ISDA/AFME Comments on Hungarian Presidency text on EMIR dated 29 April (EMIR)

- ***Supplementary comments*** *(to those of 12 May 2011)*

- *19 May 2011*

ISDA and AFME is pleased to provide further comments herein to those it provided (on 12 May 2011) on the Hungarian Presidency text of 29 April on EMIR.

1. **Access to a CCP - Now Article 8 (was Article 5)**

- In paragraph 3b, the term 'smooth and orderly functioning of markets' needs further definition. We are concerned that an infrastructure – seeking to block access for competitive reasons - could use this premise, and we believe they should be required to prove its validity. We also believe that sanctions for non-compliance should apply.

2. **Access to a venue of execution (Article 8a)**

- We believe that this provision should apply to cash securities. This provision should require vertically integrated exchange/clearing house groups to give out trade feeds. Again, we believe that the term 'smooth and orderly functioning of markets' needs to be defined for the reasons explained above. We repeat that sanctions for non-compliance should apply.

3. **Third Countries (Article 23)**

- We believe that this provision causes unintended consequences because of a sub-optimal definition of CCP and because the draft regulation does not adequately address the territorial scope of the proposal.

- The original Commission proposal defined CCP as follows (changes show differences from 29 April compromise text):

"'central counterparty (CCP)' means ~~an~~ a legal entity that legally interposes itself between the counterparties to the ~~contracts~~ traded within one or more financial markets, becoming the buyer to every seller and the seller to every buyer and which is responsible for the operation of a clearing system;" [The word "contracts" has not been replaced]

Article 1 simply states the scope of the regulation as applying to "CCPs".

- Therefore, on its face, the Regulation (always) has applied to any CCP that acts in "financial markets" regardless of the nature of the transactions cleared, i.e. it applies to CCPs that clear OTC derivatives, futures, securities, repos, stock loans, etc. (the only exception is that the provisions on interoperability in Title V only apply to CCPs that clear securities and money market instruments).

- This broad scope creates a number of problems:

    - All CCPs will have to establish individual segregation and portability arrangements. This may not be practically feasible for all types of financial instrument (futures, securities e.g.)

    - Unless clarified, cash securities (bonds and equities) will fall under the same regulation. An EU- based bank planning to execute a trade in Australian cash equities would need to be satisfied that ESMA had recognised the local CCP before trading, as once executed, transactions automatically route to the CCP. Therefore, ESMA would be required to ensure that all CCPs globally are granted equivalence prior to the Regulation being enacted, or European banks, for example, would find themselves unable to trade cash securities in those countries without recognition.

- Thus, on the face of it, article 23 prohibits <u>any</u> non-EU CCP (regardless of product cleared) from providing services to EU clearing members or EU clients of EU or non-EU clearing members unless the CCP has been judged equivalent.

- Most non-EU organised markets and many non-EU OTC markets will have clearing arrangements of some kinds with a local CCP. It is possible that only a limited number of those CCPs will benefit from an equivalence determination. The problem of obtaining such a determination will be exacerbated if EU CCPs have to provide that go beyond CPSS-IOSCO standards and that may be very difficult for others to maintain, unless the EU authorities take a flexible approach to equivalence determinations.

- This means that EU investment firms would have to cease to be clearing members of many non-EU CCPs. But even more significantly, EU based investors will not (so it seems) be able to continue to be clients of EU or non-EU clearing members of those non-EU CCPs (although it is not apparent how this rule is to be enforced). This would effectively make it impossible to operate an investment management business in the EU. Investment managers would need to move outside the EU to be able to trade on a large range of non-EU markets.

- The problem is exacerbated because the regulation does not define what it means when it refers to a person "established" in the Union or how it deals with branches of entities:

    - Entities "incorporated" in the EU are "established" in the EU. However, since a non-EU branch of an EU incorporated entity forms part of the same legal entity, it would appear that article 23 prevents a non-equivalent non-EU CCP providing

services to the non-EU branch of an EU bank. This would effectively make it very difficult for EU banks to operate a full range of services through their non-EU branches.

- If the term "established" also encompasses firms incorporated outside the EU, article 23 would have even broader impact. For example, a US bank that has a branch in the EU would then be established in the EU. A non-equivalent non-EU CCP would not be able to provide services to the US head office of that US bank (as it is part of the same legal entity that is "established" in the EU). If this were the case, this would be major disincentive to foreign banks to open branches in the EU.

- It is not apparent whether the EU has addressed the possible WTO/GATS issues from shutting in its investors in this way ("prison Europe").

4. Transparency (Article 36)

- We are concerned about the following provision in point 1 of this Article:

"A CCP **and its clearing members** shall publicly disclose the prices and fees associated with the services provided. They shall disclose the prices and fees of each service and function provided separately, including discounts and rebates and the conditions to benefit from those reductions..."

If this is intended simply as an obligation for clearers to publish the CCP fee schedule, this is not a concern (these schedules are generally public). However we are concerned as to the potential for competitive distortions if clearing members are

- Expected to publish the exact fee they pay to the CCP (and disclose in which volume bracket they are as a firm), which seems to be the case ('discounts and rebates');

- Expected to publicly disclose their own fees to clients (in addition to CCP fees).

We would underline here that clients will be able to choose between several different clearing members in complying with their clearing obligations, while there may be a more limited choice in terms of CCP services. It would seem reasonable that the focus, for the purpose of disclosure of fees, should fall on CCPs.

5. Segregation and Portability at CCPs

Segregation (Article 37)

- We do not consider that it is optimal for the EMIR to seek to regulate clearing members (especially as not all of them may be in the EU). A change to the second sub-paragraph in Article 37(2) to begin “A CCP shall require its clearing members to distinguish...” could be considered.

- In Article 37(2), the words “with the CCP” are missing.

- In Article 37(3) the drafting appears to apply to CCPs clearing exchange-traded derivatives as well as OTC derivatives (the proposal is unclear because the definition of CCP is not limited to any particular category of financial instruments). However, it may not be practical for CCPs clearing for futures exchanges (or clearing members of those CCPs) to provide individual client segregation for futures business, given the numbers of underlying accounts. Therefore, it may be necessary to provide for differential treatment of futures business e.g. by adding the following sub-paragraph: “This paragraph only applies to a CCP where it clears OTC derivatives contracts.”

- In general, there is a need to consider the suitability of these provisions to clearing of different types of financial instrument. For example, these provisions may represent a practical challenge for cash securities clearing, where clearing members often hold stock in an omnibus account. Furthermore, if a clearing member uses a sub custodian (i.e. another bank in a different country) to hold its securities, that sub custodian would also be required to hold segregated accounts. This may be an unintended consequence.

- A change could be considered to the second sub-paragraph of Article 37(3), to begin "A CCP shall require its clearing members to offer...", unless it is intended that this is optional for clearing members.

- We suggest replacement of the term “full segregation” with “individual client segregation”.

Portability (Article 45)

- In Articles 45(4a) and (4b), we think “pre-defined period” could be clarified and refer directly to a period specified in the CCP’s rules. Similarly, the expression “actively manage risk” can be clarified as being able to take all steps permitted by its rules.

- Article 45(4c): This provision appears to duplicate the provisions of Article 37(6a). However, it may go further and require the CCP to return surplus collateral directly to the clients. The CCP may not be able to identify the underlying clients or be able to allocate between them collateral held in a pooled account.

  In addition, the clearing member may have rights to apply the surplus collateral against claims that it has against the client which would be bypassed if the collateral is returned directly to the client. It may also be inconsistent with the insolvency laws applicable to the clearing member for assets which may be regarded as assets of the

clearing member (e.g. if the clearing member trades as principal) bypass the insolvency. This may be the intent of the provision but it would then be necessary to address directly the issue of conflict with national insolvency laws (and the position of third country clearing members).

It is also unclear why this provision is limited to surplus collateral. There may also be positive net balances as a result of closing out of client positions.

The question is whether the CCP should return surplus collateral (and positive balances resulting from the liquidation and netting of positions) to the clearing member or directly to the clearing member's clients.

The risk with the Article 45(4c) drafting is that it will simply be regarded as imposing an obligation on CCPs to have procedures without specifying who the surplus assets should go to nor specifying any timing requirements. Furthermore, it does not deal with positive balances on positions. We would suggest a revision in this context.

- In Article 45(6), we have concerns that the new provision set out would be too vague to be enforceable.

6. Interoperability arrangements (Article 48)

In Article 48.3, it is not clear to us how interoperability or access to a data feed will be monitored, nor is it clear what are the penalties or fees for non-compliance, in this context. It is also not clear what is meant by “control any risk” in this context, and fear that this allows a convenient premise for blocking such arrangements.