ISDA-AFME Comments on Hungarian Presidency text on EMIR dated *14 June*

9 July 2011

ISDA and AFME are pleased to have the opportunity to comment on the Hungarian Presidency text of 14 June on EMIR.

Please note that text in *italics* indicates either a new remark – often on a recent change in the text – or (where indicated) proposed text or text currently in the Council draft.

We would like to state support for the following new developments in the Presidency text:

- The extension of the scope in Article 1 to "all derivatives", including exchange-traded derivatives, for the clearing and reporting obligation. This extension will "future-proof'' EMIR so that all platforms are required to clear contracts and will address concerns regarding anti-competitive restrictions implied by vertical silos.
- The latest draft allows a *longer* transitional period (five years from the entry into force of the regulation or the review of EMIR by the European Commission) during which an exemption can be permitted from clearing for certain pension funds (Art 71).
- The deletion of a number of conditions required in previous drafts in order for intra-group transactions for financials to be exempted from the clearing requirements (Article 2a).
- The suggestion that regulatory technical standards adopted by the European Commission in relation to bilateral risk mitigants could be calibrated, where relevant, for the specific risks associated with intragroup transactions (Article 6.3).

Other comments

1-**Intra-group transactions (Recital 21a, Article 2a, Article 6)**

Intra-group transactions (IGTs) are of particular importance in Europe for financial institutions due to the preferences often expressed by clients and regulators in different Member States for these clients to deal with locally-based entities. Centralised portfolio management then allows a) banks to manage risk in a consolidated way, potentially allowing optimal pricing for the client and b) allows regulators to scrutinize a consolidated risk position in the financial institutions that they supervise.

We maintain that a clearing requirement for intragroup transactions would increase operational risk (because of the amount of clearing transactions with the CCP that would ensue, for different entities) without enhancing counterparty risk management in material terms.

We welcome the new recognition (in recital 21a) of the need for exemptions from clearing requirements for IGTs within mixed groups – a very important change for many companies.

While welcome the improvements in the text on the exemption for IGTs from clearing for financial institutions, we note with concern the many conditions attached – in this draft - to national competent authorities even having the option to exempt IGTs from bilateral collateralisation in Article 6 (conditions which we believe would make such exemptions difficult to obtain). This creates considerable legal and commercial uncertainty for regulated firms. We continue to believe that there is also a case for exempting IGTs between group entities located in the EU (or in equivalent 3rd country jurisdictions) not only from clearing but also from bilateral collateralisation requirements.

We welcome the recognition (in Article 6.3) that the specific risk-characteristics of IGTs could – if bilateral risk mitigants have to be applied to IGTs – be reflected in less stringent, risk-sensitive capital and collateral requirements than for other bilateral transactions.

We continue to believe that that where margin and associated collateral is required in intra-group transactions, it should be clear that associated collateral can be handled on a fully netted basis.

2-Indirect clearing (Article 3(2))

We maintain our concern that the current Council text may not sufficiently recognise the preferences of some clients to access clearing through banks which themselves are clients of clearing members. These clients should be allowed to continue with this preference, and the text of Article 3(2) should explicitly reflect this. *We note that the European Parliament text recognises this necessity.*

The original proposal envisages that where an EU counterparty subject to the clearing obligation is required to clear an eligible OTC derivative contract it must do so either by becoming a clearing member or a direct client of a clearing member. However, it may not always be practical for EU counterparties to become clearing members or direct clients of clearing members, in particular where the relevant CCP is located outside the EU. In those cases:

- The non-EU CCP may not be able to admit EU counterparties as clearing members if they are not subject to local regulation (and, even where this is theoretically possible, EU counterparties may not be willing to submit themselves to local regulation because of the extent of third country supervision and rules that will apply to their business outside the third country).
- Clearing members of the non-EU CCP may not be able readily to transact business with all categories of EU counterparties, in particular because they may be prohibited from seeking business in the EU by local licensing requirements in the EU (see e.g. the European Commission's proposals as part of the MiFID review which appear to limit the ability of third country firms to deal with EU counterparties unless the third country firm meets a strict equivalence criterion and restricts its business solely to business with professional clients).

Within the EU, there are also likely to be financial counterparties that have significant volumes of OTC derivatives business with clients where the clients will themselves also be subject to the clearing obligation, but the counterparty does not wish to or is not able to become clearing members of every relevant CCP across the EU. In these cases, the counterparty may wish to use other clearing members to clear its own and its clients' trades, on an omnibus basis.

A similar issue arises today where EU counterparties wish to access third country futures exchanges and clear their transactions through a non-EU clearing firm that is a member of the third country exchange and its related CCP. In that case, the EU counterparty will often trade through an EU bank or investment firm that maintains an omnibus account with the third country clearing member. Corresponding issues arise for EU firms that wish to access an EU futures exchange where they do not wish to establish a direct relationship with the clearing member.

It is also not clear to us whether sufficient consideration has been given to how segregation rules will work in practice when firms access clearing houses through a chain of intermediaries (as described above). Regulated firms need clarity on this point if they are to be ready to comply with the Regulation on time. Similarly, it is not clear to us how risk weighted capital charges will be applied in this scenario (when is the client completely protected from counterparty default?). At the very least, we urge Council members to provide ESMA with a mandate to look at these questions, with a view to EC regulatory technical standards.

3-Backloading/Frontloading (Recital 12, 12c, Article 3 & Article 4)

We continue to believe that the frontloading requirement will – for reasons explained in previous commentaries – result in legal disputes and, as a result, a large number of non-compliance cases for national regulators to deal with. It will also be impracticable in relation to dealings with non-EU counterparties.

We believe that intention of the text would be more appropriately addressed by a reference in Article 3.1 c(ii) to a "*longer*" and not "*higher*" maturity.

However we believe that the clearing requirement should only apply to contracts entered into after the date from which a class of derivatives must be cleared following a decision on eligibility by ESMA.

We note that the European Parliament opposes both frontloading and backloading for these good reasons.

4-Phasing-in (recital 12, Article 4)

We continue to believe that the clearing requirement should be rolled out in an orderly fashion. While dealers and large clients will be ready to clear quickly, the practical application of the clearing requirements to smaller clients will be much more challenging, operationally (with associated risks), and in terms of the financial impacts felt by those smaller clients.

We note that the US rulemakers are applying phasing-in to clearing requirements under Dodd-Frank. Article 4.2 of the 14 June text suggests allowance for phasing-in for 'frontloaded (i.e. contracts entered into between the date of entry into force of the Regulation and the date from which a clearing requirement as decreed by ESMA takes effect)' contracts and the category of counterparties to which the obligation applies. We believe that the clearing requirement should only apply to contracts entered into after the date from which a class of derivatives must be cleared following a decision on eligibility by ESMA, and that phased-in clearing requirements should be permitted for these contracts. It seems unwise not to give ESMA and the European Commission the flexibility to allow this, where they believe that it may be systemically or economically imprudent to require all derivatives and all counterparties in a particular class to be cleared on 'day 1'.

We note that the European Parliament believes that ESMA should be allowed to have the power to recommend phasing-in of clearing requirements.

5-Clearing criteria (Article 4)

We continue to regret the deletion of the eligibility criteria in relation to "levels of counterparty credit risk in the market, within the relevant class of derivatives and between classes of derivatives" and "the impact on competition" from the list of eligibility criteria for consideration by ESMA. We believe these were sound and helpful considerations for ESMA.

6-Bilateral risk mitigation (Article 6)

For remarks addressing intra-group transactions specifically, please see point 1.

We would welcome amendments here that would clarify that is *Initial Amount* that should be segregated at the option of the counterparties (to clarify, dealers should offer this option and clients should have a right to it), and not *Variation Margin* (which is passed back and forth frequently, subject to netting calculations). A requirement to segregate *variation* margin would have serious liquidity effects and is not generally sought by participants in derivatives business.

We recognise that the Council may feel that – if segregation of variation margin is not welcome by the broad universe of market participants – the reference to 'in accordance with their agreement' may satisfy concerns in this regard (Article 6.1b.).

We welcome the text's reference to the timing of the offer of segregation ("*if requested by the other party before the time of execution*"(Article 6.1b)), which is an important inclusion (failure to include this could result in legal disputes if counterparties cannot agree to the price associated with new requested segregation requirements. Such requests would also typically happen at moments of market difficulty, implying dangerous pro-cyclicality (liquidity effects)).

The text continues to state that mandatory risk mitigation requirements (collateral esp.) in Article 6 will only be applicable to non-cleared contracts entered into or after the entry into force of EMIR. While this improvement is welcome, we believe that mandatory collateral requirements should apply only on/after the date the clearing obligation takes effect.

We note that Article 6.1 applies to financial counterparties and all non-financial counterparties (without any qualification that the Article 6 requirements would only apply to contracts entered into by non-financials surpassing the clearing threshold). We don't believe this is the intention.

7-Transitional provisions

We believe that EMIR should include adequate transitional provisions dealing with the practical issues faced by market participants in complying. For example:

- *It should be made clear that the reporting obligation does not apply to contracts entered into before the obligation comes into force which have been substantially performed (i.e. even though some residual obligations remain outstanding). It would be meaningless for reports to include transactions where the key economic terms of the transaction have been*

performed or have expired, merely because some other terms still continue to subsist (e.g. indemnification or other provisions).

- *Where delegated or implementing acts are required in relation to a particular obligation, it should be made clear that the obligations do not arise until a specified time after those acts are adopted and published. For example, the obligations in article 5 on non-financial counterparties should not come into effect until a specified time after the adoption by the Commission of the technical standards setting the thresholds (or any revision of those thresholds). The first of these measures may not be adopted by the Commission and published until some time after the 30 June 2012 deadline. Non-financial counterparties will need some months to identify whether they are or are not subject to the resulting requirements. Similar issues arise in relation to the reporting obligation in article 7 where market participants will need time to build systems based on the final requirements as published.*

- *Even in those cases (such as article 6) where the provision could take immediate effect before the adoption of delegated acts, there should be a transitional period so that firms can take action based on the delegated acts actually adopted.*

It is worth noting that the European Parliament text has the following wording dealing with this issue:

Article 71 (2a):

The obligations of counterparties under Articles 3, 6 and 8 shall become effective six months after publication of the regulatory technical standards, implementing standards and guidelines drafted by ESA (ESMA) and adopted by the Commission.

- *The reporting obligation should only come into force some time after the Regulation comes into force to allow sufficient time for trade repositories to register under the Regulation. Otherwise, firms could be required to report under article 7 to national regulators and then repeat that reporting at a later stage when trade repositories register.*

- *The Regulation should specify a date from which the Regulation applies which is a reasonable time after the time that the initial delegated/implementing acts will have been adopted.*

- *The transitional provision in article 71(1) for CCPs should cover CCPs that are already subject to national supervision even if not technically authorised (e.g. in the UK, CCPs are exempt but not authorised).*

- *There should be express obligations on the authorities to allow adequate time for market participants to take implementing action, build systems, etc. e.g. where ESMA extends the clearing obligation or changes the information/clearing thresholds.*

- *There should be transitional provisions to deal with cases where a trade repository has registration or recognition withdrawn. Firms will need time before they are in a position to report to their competent authority.*

- *It should be made clear that nothing in the Regulation gives parties the right to terminate, amend or modify an existing derivative transaction (compare the Dodd-Frank Act).*

8-Non-financials and hedging (recital 16a, Article 5)

While we welcome the confirmation that non-financial institutions shall not be subject to any type of frontloading, we continue to have some related concerns about Article 5:

- We believe that the reference to Article 3 in Article 5.1(b) should be deleted in order to avoid any ambiguity.

- The mention of "*commercial activity or treasury financial activity*" reflected in Article 5.3 is still only partly reflected in Recital 16 and Article 5.4 (There is only reference to "*commercial activity*"). We advocate consistency on this point: maintaining the full wording "*commercial activity or treasury financial activity*" both in the recital and article.

We maintain that that reference only to interest rate, inflation, commodity and FX risk in recital 16a is inadequate for the purpose of the hedging definition. The use of CDS to hedge counterparty risk by non-financials is well known, and equity derivatives could legitimately be used to hedge risk in relation to employee share schemes, for example.

It is still not clear to us how firms are expected to know which non-financial counterparties have exceeded the threshold and hence are obliged to clear.

Article 5.3 seems to suggest that a non-hedging trade in one part of a non-financial group would prompt all transactions in the Group to have to be cleared, rather than just those in the affected entity. This seems unduly punitive in cases e.g. any energy utility company will have a trading arm and positions it takes could prompt the rest of the group to have to clear.

9-Collateral Requirements

Recital 37a still names several types of *'highly liquid'* asset which may be accepted as collateral, including: covered bonds, guarantees callable on first demand granted by a member of the European System of Central Banks (ESCB) and commercial bank guarantees from non-financial counterparties acting as clearing members.

We believe that determining the acceptability of collateral for the purpose of CCPs is a task that should be delegated to ESMA and the European Commission. We believe that giving CCPs the scope to provide for very flexible collateral requirements could – in practice – allow a race to the bottom to develop, with some market participants gravitating to CCPs implying lower costs but also lower risk management standards and therefore a much greater possibility of a CCP default with extreme systemic consequences.

We welcome the absence of any reference to such types of collateral in Article 43.

10- Access to a venue of execution (Article 8a)

We continue to believe that believe that this provision should apply to derivatives and cash securities. This provision should require vertically integrated exchange/clearing house groups to share trade feeds. Again, we believe that the term '*smooth and orderly functioning of markets'* needs to be defined, in order to ensure that it is not used to block access when blocking access is not justified. We repeat that sanctions for non-compliance should apply.

As mentioned, unhealthy barriers to competition should not be allowed to persist if vertically integrated exchange-CCP groups are to become an increasing characteristic of the European post-trade landscape.

11-Powers of ESMA (Article 15)

We note that the powers of ESMA have been reinforced in the latest text. It will now be given a vote on the college of supervisors for CCPs and third-country CCPs seeking to provide clearing services in the EU will have to be recognized by ESMA and not a national competent authority. ISDA believes that more responsibility should be left with national competent authorities.

12-Third Countries (Article 3, Article 23, Article 1)

Please note the letter drafted by 8 trade associations concerning extra-territoriality in EU and US regulation and which was sent in accompaniment to this document.

In Article 3.1 b (iv), it is still not clear how firms can implement the clearing criterion with third country counterparties (in relation to determination of counterparties that would/would not be required to clear in Europe - different firms could arrive at different answers for the same third country counterparty). It is not clear upon whom the obligation lies to make the correct determination. Does this mean third country sovereigns would be exempt, since they would be if in the EU?

Article 23 appears to prohibit <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's regulatory regime is deemed 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 EMIR CCPs have to go beyond CPSS-IOSCO standards, 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").

We regret the discrimination against non-ESCB sovereigns for the purpose of imposition of margin requirements. While we understand the reason for its insertion, we believe it is vital for EU and US regulators to work such extra-territorial aspects and divergences out in a calm way.

13- Withdrawal of Authorisation

Article 16 still does not consider the impact on clearing members of the withdrawal of CCP authorisation, nor does it contemplate clearing members being consulted prior to this withdrawal, which would be desirable. Similarly, it is not clear from Article 54a/55a and Recital 46 (withdrawal of registration of trade repository) what is intended to happen to the trade data held by the repository upon withdrawal of registration, and whether the repository would still be subject to the Article 66 obligation of confidentiality after withdrawal.

14-Transparency (Article 36)

We remain 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.

15-Participation requirements (Article 35)

Article 35.3 still doesn't specify what '*necessary additional financial resources'* clearing members must have in order to provide clearing for clients. Furthermore, Article 35.6 does not clarify what '*specific additional obligations'* are to be imposed on clearing members.

16-Segregation and Portability at CCPs *(*Article 37*)*

In Article 37.3a, no clarification has been made as to what "*reasonable commercial terms*" mean, or what authority will be setting such terms. For clarity purposes, we advocate for the commercial terms related to these segregation services to be established by the market (as the requirement will apply to all market participants, market forces should drive price competition).

The Article 37.5a contemplates a rehypothecation right for non-cash collateral held by the CCP under a security financial collateral arrangement. We do not support CCPs having a right to rehypothecate the securities collateral they receive, due to the resulting exposure of clearing members to the insolvency risk of the CCP and relevant third party counterparties. In addition, rehypothecation could result in higher capital charges falling on clearing members as their collateral is not bankruptcy remote.

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.

It is also not clear to us what is meant by '*the client's requirement'* in Article 37.3 – is this intended to reflect the CCP's margin requirements?

A number of *sell-side (dealer)* firms are concerned that they should not be required to post *'excess margin'* to CCPs, explaining that they fear that this could to lead to a situation where transactions are over-collateralised at the CCP level whilst clearing members' exposures to their clients are under-collateralised. They point out that clearing members will in practice have considerable intra-day exposure to clients, e.g. as a result of intra-day margin calls and/or the processing of transactions pending delivery of funds from clients, and that it is therefore reasonable to hold so-called "excess" collateral against such exposures as part of prudent risk management processes.

The term "*full segregation*" is still used in Art.37.4 (zero risk weighting for CCP exposure) instead of "*individual client segregation*" - presumably in error.

17-Default fund (Article 40)

Presumably the intention of "*A CCP may establish more than one default fund for the different classes of instruments it clears"* is for the CCP to establish one fund per class? This is not entirely clear from the drafting.

18-Clearing Member Default (Article 45)

Article 45.1 states that the CCP shall outline the procedures to be followed if it does not declare the default of a clearing member. It is not clear what is intended here and why a CCP would not declare a Clearing Default.

It is not clear how Art. 45.4a and 4b are intended to interact. 4a refers to the distinction made in Article 37.2 between clearing member "House" vs "Client" accounts at the CCP and seems to assume that all clients would appoint the same back-up clearing member; 4b refers to the individual client segregation scenario, which is a subset of the Article 45.4a/37.2 scenario but is not carved out from it explicitly.

Article 45.3 requires a CCP to inform the national competent authority prior to declaring a clearing member default. This should be amended so that the CCP informs the authority 'as soon as practicable after the CCP declares' a clearing default. Our concern here relates to potential delay and information leaks leading to a Lehman-style run on the relevant clearing member.

19-Dissemination of information/data (recital 24, Article 7, Article 55, Article 67)

It is of concern that the disclosure of clearing member and derivatives contract information to national and other authorities for purposes unconnected with clearing appears to be contemplated in the text. Recital 31 contemplates disclosure of information on derivatives to tax authorities; there are similar references in Art. 67.3 (ESMA shall "*share the information necessary for the exercise of their duties with other EU relevant authorities")* and Art 67b (3) permits the authority receiving the information to use it for other purposes where ESMA consents to this. The information flow to and from ESMA regardless of confidentiality etc is also evidenced in Art 67b(4) and (5), Art. 7.2 and Art. 57a (Art 55c has penalties for non-compliance).

In relation to data protection, bank secrecy and confidentiality issues, it is not clear how effective the protections for clearing members in Recital 24 and Art.7.3 can be, since they attempt to cut across contractual confidentiality obligations as well as statutory data protection and bank secrecy obligations.

20-Central Bank Liquidity (recital 18a)

We note that the reference to "CCPs to be licensed as credit institutions" is maintained (between square brackets). This means that legal uncertainty persists - as we do not know if this license will be another requirement for CCPs before they can obtain the authorisation of national authorities.

For clarity purposes, we would like the words "on one or more currencies" reinserted, as this explicitly foresees the scenario that a CCP which has access to central bank liquidity facilities could be working in different currencies.

We remain cautious about forms of language addressing access to central bank liquidity or bank licensing for CCPs being inserted into EMIR, and are concerned that *some variations on such language could undermine the operation of the single market, and Europe's open and competitive economy.*