ISDA-AFME Comments on Hungarian Presidency text on EMIR dated *6 June*

14 June 2011

ISDA and AFME are pleased to have the opportunity to comment on the Hungarian Presidency text of 6 June on EMIR.

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

- The delegation of responsibility to ESMA (and ultimately, the EC) in Article 71, with regard to definition of the types of pension scheme that can be exempted from clearing (instead a bilateral collateralisation requirement would be imposed for this purpose)).
- The new legal protections afforded trade repositories under Article 56e, regarding documents which are subject to legal privilege.

Other comments

1-Scope (broad or OTC-only)

We continue to support a broad scope of application for EMIR, including exchange-traded derivatives. We have already commented in detail on this, but, to summarise

- A broad scope will 'future-proof' EMIR so that all platforms are required to clear contracts;
- A broad scope will address long-standing (for well over a decade) concerns held at EU level on the anti-competitive restrictions implied by vertical siloes, with consequent impacts for pricing;
- It is important to understand that expanding the product scope of EMIR to include exchange-traded derivatives **does not** amount to introducing full CCP interoperability for derivatives clearing at this time. A requirement for an exchange to provide trade feeds on a non-discriminatory and transparent basis to any authorised (for clearing of those products) CCP would ensure that two members of a given exchange could choose to use a CCP of which they are both members to clear a trade, rather than being forced to use the venue's preferred CCP. This is not the same as interoperability, which would enable the parties to the trade to use **different** CCPs to clear their positions.

We also remark that the current direction of travel in the European post-trade landscape is for exchange groups to acquire or build their own vertically-integrated CCPs (see the almost daily recent media coverage on consolidation and prospective consolidation in the post-trade business). Thus, the vertical siloes that regulators agree (hence the Code of Conduct adopted under the last European Commission) represent an unhealthily anti-competitive characteristic of the EU post-trade landscape (maintaining fragmentation and leading to higher costs of clearing in Europe than apparent in competing jurisdictions) are likely to become more prevalent. It would be a pity, therefore, to miss an opportunity to address this issue.

2-Intra-group transactions (Article 2a, Article 6)

Intra-group transactions are of particular importance in Europe 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 further add 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 improvements in the text on this point, but believe that there is also a case for exempting intra-group transactions between group entities located in the EU from bilateral collateralisation requirements.

We further suggest 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.

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 Art. 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.

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 6 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'.

5-Clearing criteria (Article 4)

We believe that 'levels of counterparty credit risk in the market, within the relevant class of derivatives and between classes of derivatives' and 'the impact on competition' are factors that ESMA should consider in assessing eligibility of some types of contract for clearing and believe these should be maintained in the text (they have been deleted (except for the case of phased-in 'frontloaded' contracts in relation to the competition criterion –)) and are now factors that ESMA should pay 'due regard to' in assessing eligibility.

6-Bilateral risk mitigation (Article 6)

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 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)).

If counterparties had a right to demand segregation (to any level) during the lifetime of the contract, this would have an effect on the price, and *will* lead to legal disputes if counterparties cannot agree that price. 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.

7-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.
- As mentioned before, we welcome the alignment of the 'kick out' and kick in' periods with regard to the clearing threshold (30 days over a 3 month period).
- 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.

Art. 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.

8-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.

9- 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.

10-Third Countries (Article 3, Article 23)

In Art.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 will be addressing this issue in more detail in a letter to regulators in the coming days.

11- Withdrawal of Authorisation

Art. 16 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 Arts 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 Art. 66 obligation of confidentiality after withdrawal.

12-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.

13-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.

14-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 are concerned that this situation could have several unintended consequences, such as:

- The counterparties will be exposed to the insolvency risk of the CCP and the clearing members, as counterparties' assets will be effectively transferred to the CCP in exercising the rehypothecation;
- 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.

15-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.

16-Clearing Member Default (Article 45)

Art. 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 Art 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 Art 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.

17-Dissemination of information/data

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.