable one account to be set up with one appropriate eligible Eurozone central bank, with EURO funding passing through that account for intra-day settlement purposes; the Swiss central bank for SFR etc. ESMA should limit its selection of central banks for these purposes and review and revise that list (which should be published on its website) frequently and also in rapid response to changes in market conditions.

Q56: Do you consider that the elements outlined above would rightly outline the appropriate framework for determining concentration limits? Should ESMA consider other elements? Please justify your answer.

We agree with the setting by ESMA of concentration limits but would suggest that any diversification policy be subject to regular review, should not be influenced by political sensitivities and should focus mainly on short-term financial instruments or commercial paper issued by appropriate sovereigns or multilateral development banks or multilateral financial institutions such as the European Investment Bank and the European Bank for Reconstruction and Development. The short-term duration of such instruments would ensure that the CCP reviews its investment policy and the concentration of its exposures regularly.

ESMA may also wish to set a cap on the cash collateral which can be repoed out by the CCP for a particular issuer's/guarantor's financial instruments and to restrict the number of issuers/guarantors

whose securities may be used for repo purposes, as set out in ESMA's lists of eligibility criteria displayed on its website.

ESMA's policies on diversification and concentration limits should leave ESMA free to direct that CCP investment should be in cash form only, should market conditions so dictate for any period of time.

Reporting – operations, granularity, standards aspects (Questions 69 to 76).

Q57: What are your views on the definitions of back and stress testing?

As a starting foundation, any new regime should draw on the existing definitions and standards prevalent in current clearing practices, such as those which support contemporary futures and commodity clearing. That said, any new regime must include regular CCP back-testing of its initial margin calculation and periodic disclosure by the CCP to its CMs and regulators of its back-testing methodology, its stress tests and results. Such tests should be performed with current data and historic scenarios, with tests based on historic data limited to a time horizon of 1 year. We further view the relevant local CCP supervisors as having responsibility for periodically reviewing the stress test methodology and, if appropriate, requiring changes. We accept that a CCP must have discretion in determining the methodology it uses to make the calculation to comply with the requirements as this will enable the margin to be tailored to the specific business of a particular CCP. This is important as the exposures of one CCP, which clears product "A" are likely to be different from those of another CCP which clears product "B". Self-certification of compliance with margin calculations is not adequate.

Q58: What are your views on the possible requirements for a CCP's validation process?

CCPs' role as systemically important infrastructures will only increase once EMIR is implemented as more OTC trades are channeled through their systems. Accordingly, CCPs must not be held to lower standards than other systemically important firms (such as banks) in respect to model validation, backtesting etc. The capacity of a CCP to model its exposure is a crucial risk management competency and must be validated. Accordingly, the requirements listed in the DP are reasonable.

Q59: What are your views on the possible back testing requirements?

As argued above, the systemically important nature of CCPs requires that their risk management processes be held to the highest standards. Back testing, like stress testing, should be performed with historic scenarios on current data, but we must highlight that such testing is not the only measure that will build confidence in a CCP robustness.; exposure limits should also be calibrated and tested against conditions of extreme stress. Any involvement in back testing requiring submission of historic data would need to be on a voluntary basis only, and limited to a time horizon of less than 1 year.

Q60: Would it be appropriate to mandate the disclosure of back testing results and analysis to clients if they request to see such information?

We support such disclosure, but clients should have access to only to the back testing results for their own portfolios. Confidentiality of client information is a key concern. A case-in-point is in the US, where as part of Dodd-Frank, the DTC Trade Repository regularly publishes aggregated statistics but not specific identifying data.

The calculation of initial margin must ensure a safety standard that is “robust”, which should mean in this context that an exception should not occur on average more than once a year. This entails a high confidence level for whatever holding period is prudent for that asset class; regular CCP back-testing of its initial margin calculation; and periodic public disclosure by the CCP of its back-testing methodology and results.

Q61: Should the time horizons for back tests specified under 144(e) be more granular? If so, what should the minimum time horizon be? Should this be different for different classes of financial instruments?

No comment.

Q62: What are your views on the possible stress testing requirements?

We support stress tests, however the requirements set out in this discussion paper should represent minimum standards only - CCPs should be free expand to expand on such criteria in response to either market conditions or customer demand. As argued above, such stress tests should be based on historic scenarios on current data, with involvement in back testing requiring submission of historic data and limited to a time horizon of less than 1 year.

Q63: Would it be appropriate to mandate the disclosure of stress testing results and analysis to clients if they request to see such information?

A CCP’s methodology must be transparent, with market disclosure of the stress tests, their results and the methodology underpinning them.

In line with our response to question 60, clients should have access to stress testing results for their own portfolios only. Again, confidentiality of client information must be observed, with only anonymous, aggregated data made public.

Q64: What are your views on the possible requirements for reverse stress tests? And what impact do you think such requirements would have on industry?

It is very important that a CCP conducts reverse stress tests to measure its credit risk rather than rely on the potentially false comfort provided by compliance with the backstop. Reverse stress tests should be required for determining the size of the financial resources package. (In contrast to orthodox stress tests, reverse stress tests start from a hypothesized outcome (such as a CCP breaching regulatory capital requirements or CCP insolvency) and then ask what events could lead to such an outcome.) Regardless, we reiterate that as systemically important infrastructures, CCPs must be held to the same risk management standards as other similarly systemically important firms.

Q65: Should there be any other parties involved in the definition and review of tests? Please justify your answer and explain the extent to which suggested parties should be involved?

We agree that a risk committee – properly empowered by an appropriate and properly defined governance structure - be involved in definition and review of tests. However, the CCP should also consider suggestions from other parties at risk, e.g. other clearing members or clients or other CCPs linked via interoperability or cross-margin agreements.

Q66: Should the testing of default procedures involve a simulation process?

A simulation process could add to the effectiveness of a CCP's default procedures through active testing but it would represent just one component of the CCPs wider risk management framework. The efficacy of that framework would have to be judged in the whole, not just on the results of any required simulation process. In any event, clearing members should participate in the review of the default procedures and default framework. Were a simulation to feature in that framework, a critical step would be the CCP reviewing results of tests with clearing members to ascertain whether corrective action is required, and implementing such actions - if necessary - accordingly.

Q67: Are the frequencies specified above appropriate? If no, please justify your answer.

We agree with the position of the discussion paper on this issue.

Q68: In your view what key information regarding CCP risk management models and assumptions adopted to perform stress tests should be publicly disclosed?

Transparency of CCP risk management practices is essential to reduce systemic risk, not only from the point of view of ensuring the safety of the CCP, but also because a CCP's contingency plans may have a significant bearing on a clearing member's own contingency plans. Accordingly, transparency

is at the core of Principle 23 from the CPSS-IOSCO Consultative report *“Principles for Financial Market Infrastructures”* and is needed to ensure compliance with this principle. Greater transparency of the following key information should be mandated:

- Organisational requirements - Risk, default management, advisory committee documents describing committee roles & responsibilities, scope of decision-making authority, composition and nomination process, allocation of fiduciary responsibilities and frequency of meetings;
- Clearing member requirements and ongoing monitoring – documentation of credit rating methodology and framework and ongoing review process for individual clearing members, as well as, composition and exposure to of CCP member base;
- Initial margin and guaranty fund methodology – standard reporting - regulatory capital calculations;
- Composition/value of initial margin and guaranty fund;
- Default procedures;

III.III Trade Repositories

General comments:

Defining exactly how Trade Repositories should function and work within the existing infrastructure is a complex process with asset class specific components. It requires ongoing discussion between potential Trade Repository operators, market participants and regulators.

In the US, industry representatives and the CFTC are engaging in a regular formal forum with a view to ensuring that a workable and robust solution is designed and delivered to meet the G20 commitments within the Dodd Frank and CFTC regulatory framework.

ISDA and industry representatives would welcome engaging with ESMA in a similar way, preferably early in the process to ensure we can meet regulatory objectives while leveraging existing market infrastructure.

These draft technical standards are a good and welcome step to better understand the ultimate reporting requirements. In certain instances the standards provide insufficient detail and the additional level of detail could impact the responses to the questions in this section. For example, the standards are silent on reporting timeframes and whether such reporting should be done in one or multiple reports. There is also little information on the level and type of continuation data that should be provided for a transaction.

Particularly troubling is the dual reporting currently contemplated by ESMA. The counterparty data in Annex 2, table 1 need to be reported by both parties to the trade. The common data in table 2 only needs to be provided once if the reporting party also reports on behalf of the counterparty. There is no common identifier linking the data in table 1 to the data in table 2.

For the avoidance of doubt, the responses below focus on OTC derivatives, not listed derivatives.

Finally, we recommend the use of the Industry standard language FpML for reporting data to the Trade Repositories, including the use of the generic product FpML template for exotic products and strongly encourage ESMA to coordinate with other regulators to ensure consistent application of data definitions and best practices.

Q69: What is your view on the need to ensure consistency between different transaction reporting mechanism and the best ways to address it, having in mind any specific items to be reported where particular challenges could be anticipated.

We strongly favour consistency between different reporting mechanisms, and would prefer to see the TRs as the basis for reporting under MIFID and EMIR. At the same time we strongly favour consistent regulatory requirements in different jurisdictions.

We do note that the scope for reporting requires additional information not required by MiFID, though MiFID has a significantly wider product scope.

If trades are reported under EMIR, the reporting obligation under MIFID should be considered satisfied irrespective of whether the TR is a registered ARM.

We also strongly recommend one global Trade Repository per asset class and a single trade record within that repository. The approach to have (a) counterparty data that needs to be reported separately by each party to the trade and (b) common data that may be reported by only one party, is different from current reporting flows to TRs in other jurisdictions. We believe that the proposed approach will limit the leveraging of existing infrastructure, significantly increase the reporting complexity and increase considerably the cost of reporting. Requiring both parties to the trade to submit data may cause challenges to the timeliness of data being available to report on, may introduce extraterritoriality constraints and may make it difficult for regulators to have a clear, unambiguous view of the trade record. This must be weighted against the added value these fields will provide. We would welcome the opportunity to understand how this data would be used and to help develop alternative solutions to achieve the same goals. Moreover this information might be difficult to provide in the case of electronic trading.

Q70: Are the possible fields included in the attached table, under Parties to the Contract, sufficient to accurately identify counterparties for the purposes listed above? What other fields or formats could be considered?

The fields in table 1 are generally sufficient to identify counterparties accurately. We have the following comments:

- We fully support the global efforts to establish a Legal Entity Identifier (LEI). The description of the fields rightfully states that certain fields do not need to be reported if a LEI is provided from which the information can be derived.
- We suggest to include the legal structure (AG, PLC, LLP, NV, etc), in addition to the party name.

- For the corporate sector of the counterparty, we recommend using existing industry classifications such as SIC (Standard Industrial Classification). We understand that “corporate sector” might be added in the future to the definition of LEI. The standards should allow to discontinue reporting of separate fields if in the future they become part of industry identifiers such as LEI. In certain instances the description of the fields in table 1 is not unambiguous. Specifically, it is unclear whether the requested information relates to the reporting party or the counterparty to the trade.
- Buyer/Seller designation is not applicable to all derivatives e.g. who is the buyer of an FX forward?
- “Trade with non-EEA Counterparty” and “Directly linked to commercial activity or treasury financing” would be problematic fields particularly for electronically executed trades.

To the extent possible we recommend using ISDA defined terms for the field descriptions. For example Settlement type instead of Delivery type and Option expiration date / expiration date instead of Maturity date.

Comments on the Common data fields:

- Section 2a: Taxonomy: for derivatives, leverage the ISDA asset class recommendations for credit, rates, FX, commodities, and credit.
- Section 2b: price/rate/spread: indicate if commission and/or accrued interest are included
- Log: more detail needs to be provided on the requirements for cancels and amends. The use of free text fields is not efficient in this regard.
- Upfront payment: this information is ordinarily included in the price of the trade and not as a separate attribute.

Q 71: How should beneficiaries be identified for the purpose of reporting to a TR, notably in the case of long chains of beneficiaries?

We fully agree with the statement in the paper that the identification of the beneficiaries in certain structures, such as funds, could prove difficult. We recommend using the beneficiary information provided as part of the LEI for regular reporting.

Additional clarity on the meaning of ‘beneficiaries’ would be welcome.

Q72: What are the main challenges and possible solutions associated to counterparty codes? Do you consider that a better identifier than a client code could be used for the purpose of identifying individuals?

The Trade Associations are pleased to note that ESMA's paper recognizes the importance of developing globally accepted LEI. The industry strongly supports the use of LEI for the identification of counterparties and is awaiting approval from the global regulatory community under the auspices of the FSB. In order to provide transparency and allow for monitoring of systemic risk on a global basis, it is imperative that a standard is designed for global use. A timely approval by the regulatory community, which allows for sufficient implementation time, is one of the key challenges for the implementation of LEI. The registration for and implementation of a LEI itself will follow a phased approach, taking into account the size and sophistication of the parties.

We fully support the Financial Stability Board's (FSB) current LEI process and are actively involved through the Industry Advisory Panel. While we fully recognize and support that the FSB yet has to make recommendations on a global LEI standard and its implementation, we respectfully would like to draw your attention to the efforts of the Trade Associations which have made the following recommendations for the LEI Solution Providers, which was originally released in July 2011:

- **Standards body** – The International Organization for Standardization, i.e., ISO's new standard, ISO 17442, is recommended for use as the new, authoritative legal entity identification standard.
- **Core Issuing and Facilities Manager** – The Depository Trust & Clearing Corporation (DTCC) and the Society for Worldwide Interbank Financial Telecommunications (SWIFT), along with DTCC's wholly-owned subsidiary AVOX Limited, are recommended as key partners to operate the core LEI utility as the central point for data collection, data maintenance, LEI assignment, and quality assurance.
- **Federated Registration** – ANNA, through its network of local national numbering agencies (NNAs), is recommended as a key partner in the solution for registering, validating and maintaining LEIs for issuers, obligors, and other relevant parties in their home markets. The NNAs are envisioned to serve as the "face" of the LEI Utility to those markets.

The Trade Associations believe that the LEI standard, and the issuance capability and management solution recommended by the industry can be implemented and available for use before January 2013, such that the EU and the other G20 countries can meet their G-20 commitments. We hope that this will allow ESMA to recommend the use of the global LEI standard in its final report and submission of draft technical standards to the EU Commission. If, however, the use of another code is required as an interim step, as a precautionary measure we would suggest providing for a 20 digit field identifier in the report formats to be able to accommodate the ISO LEI at a later date.

A timely approval by the regulatory community, which allows for sufficient implementation time, is one of the key challenges for the implementation of LEI.

Q 73: What taxonomy and codes should be used for identifying derivatives products when reporting to TR, particularly as regards commodities or other assets for which ISIN can not be used? In which circumstances should baskets be flagged as such, or should their composition be identified as well and how? Is there any particular aspect to be considered as regards a possible UPI?

Various industry working groups - focused on the different asset classes - developed an initial taxonomy for OTC derivatives in the summer and fall of 2011. The draft taxonomy and rules of

operation, that govern the process for future changes to the taxonomy, were published for public comment in December 2011.

The comments received during the public comment period were reviewed by the working groups and implemented where appropriate. The current version of the OTC Taxonomy is available on the ISDA website together with the rules of operation document that sets forth the process for future reviews of the taxonomy.

Discussions have started with ISO to make the ISDA taxonomy the basis for coverage of OTC derivatives taxonomy in the ISO framework. The ISDA taxonomy has been integrated into the FpML standard which is the industry standard for TR reporting.

For more information, see: <http://www2.isda.org/otc-taxonomies-and-upi/>

With respect to commodities, ISDA and FpML have developed a standard to represent the underlyers applicable to the commodity markets. We expect this standard to be adopted globally.

With regard to baskets, the FpML data representation provides effective support for the representation of baskets across the various relevant asset classes.

We strongly encourage ESMA to follow and use the industry standards established in this area and to allow the leveraging of the existing infrastructure.

Q 74: How complex would be for counterparties to agree on a trade ID to be communicated to the TR for bilaterally executed transactions? If such a procedure is unfeasible, what would the best solution be to generate the trade ID?

We strongly recommend the adoption of the Unique Trade Identifier(UTI) work done by the industry. A paper describing issues around Unique Trade Identifiers and potential solutions is currently being drafted by the ISDA USI working group. We will share this paper with ESMA when finalized. As is the case with other identifiers a consistent global application will yield most benefits for regulators and the industry alike.

Specifically, as far as the UTI namespace use is concerned we strongly encourage a global adoption of the standards in line with the specifications developed by the CFTC for USI (Unique Swap Identifier).

It would be extremely challenging to ensure that the same trade identifier is submitted by both counterparties, should both counterparties need to report in advance of confirmation, as there is currently no mechanism for dissemination of the identifier, pre trade confirmation. The confirmation is intended to be the mechanism for sharing the common trade identifier. If only one party is reporting it is more straightforward to agree on a trade ID to be communicated to the TR.

Q 75: Would information about fees incorporated into pricing of trades be feasible to extract in your view?

The impact of fees on the pricing of trades and how to extract different components from a price are very complex matters. We encourage ESMA to work closely with market participants when tackling these issues and to coordinate with other regulators, such as the US regulators, which are looking to get similar breakdowns of pricing information.

Q 76: What is your view of the granularity level of the information to be requested under these fields and in particular the format as suggested in the attached table?

We recommend that clearing related attributes should be provided by the Clearing Houses as opposed to the counterparties to the original trade execution.

Q 77: Are the elements in the attached table appropriate in number and scope for each of these classes? Would there be any additional class-specific elements that should be considered, particularly as regards credit, equity and commodity derivatives? As regards format, comments are welcome on the possible codes listed in the table.

For some of the specific fields, we refer back to the comments on the common data fields in the response to question 70.

We welcome that Annex 2 envisages the reporting of different detailed data fields by asset class, the intention rightly being to recognize that some fields will apply to certain asset classes, but not to others. Defining the right set of fields for different purposes is a tremendous challenge, and clearly the population and detail of these fields will likely change over time.

Irrespective of asset class variations, the terms of minimum data reporting requirements suggested in Annex 2 should be subject to rigorous cost/benefit analysis. We suggest that it would be of particular value for the Technical Standards to explicitly recommend a distinct approach to data collection as it relates to the economic terms of standardized (cleared) products on the one hand, and complex and bespoke products on the other. ISDA recommends that regulators adopt a 'generic' data representation for the latter, which provide summary electronic representation of the transaction economics while still equipping regulators with the appropriate set of information as it relates to counterparty and valuation information. Such an approach has been successfully adopted at the marketplace level in the DTCC Trade Information Warehouse as part of its Copper Record, striking an effective balance between the need for an appropriate representation of the terms of the contract on one hand, and the economic reality and innovation cycle of those derivatives products on the other hand. The data representation should be tied in to existing data standards such as FpML in order to allow reuse of investment in this area and ongoing benefits in areas such as electronic processing.

The FpML Standards Committee mandated the formation of the FpML reporting working group in early 2011 to support global regulatory requirements by ensuring that FpML can represent all required data elements to be reported to TRs, and by demonstrating how FpML can meet real-time reporting requirements. The FpML process is open: working group participants include representatives from dealers, buy side, utilities, vendors and representatives from the regulatory community; and transparent: all e-mail communications and meeting notes are available on the working group distribution list. The current regulatory reporting requirements are incorporated in

the last call working draft for FpML version 5.3^[1]. We welcome further regulatory input into these discussions, in particular from ESMA to ensure coverage of the fields required by ESMA, while leveraging the reporting work done for other regulatory jurisdictions.

Data on exposures

Q78: Given that daily mark-to-market valuations are required to be calculated by counterparties under [Article 6/8] of EMIR, how complex would it be to report data on exposures and how could this be made possible, particularly in the case of bilateral trades, and in which implementation timeline? Would the same arguments also apply to the reporting of collateral?

With respect to the complexity and practicality of reporting bi-lateral trade exposure, ISDA suggests that ESMA consider the creation of a “Counterparty Exposure Repository” as described below. We make this suggestion in place of requiring mark-to-market data to be reported to GTRs on a transaction or swap level, which would not achieve the regulatory objective of calculating current exposure net of collateral due to the portfolio nature of collateral. We note that ISDA first made this suggestion for a Counterparty Exposure Repository to the ODSG in June 2010, and then again in meetings with and comment letters to certain US regulators in 2011. We still think it is a good idea, and commend the current interest of ESMA and EBA.

ISDA suggests that a Counterparty Exposure Repository could be created to contain the net mark-to-market exposure for each counterparty portfolio and the corresponding collateral. The data must be maintained at a portfolio level in the repository, and firms currently maintain this information for internal risk management purposes, therefore, on a relative basis, this should be straightforward to implement. We do not believe that having access to current exposure information on a trade by trade basis would support supervisors in monitoring and managing systemic risk since the risk is governed by portfolio based Master Agreements that provide for netting and credit support. To have a true picture of the risks a party is running, one needs to look at the exposure as if one of the counterparties had defaulted under the terms reflected in appropriate legal agreements and supported by legal opinions. From a timing standpoint, we would suggest that the development of a Counterparty Exposure Repository follow along from the development of industry work around unique counterparty identifier (LEI) as this will enable the accurate cross-market aggregation of data by counterparty.

We would propose that the Counterparty Exposure Repository would receive and house the list of data elements listed (A) through (F) below. The Counterparty Exposure Repository should operate on a non-profit basis and be subject to similar requirements as global trade repositories. We also suggest that registered global trade repositories make accessible, at a reasonable fee, to the Counterparty Exposure Repository the primary economic terms of any swap and security-based swap transaction reported to the swap data repository. This would provide the information that we believe the systemic risk and prudential regulators need to perform their respective oversight functions.

We would urge ESMA to follow the doctrine of “less is more”, meaning that by careful selection of a smaller number of key data elements the burden imposed on market participants will be smaller and

^[1] www.fpml.org

less costly to manage, and yet the essential data to permit proper market oversight can be obtained. In this regard, firms could submit for each portfolio the following information to the repository:

- A. Current net portfolio mark-to-market value in US\$ of the collateralized portfolio¹, from the perspective of the reporting party;
- B. Current net portfolio mark-to-market value in US\$ of the total portfolio covered by the ISDA agreement², from the perspective of the reporting party;
- C. Currently applicable unsecured Threshold, both for the Reporting Party and for the Reporting Party's Counterparty;
- D. Currently applicable Independent Amount³, both for the Reporting Party and for the Reporting Party's Counterparty;
- E. Currently applicable Minimum Transfer Amount, both for the Reporting Party and for the Reporting Party's Counterparty; and
- F. Currently held collateral balance, excluding collateral in transit, collateral to be itemized (e.g. USD cash, US treasuries, letters of credit, etc. by ISO CCY code and/or CUSIP/ISIN) and, for each of the collateral held by Reporting Party and held by Reporting Party's Counterparty, broken down into (I) USD equivalent of cash collateral held before haircuts are applied, (II) USD equivalent of cash collateral held after haircuts are applied⁴, (III) USD equivalent of securities collateral held before haircuts are applied, (IV) USD equivalent of securities collateral held after haircuts are applied, (V) the USD equivalent total before haircuts are applied which would be the sum of items (I) and (III) above, and (VI) the USD equivalent total after haircuts are applied which would be the sum of (II) and (IV) above.

1 This would only include the mark to market of the portfolio covered by the CSA.

2 Frequently, certain trades are excluded from collateralization under a CSA, but would be included in the exposure in the event of default.

3 Independent Amount can be defined at the level of the portfolio of transactions between two parties, or can be defined uniquely for each individual transaction but for purposes of the proposed repository, the aggregate Independent Amount is important.

4 Although not common in practice, a haircut may also be applied to cash in currencies other than the "Base Currency" to protect against adverse movements in exchange rates.

Q 79: (reporting to TR by third parties). Do you agree with the proposed approach? What are in your view the main challenges in third party reporting and the best way to address them.

We agree that third parties should be allowed to report on behalf of counterparties and share the expectation with ESMA that such parties, if used, will be carefully selected to ensure accurate and timely information to the TRs.

We understand that the reporting parties stay responsible for the reporting and as such will intervene with the third party if the reporting obligations are not met. In principle we agree that ESMA should have the powers to take action if the failure of reporting obligations does not allow the TRs to fulfill their obligations. However, given the short consultation deadline, we did not have a chance to discuss this in detail and would like to get back to ESMA with more details at a later point in time.

Application for Registration (Article 52)

**Q80: Do you envisage any issues in providing the information/documentation as outlined above?
In particular:**

a) what would the appropriate timeline over which ESMA should be requesting business plans (e.g. 1, 3, 5 years?)

A80a

We are supportive of the documentation outlined above. Additionally, we believe that ESMA should require applicants to provide balance sheet and statement of income and expenses along with business plans no greater than on an annual basis.

b) what would the appropriate and prudent length of time for which a TR must have sufficient financial resources enabling it to cover its operating costs (e.g. 6 months / 1 year)?

We believe that it may be appropriate to define the amount of equity capital to be held in liquid assets for these purposes by the amount of key operating expenses necessary to the TR to continue to provide critical services and operations. This limitation to “critical services and operations” reflects that, in a circumstance where a wind-down or reorganization is the projected next step, certain expenses, e.g., start-up expenses and capitalized expenses, strategic initiatives, new product development and marketing expenses, would not be incurred, and that other services ancillary to the TR core responsibilities likely would be curtailed quickly. This operational definition of the required amount of equity capital accords is in line with CPSS – IOSCO report on Principles for financial market infrastructures which argues that liquid net assets should be available for going concern expenses and for wind-down or reorganization.

As regards the amount of equity capital required (whether it should be equivalent to 6, 9 or 12 months of expenses), we support the maintenance in reserve of six months’ equity capital which, as suggested above, should be for the amount of ongoing operating expenses for that length of time. It is our view that six months is more than reasonable because any resolution of a financial market infrastructure would have to happen quickly; that is, the period during which the TR might operate subject to a wind-down or reorganization is likely to be less than six months. During these six months, if the infrastructure is winding down, its expenses should be reducing, so that the six month reserve should be more than sufficient. We believe that the ESMA should clarify that no additional amount may be required for a TR to be in compliance, although, of course, it may elect to hold more as it may deem necessary, prudent and appropriate.

Format of application

Q81: What is your view on these concerns and the ways proposed to address them? Would there be any other concerns to be addressed under the application for registration and tools that could be used?

A81

We are supportive of the format for the application process as identified above. In addition, we strongly believe that another important consideration should be the confidentiality of the documents submitted to ESMA; in particular confidentiality with respect to any documentation that discloses the applicant's intellectual property and business sensitive information, such as technical specifications and security policies. Also, given the size of the documents, it would be beneficial if ESMA could provide for a secured website where an applicant can submit the data to ESMA and receive confirmation of receipt.

Transparency and data availability (Article 67)

Q82: What level of aggregation should be considered for data being disclosed to the public?

As a general approach, we agree with statement 208 that information disclosed to the public by a Trade Repository should be on an aggregated level. Furthermore we also believe that such data would, by definition, be anonymised. This establishes the fundamental principle of Public reporting that it should not be possible, from the information provided, for any party to calculate or imply any positional or trade relate information pertaining to a particular market participant, either directly or indirectly.

Our recommendation is that ESMA institutes a procedure where any new public report proposed to be produced by a Trade Repository is subject to a consultation process prior to approval and implementation. The nature of the OTC markets – particularly in illiquid and/or customised market segments – means that certain levels of aggregation may, when coupled with the market knowledge of some participants, convey more information than was intended by the initial proposal. A consultation process would highlight such unintended consequences and allow proposed reports to be suitably amended prior to being mandated for production.

There are a range of dimensions along which this issue of unintended transparency can arise, inter alia:

- Geographic location of counterparties;
- Market sector of counterparties;
- Location of delivery;
- Contract underlying;

By way of example, for some commodity markets there are so few participants that even the most basic further granularity (for example in terms of delivery location or even the market sector of counterparties) runs the risk of unwittingly enabling others to identify the positions of individual participants. Data should be aggregated at an appropriate level to produce market wide statistics only.

Given the different nature of the markets by asset class (and often by sub asset class), the required reporting by a Trade Repository will differ materially by asset class. Trying to define ahead of time, for each market, a list of all the possible dimensions of disclosure that may cause unintended issues is impossible given the continually evolving nature of OTC markets. By introducing a consultation process as part of the development of new public reports, ESMA allows for the market to continue to develop and evolve whilst ensuring unintended disclosures are avoided.

Over and above this, there should be an annual review of all public reports produced by Trade Repositories to ensure that market conditions have not changed in such a way as to render such reports either a) no longer relevant or b) over transparent.

Despite the very limited scope of Q82 (level of aggregation for publicly disclosed data) and Q83 (frequency of such disclosure), comments made by ESMA in point 202 to 208 appear to be very broad without no apparent links to Q82 and Q83. These comments give rise to a more general issue concerning the degree of aggregation applicable to data being published by Trade Repositories when it comes to Regulatory disclosures.

In particular, it is not clear that an implicit assumption that all *relevant* competent authorities should have access to transaction level information by default is appropriate. Given the limited mandate given by Article 67 of EMIR (asking ESMA, after consulting the members of the ESCB, to “*develop draft regulatory technical standards specifying the frequency and the details of the information referred to in paragraphs 1 and 2 as well as operational standards required in order to aggregate and compare data across repositories and for the entities referred to in paragraph 2 to have access to information as necessary*”), we are of the view that ESMA is exceeding its delegated powers.

Given the confidential and sensitive nature of the information contained within TRs’, data should only be provided to Regulators in direct support of their regulatory mission. Therefore, for example, the level of granularity of data that is appropriate to provide to Central Banks and other Prudential Regulators might differ to that which it is appropriate for a Trade Repository to provide to, say, Markets Regulators.

ESMA - without the relevant delegated power – appears of the view that authorities, including ESMA, having a supervisory mandate, should have full and direct access to all trade-level data, although EMIR does not contain any such statement. Title VI (“Registration and Surveillance of trade repositories”) and Title VII (“Requirements for trade repositories”) of EMIR create a supervision mechanisms built exclusively around considerations regarding robustness, appropriate management, confidentiality, operational reliability and there is no provision, including in Article 67 on “Transparency and data availability”, imposing that this surveillance implies full and direct access to all trade-level data,

Therefore, as part of the Technical Standards, ESMA should define the categories of regulators that have rights to access a Trade Repository and, furthermore, for each category, the level of granularity that is suitable. We believe that the work carried out to date by the OTC Derivatives Regulators’ Forum in this area sets out a reasonable approach. We note

1. That ESMA itself should be included in this categorisation, noting that in comment 206a, ESMA is considered as being legitimate to have access to all data at trade-level. Although Article 67.2 (a) of EMIR includes ESMA in the list of the recipient entities, it is only with regard to “the necessary information to enable [it] to fulfil [its] respective responsibilities and mandates” and does not mention that it is “for all data” ;

2. The same applies regarding point 206b on ACER ; and
3. That it is not obvious that regulators of venues of execution should have a defined right of access – rather that they should obtain their data directly from the venue of execution.

Finally, the Technical Standards should specify the terms under which data is provided to competent authorities and other regulators. Specifically, data should be provided to regulators in response to requests that are specific, targeted, bounded and relevant. In comment 206c, ESMA goes well beyond EMIR adding “that notwithstanding the objective of supervision (prudential or conduct of business) the relevant competent authorities should have access to the full list of details reported by or on behalf of the supervised entities”.

Q83: What should the frequency of public disclosure be (weekly? monthly?); and should it vary depending on the class of derivatives or liquidity impact concerns; if yes, how?

There are a range of reports in the markets that are made on a weekly basis and, as a general rule, aggregate anonymised public data has, in those areas where a precedent has been set, worked reasonably on such a basis.

That said, not all reports and metrics change materially in a week across the market as a whole. For example, aggregate market exposures tend to change less frequently. Our recommendation therefore is that, as part of the proposed ESMA consultation process for each new report (see response to Q82), opinions are sought as to a suitable frequency of publication of the report. Furthermore, as part of the annual review proposed in our response to Q82, the frequency of publication should be validated. For example, we believe that where no reports currently exist, frequency should be a factor of liquidity, with less liquid contracts tending to be disclosed less frequently (perhaps monthly) and highly liquid contracts being disclosed more often (perhaps weekly). We are concerned that, for less liquid contracts where there are often wide spreads and large degrees of volatility, weekly publication of data would give observers a misleading impression of the market and could add to this volatility.

It is important that public reports are published on a predictable and reliable basis. ESMA should ensure that all Trade Repositories that contain data pertaining to an asset class covered by a particular report should publish their reports reliably and predictably according to predefined timescales. It is vitally important that a report is « made public » to the entire public at the same time, and that nobody obtains advance information, either through the mechanism selected for publication, nor by a capacity for more sophisticated connectivity giving an inherent advantage.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

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Since 1985, **ISDA** has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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