**6 November, 2014**

# ISDA/FIA Europe submission on the ESMA Clearing Obligation for FX NDFs CP

## Introduction

The International Swaps and Derivatives Association ("**ISDA**") and FIA Europe welcome this opportunity to respond to the consultation paper on the draft regulatory technical standards ("**RTS**") establishing a clearing obligation for foreign-exchange non-deliverable forward ("**FX NDF**") OTC derivatives classes.

We strongly support the overarching goal of reducing systemic risk in the OTC derivatives market by introducing an obligation to clear certain classes of OTC derivatives at central counterparties ("**CCPs**") that have been authorised or recognised in accordance with the requirements of Regulation (EU) No 648/2012 ("**EMIR**"). However, we have a number of significant concerns about the proposed RTS for FX NDF contracts.

This response is intended to continue the constructive ongoing dialogue between ESMA and derivatives market participants and to focus on the practical concerns and risks surrounding the implementation of the clearing obligation. We hope that our comments in this response and follow-up discussions will assist ESMA with the preparation of the form of RTS which will be submitted to the European Commission (the "**Commission**"). In particular, we would like to highlight the following critical issues:

## A. Suitability of the FX NDF asset class for clearing

1. There are distinguishing characteristics of the FX NDF market which make this asset class unsuitable for mandatory clearing at this time. In particular:

    a) the FX NDF market is significantly smaller than other OTC derivative asset classes, such as interest-rate OTC derivatives ("**IRS**") and credit OTC derivatives ("**CDS**"). While mandating FX NDF clearing would transfer a certain amount of bilateral exposure which exists between market participants to CCPs, the amount of risk in the FX NDF market is significantly less than for IRS and CDS; and

    b) as FX NDF clearing is relatively new in comparison with IRS and CDS clearing, FX NDF clearing services need time to mature, for their practices to be properly bedded down and "battle-tested" and for fundamental unresolved

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issues to be properly addressed. Additional risk may be unnecessarily introduced to this global currency market by the imposition of a clearing

c) mandate at this point in time and, as a result, undermine the benefits of central clearing.

2. If, contrary to the above, ESMA determines that a clearing obligation should be imposed for FX NDFs, we would urge ESMA to ensure that the following characteristics of the FX NDF market are adequately reflected in the clearing obligation: (i) the standardisation of contracts; (ii) the relatively small size of this market, particularly as compared to other OTC derivative asset classes; (iii) the limited development of pre-existing voluntary clearing in this market, particularly client-clearing; (iv) the relative unfamiliarity of CCPs with managing disruption events affecting the currencies of emerging market jurisdictions and thus the valuation and settlement of these contracts; (v) the concentration of trading in short-dated tenors; and (vi) the importance of emerging market financial institutions as liquidity providers (local price-making banks that may not technically be subject to EMIR, and that may be reluctant to make markets in FX NDFs that have to be cleared).

## B. Identification of contracts subject to the clearing obligation

3. To avoid undermining the level of standardisation achieved to date for FX NDFs, any clearing obligation for these contracts must be limited to standardised contracts which incorporate industry standardised currency templates, in the form published by the Emerging Markets Trade Association ("**EMTA**") (without modification).

4. Any clearing obligation for FX NDFs should be limited to contracts with a tenor of one year or less. As open interest in FX NDF contracts is concentrated in shorter-dated tenors, there is insufficient liquidity beyond the one year tenor to support clearing.

5. To prevent decisions of CCPs to cease clearing a particular contract from dictating whether that contract is tradable, the application of the clearing obligation to a particular contract should be conditional not only on the contract being of a type that would have been accepted for clearing by a CCP at the time of its authorisation, but also on the contract being of a type which will be accepted for clearing by an authorised or recognised CCP as at the later of (i) the date of trading and (ii) the date on which the contract is required to be cleared under EMIR.

## C. Counterparty categorisation

6. Only counterparties which are clearing members for one of the FX NDF classes should be included in Category 1 for the purposes of the FX NDF clearing obligation. Given the modest overlap between clearing members in FX NDFs, on the one hand, and IRS and CDS on the other, a significant number of counterparties who would be treated as Category 1 counterparties under a cumulative classification approach would need to establish clearing arrangements within a six month timeframe. Given the infancy of clearing services for FX NDFs and the fact that currently there is only one authorised or recognised CCP clearing FX NDFs, it will be operationally challenging for this number of counterparties to establish the necessary clearing arrangements in this timeframe.

7. The EUR 8 billion threshold proposed to distinguish between Category 2 and Category 3 counterparties must be adjusted to ensure that market participants have sufficient clarity as to how the threshold should be calculated and sufficient time, after the RTS on FX NDF has come into force, to assess their own categorisation and establish the categorisation of their counterparties and clients.

## D. Phase-in periods

8. Any determination to introduce a clearing obligation for FX NDFs at this time requires a sufficiently extended phase-in period to allow for market participants to address fundamental outstanding issues arising largely from the infancy of FX NDF clearing. We believe that appropriate phase-in periods for FX NDFs would be twelve months for Category 1 counterparties, twenty-four months for Category 2 counterparties, thirty months for Category 3 counterparties and thirty-six months for Category 4 counterparties.

## E. Frontloading

9. Given the concentration of open interest in FX NDFs in very short-dated tenors and the relatively limited size of this market, there is limited value in applying a frontloading requirement to FX NDF contracts (for any counterparty type). Any clearing obligation for these contracts should only apply to FX NDF contracts entered into or novated on or after the date the clearing obligation takes effect.

10. If a frontloading requirement is nevertheless imposed on FX NDF contracts, the minimum remaining maturity, as referred to in Article 4(1)(b) of the draft RTS on FX NDF, for contracts entered into or novated on or after the RTS on FX NDF is published in the Official Journal and before the end of the applicable phase-in period should be set at six months instead of the proposed three months. There is no reason to suggest that FX NDFs with a residual maturity between three and six months will contribute to systemic risk any more than IRS and/or CDS with the same residual maturity.

**Question 1: Do you have any comment on the clearing obligation procedure described in Section 1?**

## A. Structure of the clearing obligation RTS

We believe ESMA should adopt a single RTS which is amended, through the addition of multiple annexes, as new classes of OTC derivatives are declared subject to the clearing obligation. Please refer to our answers to question 1 in our responses to:

- Consultation paper no. 1 on interest-rate OTC derivatives ("**ISDA/FIA Europe IRS Response**") www2.isda.org/attachment/Njg0NQ==/ISDA_FIA_Europe_CO_CP%20Response1.pdf,
- Consultation paper no. 2 on credit OTC derivatives ("**ISDA/FIA Europe CDS Response**") www2.isda.org/attachment/NzAxMg==/ISDA_CDS_Response_FINAL_SEP2014_3.pdf).

This would allow the categorisation of counterparties to be assessed on an asset class basis, meaning a counterparty could be a Category 1 counterparty for one asset class but a Category 2, 3 or 4 counterparty for another.

## B. Counterparty categorisation on an asset-class basis

We recommend that:

### a) Counterparty categorisation should be undertaken on an asset-class basis

ESMA left open this possibility in its final report on the clearing obligation for IRS ("**IRS Final Report**"), noting that the RTS on IRS was not directly impacted by the choice between a cumulative or non-cumulative (i.e. asset-class) approach to counterparty classification. This choice will, however, have a direct impact on the clearing of FX NDF contracts and we therefore urge ESMA to recognise the difficulties that clearing members of the IRS and CDS asset classes will have if they are to be treated as Category 1 counterparties for the FX NDF asset class as well.

In its consultation paper on FX NDFs ("**FX NDF CP**"), ESMA focuses on the fact that all the clearing members of LCH.Clearnet Ltd (currently the only authorised CCP offering an FX NDF clearing service) are also clearing members for at least one of the IRS or CDS classes that are proposed to be subject to the clearing obligation. This is, however, a small subset of the total number of clearing members clearing IRS and/or CDS contracts. Whereas for IRS, there are a total of 110 clearing members at entity level, clearing through five EU CCPs (paragraph 157 of ESMA consultation paper no. 1 on IRS ("**IRS CP**")), for FX NDFs there are only 20 clearing members at an entity level clearing through a single CCP, LCH.Clearnet Ltd, of which only two clearing members currently support client clearing activity (paragraph 100 of the FX NDF CP).

This means that a substantial number of counterparties will be treated as Category 1 counterparties for the purposes of the FX NDF clearing obligation, and therefore subject

to the shortest phase-in period, even though they do not currently have the capacity to clear these contracts.

Whilst we appreciate ESMA's objective to include within Category 1 the most sophisticated and experienced counterparties, we strongly believe that ESMA has underestimated the technological and operational issues that will need to be overcome by these counterparties before they can start clearing FX NDF contracts. Given that so few FX NDF clearing members currently offer client clearing services, most counterparties will need to become a clearing member at a new CCP, if not already a member of LCH.Clearnet Ltd, or put in place additional clearing arrangements at LCH.Clearnet Ltd to ensure that it can clear any in-scope FX NDF contracts.

We would reiterate our view that it cannot be assumed that the process of Category 1 counterparties becoming members of CCPs in a six-month phase-in period will be a seamless one, particularly given the need for legal opinions, technical convergence and satisfaction of all the other criteria required for admission to a CCP. The process of joining a new CCP or CCP service takes time to appropriately build and test new operational procedures. Potential delays in this on-boarding period should not be overlooked, particularly in circumstances where numerous parties may be seeking to on-board at the same time. Moreover, even if a counterparty is already a member of a relevant CCP, it may take a considerable length of time before it is able to extend its terms of membership to cover the clearing of additional classes at that CCP.

The difficulties of this on-boarding process are likely to be more pronounced for the FX NDF asset class as currently there is only one authorised CCP offering clearing services and, in comparison with the more established clearing services for IRS and CDS, this clearing service is relatively new and small in size. Given the modest overlap between clearing members in FX NDFs, on the one hand, and IRS and/or CDS on the other, a significant number of counterparties, who would be treated as Category 1 counterparties under the cumulative classification approach, will need to establish arrangements with LCH.Clearnet Ltd. Whilst we appreciate that the scalability of clearing services forms part of the CCP authorisation procedure, there are no guarantees that CCPs will be able to scale-up to the extent necessary in a 6 month timeframe.

**b) ESMA should develop a register of clearing members to assist market participants with their determination of which clients and counterparties are Category 1 counterparties for a particular asset class**

We would also encourage ESMA to provide clarity to the market by establishing a register of clearing members (which includes their LEIs) which would assist market participants when establishing whether a particular counterparty is a Category 1 counterparty for a given asset class. Alternatively, CCPs should be encouraged to publish lists of their clearing members (including their LEIs) as of the date each RTS comes into force.

## C. Middleware to support straight-through processing

The RTS should further take into account the critical requirement that relevant middleware is available to support straight-through processing ("**STP**") technology for clearing of a particular contract.

Failure to take middleware STP operability into account in identifying which contracts should be subject to the clearing obligation will mean that whilst it may be technically possible to submit the particular contract for clearing using a manual method (for example, a manual spreadsheet upload), the use of such manual processes creates exactly the type of operational risk which ESMA and market participants are aiming to reduce. The lack of suitable middleware technology proved to be a problem for market participants in the initial months of the CFTC clearing mandate in the US.

To prevent similar issues arising in the EU we recommend that an appropriate phase-in period is provided during which contracts subject to the clearing obligation do not have to be cleared if the necessary middleware is not available to support the STP of these contracts. We understand that this should only be an issue for a small number of bespoke contracts and that a period of three to six months should be sufficient time for the market to develop the necessary middleware technology.

**Question 2: Do you consider that the proposed structure for the FX NDF classes enables counterparties to identify which contracts are subject to the clearing obligation?**

ISDA and FIA Europe agree with and support the response from GFXD to this question 2 regarding the need to expand the list of characteristics used to define the FX NDF classes in Annex 1 of the draft RTS on FX NDF to include the adoption of an applicable EMTA published currency template. ISDA and FIA Europe also agree with and support the response from GFXD to question 5, sub-section "*Developing a framework for how contracts that have become less liquid would move out of the clearing mandate*". (See http://www.gfma.org/fx/).

In addition, we have significant concerns that the proposed structure could create situations where certain derivatives are rendered untradeable on both a cleared and uncleared basis, solely on the decision of authorised CCPs to cease clearing the products.

**A. Mitigation of trading ban situations**

We fully appreciate the effort by ESMA to increase derivatives market participants' ability to determine which contracts must be cleared and to prevent a situation where the clearing obligation would lead to a de facto trading ban on contracts that meet the five characteristics of the RTS on FX NDF but that CCPs do not clear because of non-standard features. We note that in paragraphs 26 through 28 of the IRS Final Report ESMA feels it has addressed this situation by amending the relevant recitals to "*contracts that the authorised CCPs have accepted for clearing at the time of authorisation*". ESMA reiterated that the bottom up approach overall means that there should not be any trading ban that could result from the structure.

However, this analysis does not contemplate that a CCP may choose to stop clearing certain contracts following its authorisation, a process that does not in itself remove the clearing obligation even if no other CCP clears those contracts. Firms would then be left with a situation where a contract contains the specified characteristics and was clearable at the time of authorisation but where no authorised or recognised CCP is willing to clear that contract. Article 5(6) of EMIR does not cover this situation – it only works to remove the clearing obligation where no CCPs are authorised or recognised to clear a particular class of contracts.

It does not apply where a CCP continues to be authorised to clear the class of contracts but, in practice, ceases to do so.

We note that this issue is complicated further if a CCP removes a clearing service during frontloading Period B, and it is unclear how the firm and the client would be able to remediate this situation while remaining in compliance with the RTS, other than by terminating the contract. We would be surprised if this was ESMA's intention – as again it would amount to a retrospective ban on the trading of a particular contract (again contrary to ESMA's intention, as set out in paragraph 26 of the IRS Final Report).

**In order to prevent decisions of CCPs to cease clearing a particular contract from dictating whether that contract is tradable, the application of the clearing obligation to a particular contract should be conditional not only on the contract being of a type that would have been accepted for clearing by a CCP at the time of its authorisation, but also on the contract being of a type which will be accepted for clearing by an authorised or recognised CCP as at the later of (i) the date of trading and (ii) the date on which the contract is required to be cleared under EMIR. We again reiterate that this RTS modification would not result in a change in the outcome of what the policy has suggested should be subject to the clearing obligation, rather it provides a necessary clarification to the legal certainty of that policy.**

**B. Liquidation of contracts at a CCP that has lost its authorisation**

The proposed structure of the clearing obligation currently gives no ability for firms to liquidate the risk that sits at a CCP that had been clearing mandatorily clearable contracts but then subsequently had its authorisation revoked and where the clearing obligation still remains because another CCP clears those contracts. In such cases, any requirement for firms to move outstanding contracts to another CCP may be impractical and in some cases may negatively impact financial stability.

In our view, ESMA should ensure that:

a) to the extent a clearing obligation is still in force, a firm may either liquidate its positions on the de-authorised or de-recognised CCP or, where the CCP (notwithstanding the de-authorisation or de-recognition) continues to provide clearing services in respect of the relevant contracts, retain its outstanding positions at the relevant CCP.

b) if a CCP is de-authorised and therefore ceases to provide clearing services, members should be provided with sufficient time, in order to mitigate the impact on the markets, to transfer and/or liquidate their positions and should not be required to do so immediately. In particular, ESMA should consult with clearing members and take into account (i) the relative size and importance of the de-authorised or de-recognised CCP in the market, (ii) the availability of capacity at alternative CCPs and (iii) the proportion of clearing members who already have arrangements in place with such alternative CCPs, before setting a time-line for transfer/liquidation.

In our view, this approach would be consistent with EU policy objectives as set out in other EU legislation - in particular the Capital Requirements Regulation 575/2013, which provides

for a period of time in which clearing members may continue to calculate their exposure with beneficial qualifying-CCP capital treatment even following revocation of CCP status.

**Question 3: In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to NDF derivatives?**

ISDA and FIA Europe agree with and support the response from GFXD to this question 3 (see http://www.gfma.org/fx/).

**Question 4: For the currency pairs proposed for the clearing obligation on the NDF class, do you consider there are risks to include longer maturities, up to 2 year tenor?**

ISDA and FIA Europe agree with and support the response from GFXD to this question 4 (see http://www.gfma.org/fx/).

**Question 5: Do you have any comment on the analysis presented in Section 4.1?**

ISDA and FIA Europe agree with and support the response from GFXD to this question 5 (see http://www.gfma.org/fx/).

**Question 6: Do you agree with the proposal to keep the same definition of the categories of counterparties for the NDF classes than for the credit and the interest rate asset classes? Please explain why and possible alternatives.**

As indicated in our response to question 1, we believe that Category 1 should be assessed on an asset class basis. This would mean that only those entities which are clearing members for the FX NDF classes should be included in Category 1 for the purposes of the FX NDF clearing obligation.

In terms of the proposed definitions of Categories 2 to 4, we agree that conceptually the definitions should be consistent across the asset classes. This would create more certainty and would reduce the operational burden and client outreach exercise in assessing a counterparty's classification. However, we have significant concerns about the Category 2 and Category 3 definitions proposed by ESMA.

**A. Counterparty categorisation on an asset-class basis**

Please see our response to question 1 above. In summary, we recommend that:

a) Category 1 categorisation should be undertaken on an asset-class basis; and

b) ESMA should develop a register of clearing members to assist market participants with their determination of which clients and counterparties are Category 1 counterparties for a particular asset class.

**B. The threshold test for Category 2 / 3**

ESMA proposes to use the same Category 2 / 3 threshold, including the same assessment dates, for all asset classes. This means that the assessment made for the purposes of the IRS

asset class will be determinative of counterparties' categorisation for all subsequent asset classes, including the FX NDF asset class.

Whilst we have significant concerns about the merits, and the practical application, of the proposed Category 2 / 3 threshold for all asset classes, if the threshold-based approach is adopted for the IRS and CDS classes then the same approach should be adopted for the FX NDF asset class. In particular, the assessment dates must be the same for all asset classes to ensure that market participants only have to conduct the categorisation process once.

During follow-up communications with ESMA in the context of the final draft RTS on IRS, ISDA has expressed its concerns with the proposed threshold-based approach for Category 2 and Category 3 counterparties and its interaction with the frontloading requirement. These concerns, and ISDA's recommendations on a way forward, are shared and supported by FIA Europe. Whilst we do not wish to set these concerns out here in the same level of detail, we would be happy to discuss them with ESMA in more detail if that would be helpful for ESMA's development of the final draft RTS on FX NDF.

We must stress that the counterparty categorisation proposed for FX NDFs will only work effectively if our concerns regarding the threshold are adequately dealt with as part of the process of finalising the RTS on IRS.

Our concerns relate principally to the following negative effects of the threshold-based approach:

- applying de facto retroactive legal obligations, by requiring entities to gather group data and assess their status by reference to criteria which are not yet settled or contained in any adopted legislation; and

- as a result, reintroducing the legal uncertainty which it purports to address.

To address these issues, ISDA has made the following recommendations in the context of the IRS asset class, which FIA Europe supports, and we reiterate them here again:

**a) Timing**

ISDA submits that the Category 2 / 3 assessment period for financial counterparties ("**FCs**") should only be expected to apply from the date that the RTS enters into force and that the three month assessment period should run from that date at the earliest.

ISDA further recommends an additional period at the end of any such assessment be given to allow FCs time to use industry tools available at that time to communicate their status to relevant counterparties. This would have the effect that Period B for FCs not in Category 1 would commence after the expiry of (1) the three month assessment period, which should run from the date that the RTS enters into force, and (2) such additional period of time following the end of the assessment period.

This change in timeframe has the practical benefits of allowing FCs, with the benefit of legal certainty, sufficient time to address the practical challenges of applying the assessment and also for a systems-based tool to be developed in good time, based on

the final RTS, so as to be available for use by and well publicised to market participants.

Even if ESMA is not minded to adopt the approach above on the basis of legal certainty, we are very concerned that it would not be possible for the market to achieve meaningful compliance in a timescale much shorter than that which we have advocated, and certainly not immediately upon publication of the RTS.

**b) Clarifications regarding the calculation of the threshold**

For the purposes of the Category 2 / 3 threshold, detailed clarification is needed as to the scope of a counterparty's 'group', in particular by reference to comparable provisions in the BCBS-IOSCO Working Group on Margin Requirements (**WGMR**) context.

Confirmation is needed that intragroup transactions will not be double-counted in the calculation of the threshold.

**c) Responsibilities of counterparties**

The obligation will fall upon market participants to establish their own position within the four categories. However, other market participants dealing with Category 2 / 3 counterparties will need to know such counterparties' categorisation in order to establish whether the relationship may then attract frontloading and also to understand respective phase-in periods.

ESMA should provide very clear guidance to market participants as to the responsibilities of each counterparty in this context, in ESMA Q&A Guidance published as a matter of urgency. We believe this guidance should address issues similar to those contemplated in ESMA OTC Q&A Question 4[1], in particular:

- **ability of an entity to rely on its counterparty's representation or other confirmation of categorisation for these purposes**: a party will not be able to assess its counterparty's positions on a group basis.

- **presumption in the absence of counterparty confirmation**: it cannot be taken as given that all counterparties (particularly those that are third country entities) will be able to run the threshold calculation in the proposed timeframe so there may be a number of counterparties who are unable to provide a representation or other confirmation promptly. From a perspective of legal certainty, Category 1 / 2 entities need clear guidance as to how they should classify non-representing Category 2 / 3 counterparties (in the same way that ESMA has previously given guidance to FCs in relation to non-representing non-financial counterparties). Should the guidance amount to a presumption of Category 2 classification for non-representing firms, the potentially adverse impact of such a presumption on non-representing firms (in effect resulting in frontloading for non-representing Category 3 firms in exactly the way ESMA is trying to avoid with the threshold)

[1] http://www.esma.europa.eu/system/files/2014-815.pdf

can only serve to re-emphasise the need to ensure legal certainty and operational feasibility for those firms in relation to the threshold test.

**C. Application of the frontloading requirement to intra-group transactions**

Confirmation is needed that intragroup transactions (including those which involve a third country counterparty) will not be subject to frontloading, or, in any event, clarification as to the interaction of frontloading provisions with the intragroup transaction exemption.

**D. Treatment of pension scheme contracts**

Please refer to our answers to question 7 in the ISDA/FIA Europe IRS Response and question 5 in the ISDA/FIA Europe CDS Response.

**E. Categorisation of third country entities**

Please refer to our answers to question 7 in the ISDA/FIA Europe IRS Response and question 5 in the ISDA/FIA Europe CDS Response.

**Question 7: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.**

ISDA and FIA Europe agree with and support the response from GFXD to this question 7 (see http://www.gfma.org/fx/).

**Question 8: Do you have comments on the minimum remaining maturities for NDFs?**

ISDA and FIA Europe agree with and support the response from GFXD to this question 8 (see http://www.gfma.org/fx/).

**Question 9: Please indicate your comments on the draft RTS other than those already made in the previous questions.**

Please refer to our answers to question 12 in the ISDA/FIA Europe IRS Response and question 8 ISDA/FIA Europe CDS Response.

**Question 10: Please indicate your comments on the Impact Assessment.**

We have no comments on the impact assessment.

**About ISDA**

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.]

**About FIA Europe**

FIA Europe, formerly the Futures and Options Association (FOA), represents some 175 firms involved in the exchange-traded and centrally-cleared derivatives markets – including banks, brokers, commodity firms, exchanges, CCPS, vendors, law firms and consultants. FIA Europe works with its members to maintain constructive dialogue with government and regulatory authorities and deliver high standards of industry practice. FIA Europe, last year, formed an affiliation with FIA under a new structure – FIA Global. Under this arrangement, FIA, FIA Europe and FIA Asia have strengthened their influence on cross-border issues, substantially increasing the coordination and information flow between regions and providing a powerful global voice to express the views of their members. The organisations preserve their ability to deal with legislative, regulatory and market issues in their respective time-zones and continue to operate with their own leadership and staff, separate boards of directors and distinct memberships.