



14 July 2014

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Attention: Andrea Enria, Chairperson

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Attention: Gabriel Bernardino, Chairman

**Re: Consultation Paper regarding draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP**

Ladies and Gentlemen,

The International Swaps and Derivatives Association<sup>1</sup> ("ISDA") and the Securities Industry and Financial Markets Association<sup>2</sup> ("SIFMA") (hereinafter referred to as the "Associations")

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<sup>1</sup> 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](http://www.isda.org).

<sup>2</sup> The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

welcome this opportunity to respond to the Consultation Paper on the Draft regulatory technical standards (the "**Draft RTS**") on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Art. 11(15) of Regulation (EU) No 648/2012 published by the European Securities and Markets Authority ("**ESMA**"), the European Banking Authority ("**EBA**") and the European Insurance and the Occupational Pensions Authority ("**EIOPA**", and together with ESMA and EBA, the European Supervisory Authorities, the "**ESAs**") on 14 April 2014.

## **INTRODUCTION**

The Associations strongly support the goals of strengthening systemic resiliency in the non-centrally cleared derivatives market by establishing risk mitigation techniques and margin requirements in accordance with the requirements of Regulation (EU) No 648/2012 ("**EMIR**"). While the Draft RTS are an important step forward for establishing a detailed set of requirements for the collection and protection of margin in the OTC-derivatives market in the European Union (the "**EU**"), it is important that the ESAs continue to focus on the practical issues relating to the implementation of such rules and the overall purpose of reducing systemic risk. This letter is intended to continue the constructive ongoing dialogue between the ESAs and derivatives market participants and to focus on the practical concerns and risks surrounding the implementation of the margin rules, including the harmonization of such rules with those of foreign regulators. We hope that our comments in this letter and follow-up discussions will inform further drafts of the RTS that the ESAs will submit to the European Commission (the "**Commission**").

This letter indicates the areas of the Draft RTS where we believe additional rulemaking and clarification could be helpful and provides suggestions for certain provisions to ensure effective implementation. In particular, we highlight the following critical issues:

- 1. Non-EU NFC-s and sovereigns:** Non-EU entities that would not qualify as FCs or NFC+s and non-EU sovereigns should not be required to post IM or VM.
- 2. IM model:** The mandatory capture of main non-linear dependencies and certain other model requirements are overly rigid and prescriptive.
- 3. Concentration limits:** The proposed concentration limits are too restrictive.
- 4. 8% haircut for FX mismatch:** An 8% FX haircut on mismatched collateral would create operational, credit and settlement risk.
- 5. Timing and VM phase-in:** Market participants will need two years from the adoption of final rules to implement the margin requirements and the ESAs should phase in the requirement to post VM.
- 6. Documentation:** The documentation requirements, particularly the requirement to enter into agreements with NFC-s, are overly burdensome.
- 7. International consistency:** Margin rules should be consistent across the major financial jurisdictions.

**Definitions:** For the purposes of this letter:

"**FC**" is a financial counterparty as defined in EMIR; an "**NFC+**" is a non-financial counterparty as defined in EMIR that is referred to in Art. 10 of EMIR; and an "**NFC-**" is a non-financial counterparty as defined in EMIR other than one that is referred to in Art. 10 of EMIR.

"**IM**" is initial margin and "**VM**" is variation margin.

"**50M Threshold**" is the exemption for FCs from the requirement to exchange IM if the total IM to be exchanged at the group level is less than or equal to EUR 50 million. (See Chap. 1, Art. 2 GEN, para. 3 (p. 23) of the Draft RTS.)

"**8B Threshold**" is the exemption from the IM collection requirements if one of the parties has less than EUR 8 billion (or higher amounts before 2019) in aggregate notional amount of derivatives. (See Chap. 5, Art. 1 FP, para. 3 (p. 46) of the Draft RTS.)

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## I. SCOPE

### A. A non-EU entity should not be required to post margin if (a) it would not be an FC or NFC+ if established in the EU; or (b) it is a sovereign, a central bank or a multilateral development bank.

The Draft RTS permit an FC or NFC+ that enters into a derivative contract with an NFC- to agree that no exchange of margin is required. (Chap. 1, Art. 2 GEN, para. 4(b) (p. 24)). However, no exemption applies to derivative contracts between an FC/NFC+ and a non-EU entity, even if that non-EU entity would not be an FC or NFC+ if it were established in the EU.

(i) **Non-EU entities other than FCs and NFC+s:** We propose that margin would only be required from a non-EU entity if the entity would be an FC or NFC+ if it were established in the EU. This proposal is consistent with the paper (the "**BCBS-IOSCO Paper**") on uncleared derivative margin issued in September 2013 by an international group of regulators.<sup>3</sup> The BCBS-IOSCO Paper states that "the margin requirements need not apply to non-centrally cleared derivatives to which non-financial entities that are not systemically important are a party, given that (i) such transactions are viewed as posing little or no systemic risk and (ii) such transactions are exempted from the central clearing mandate under most national regimes."<sup>4</sup> We strongly agree with this view. The goal of the Draft RTS (p. 6) is to reduce counterparty credit risk and mitigate potential risk. This goal is in no way undermined by extending the exemption for NFC-s to non-EU entities that would not be an FC or NFC+ if established in the EU. Excluding non-EU entities that would not qualify as FCs or NFC+s if established in the EU is also consistent with the scope of the clearing mandate under Art. 4(1)(a)(iv) of EMIR.

**EMIR allows flexibility in regard to both scope and level of mandatory margin requirements:** We understand that there may be concerns that Art. 11(3) of EMIR should be understood as requiring FCs to have procedures to exchange margin in respect of all their uncleared OTC-derivative contracts entered into on after 16 August 2012 and NFC+s to have procedures to exchange margin in respect of all their uncleared OTC-derivative contracts after they exceed the clearing threshold and that, accordingly, the RTS can only exempt FCs and NFC+s from collecting margin from NFC-s and the entities covered by Art. 1(4) and (5) of EMIR.

However, we consider that Art. 11(3) and Art. 11(15) of EMIR allow the ESAs and the Commission considerably greater flexibility in setting the scope of the mandatory margin requirements. Art. 11(3) is not expressed in terms that require an FC or NFC+ to require an exchange of margin with respect to all their relevant contracts. Art. 11(3) requires FCs and NFC+s to have procedures for the exchange of collateral for the portfolio of contracts covered by Art. 11(3) but that does not mean that those procedures require margin to be collected for each and every contract.

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<sup>3</sup> "Margin requirements for non-centrally cleared derivatives", by Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (Sep. 2013).

<sup>4</sup> BCBS-IOSCO Paper at 8.

As the Commission services stated in their letter to ISDA dated 28 August 2012 and reiterated in their FAQ on EMIR<sup>5</sup>, the provisions of Art. 11(3) were directly applicable from 16 August 2012 but until the time that the relevant RTS come into force, "counterparties have the freedom to apply their own rules on collateral in accordance with the conditions laid down in Art. 11(3)". If Art. 11(3) requires that FCs and NFC+s must have procedures to exchange collateral with all their counterparties (other than NFC-s and entities covered by Art. 1(4) or (5) of EMIR), FCs and NFC+s would already be required to comply with this condition. This would be inconsistent with the general understanding of the Commission guidance shared by regulators to date. This guidance was clearly given in the context of current market practices where counterparties' existing internal procedures for the collateralization of their uncleared OTC-derivatives do not generally require counterparties to collect collateral from all non-EU entities.

In addition, EMIR clearly provides that the RTS can specify that a zero level of collateral is required in particular cases where a zero level is justified by the policy considerations underlying Art. 11(3). As the Commission services state in the FAQs, "the precise level and exact type of collateral to be exchanged will be specified by [the RTS]". This reflects Art. 11(15)(a) of EMIR which provides that the RTS shall specify, among other things, "the levels and type of collateral...required for compliance with [Art. 11(3)]". The draft RTS already contemplate that a zero level of collateral will be permitted in some cases. For example, the Draft RTS do not require an FC or NFC+ to collect any collateral where it enters into contracts the exposure under which will always be under the EUR 500,000 minimum transfer amount (at least where one of the counterparties' aggregate notional amount of derivatives is below the 8B Threshold). It follows that the RTS can specify a zero level of collateral for some cases and there is no reason, in principle, not to specify a zero level of collateral in other cases where policy considerations dictate that this should be the case.

We consider that Art. 11(3) and (15)(a) were intended to provide more flexibility to the ESAs in determining the scope of the margin obligation than provided by Art. 4 of EMIR in relation to the clearing obligation. Art. 4 prescribes that the clearing obligation shall apply where the parties to the contract are an FC/NFC+ and a non-EU entity that would be an FC or NFC+ if it were established in the EU and, conversely, prescribes that the clearing obligation does not apply where one of the parties to the contract is a non-EU entity that would not be an FC or NFC+ if it were established in the EU (or an entity covered by Art. 1(4) or (5)). In contrast, Art. 11(3) and (15)(a) require the ESAs to determine where it is appropriate that FCs and NFC+s should collect collateral from their counterparties and the level of collateral that should be required, subject only to the implicit constraint that they should not require collateral to be posted by NFC-s or entities within the scope of Art. 1(4) or (5). Thus, while the RTS could specify that FCs or

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<sup>5</sup> European Commission response to ISDA regarding Application of Art. 11 (3) EMIR, dated 28 August 2012, available at: <https://www2.isda.org/attachment/NTI1MQ==/EC%20response%20EMIR%20article%2011%20retroactivity.pdf>; and European Commission, EMIR: Frequently Asked Questions, updated 18 December 2013, available at: [http://ec.europa.eu/internal\\_market/financial-markets/docs/derivatives/emir-faqs\\_en.pdf](http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/emir-faqs_en.pdf)

NFC+s must have procedures to collect margin from counterparties that are not subject to the clearing obligation, they are not required to do so where policy considerations dictate otherwise.

The intended scope of this flexibility is reinforced by Art. 11(4) of EMIR which requires FCs to hold an appropriate and proportionate level of capital to manage the risk not covered by an appropriate exchange of collateral. This recognizes that there will be cases where Art. 11(3) will not require an exchange of collateral and that it is not possible to enumerate these cases in advance (as it will depend on the RTS adopted under Art. 11(15)).

**Comparability to Art. 4 Mandatory Clearing:** EMIR Recital 24 indicates the scope of parties subject to Art. 11 by linking Art. 11 requirements to “market participants that are subject to the clearing obligation”. Further, the intragroup exemptions as identified in Art. 11(6, 7, 8, 9 and 10) share the same reference as Art. 4 to the Art. 3 definition of an intragroup transaction, suggesting that it is appropriate to adopt a consistent approach to the inclusion of and application to non-EU entities as it relates to the definition of a group.

In addition, in reading across to other European regulation as part of a broader policy consideration, we note that the CVA charge (a charge only applicable to uncleared derivatives), which is part of the Capital Requirements Regulation (“**CRR**”), is consistent with the extraterritorial reach of the EMIR Art. 4 clearing obligation. CRR Art. 382(4)(a) states: “The following transactions shall be excluded from the own funds requirements for CVA risk: (a) transactions with non-financial counterparties as defined in point (9) of Art. 2 of Regulation (EU) No 648/2012, or with non-financial counterparties established in a third country, where those transactions do not exceed the clearing threshold as specified in Art. 10(3) and (4) of that Regulation.” We see no reason to create a discrepancy between the CVA charge and the margin requirements with respect to uncleared derivatives with non-EU parties that would be NFC-s if organized in the EU.

**(ii) Sovereign/Central Bank/Multilateral Development Bank:** Sovereigns, central banks and multilateral development banks do not pose systemic or counterparty risk in the same way that private actors do and it is not appropriate to impose the same collateral requirements on them.

We recognize that Art. 1(4)<sup>6</sup> of EMIR already provides an exemption for Japanese and US central banks and debt management offices and that Art. 1(5)(a) of EMIR already provides an exemption for the multilateral development banks listed in what is now Art. 117 of the Capital Requirements Regulation. However, these exemptions do not currently extend to all non-EU sovereigns or central banks or all derivatives activities of those sovereigns that are covered (as they are limited to those bodies charged with or intervening in the management of the public debt). In addition, they do not cover all multilateral development banks.<sup>7</sup>

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<sup>6</sup> As amended by Regulation (EU) No 1002/2013 of 12 July 2013.

<sup>7</sup> The exempt multilateral development banks are:  
(a) the International Bank for Reconstruction and Development;  
(b) the International Finance Corporation;  
(c) the Inter-American Development Bank;  
(d) the Asian Development Bank;

Therefore, we propose that all non-EU sovereigns, central banks and multilateral development banks be explicitly exempted from the margin requirements. This proposal is consistent with the BCBS-IOSCO Paper (p. 8). This could be achieved by including a more general derogation in Chap. 1, Art. 2 GEN, para. 4 to cover these entities. Alternatively, it could be achieved by the Commission using the powers in Art. 1(6) of EMIR to amend the list in Art. 1(4) or the powers in Art. 457 of the CRR to add to the list of multilateral development banks in Art. 117 of that Regulation.

**(iii) Adverse effect:** Imposing requirements on FCs and NFC+s to collect margin from all non-EU entities would have a significant adverse effect on the ability of non-EU corporates, sovereigns and central banks to trade with EU firms. This would severely affect the ability of EU firms to compete with firms from non-EU jurisdictions that follow the recommendations in the BCBS-IOSCO Paper. Non-EU corporate, sovereign and central bank counterparties will shun EU counterparties and the restrictions on the ability of EU firms to participate in global markets will have an impact on the liquidity of EU markets as a reduced range of risk management opportunities can be handled here.

In addition, EU banks which operate through branches outside the EU actively participate in local markets, dealing with local corporate, central banks and sovereigns through the branch. They will not be able to compete with local counterparties that are organized outside of the EU if those jurisdictions follow the recommendations in the BCBS-IOSCO Paper.

**B. Within the EU, the exemption for NFC-s should be extended to entities that are not FCs or NFC+s and to EU sovereigns.**

The Draft RTS appear to state that FCs and NFC+s must collect margin from all entities unless a specific exemption applies. The Draft RTS include an exemption for NFC-s (Chap. 1, Art. 2 GEN, para. 4(b), (p. 24)). However, an individual or entity that is not an "undertaking" does not qualify as an NFC- (under the definition of non-financial counterparty in EMIR). As a result, the NFC- exemption is not available to an EU individual or entity that is not an "undertaking". We request that the ESAs extend the exemption for NFC-s to include such individuals and entities.

EMIR does contain an exemption for "Union public bodies charged with or intervening in the management of the public debt" (Art. 1(4)(a)). The Commission has indicated that this exemption may be available for a wide range of public sector bodies, including municipalities. However, we consider it important that the RTS make clear that FCs and NFC+s are not required to collect margin from EU sovereigns, regardless of the capacity in which they are acting,

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- (e) the African Development Bank;
  - (f) the Council of Europe Development Bank;
  - (g) the Nordic Investment Bank;
  - (h) the Caribbean Development Bank;
  - (i) the European Bank for Reconstruction and Development;
  - (j) the European Investment Bank;
  - (k) the European Investment Fund;
  - (l) the Multilateral Investment Guarantee Agency;
  - (m) the International Finance Facility for Immunization; and
  - (n) the Islamic Development Bank.



consistent with our proposal in relation to non-EU sovereigns and the BCBS-IOSCO Paper, as described above.

As discussed above, we consider that Art. 11(15) provides the ESAs the power to specify the scope of the procedures under Art. 11(3). Therefore we propose that the RTS be framed in a way that does not require the collection of margin from persons that are not undertakings and that they include a general exemption for transactions with EU sovereigns.

**C. Change in a party's status should not change its margin requirements during the life of a derivative.**

The RTS should specify that a party's status for purposes of the margin requirements is determined when the parties enter into the derivative. If the party changes status during the life of a derivative (for example, if it becomes an NFC+ although it had been an NFC-), the margin requirements for that derivative should not change. This is consistent with the position taken by the ESAs for clearing. Also, any other position would make it difficult to price derivatives: if a change in status results in change in a margin requirements, the economics of the swap would change dramatically.

**D. Indirectly cleared transactions should not be subject to RTS margin requirements.**

The Draft RTS provide that indirectly cleared transactions that are intermediated through a clearing member are exempt if the client provides margin "consistent with the relevant ... CCP's margin requirements". (Chap. 1, Art. 2 GEN, para. (4)(d) (p. 24)).

The RTS should not impose margin requirements on indirectly cleared transactions. The RTS are adopted pursuant to Art. 11 of EMIR which covers OTC-derivative contracts not cleared by a CCP (as stated in the title of Art. 11 and confirmed by ESMA in OTC Answer 12(j) of its Questions and Answers on the Implementation of EMIR).<sup>8</sup> Transactions cleared as a direct or indirect client through a clearing member of an EU or non-EU CCP are still "cleared" transactions to which Art. 11 of EMIR does not apply. Art. 11 of EMIR does not apply to transactions cleared at a CCP, whether by a clearing member or as a direct or indirect client of the clearing member.

In any event, if the RTS were to include provisions for a specific exemption for indirectly cleared transactions, it would be necessary to clarify what is meant by the term "consistent": it should not prevent clearing members from pre-funding collateral at the CCP in respect of their clients' positions, or asking their clients for more collateral or for different forms of collateral (or applying different haircuts to that collateral) than the collateral or haircuts required by the CCP. If the requirement prevented a party from asking for more collateral from its client, this would have the perverse effect of discouraging risk mitigation. Allowing a clearing member to request from a client different forms of collateral and/or different haircuts from those required by the CCP would give an intermediary the flexibility to obtain the collateral that is best suited to a particular client and to manage the risks and burdens related to a particular client relationship.

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<sup>8</sup> ESMA Questions and Answers, Implementation of the Regulation (EU) No 648/2012 on OTC Derivatives, central counterparties and trade repositories (EMIR), ("ESMA Q&A"), p. 26. Available at: <http://www.esma.europa.eu/system/files/2014-682.pdf>

## **II. THRESHOLDS**

### **A. The 50M Threshold and the 8B Threshold (each a "Threshold" and collectively, the "Thresholds").**

#### **(i) The 50M Threshold should apply to NFC+s as well as FCs.**

The 50M Threshold in Chap. 1, Art. 2 GEN, para. 3 (p. 23) of the Draft RTS only applies to FCs. We submit this threshold should also apply to NFC+s. The BCBS-IOSCO Paper does not distinguish between FCs and non-financial entities in applying the 50M Threshold (Para 2.2, p. 9) and explains (para. 2(h), p. 8) that the 50M Threshold helps to manage the liquidity impact associated with initial margin requirements. This rationale – managing the liquidity impact – applies to NFC+s' collection of IM as well as to FCs' collection of IM. Also, nothing in the text of EMIR suggests that NFC+s should be treated differently than FCs for these purposes.

#### **(ii) The 50M Threshold should not require an agreement to "hold capital".**

Chap. 1, Art. 2 GEN, para. 3 (p. 23) of the Draft RTS requires parties that are using the 50M Threshold to agree between each other that "they will hold capital against their exposure to their counterparties."

We propose deleting the requirement that the parties must enter into an agreement to hold capital in order to qualify for the threshold. For FCs subject to capital requirements, the amount of capital required will be determined by regulation, so no additional agreement is needed. For NFC+s or FCs that have no capital requirements, it is unclear why such an agreement should be required and how such an agreement could work in practice. Among other considerations, it is not clear what it would mean for an unregulated entity to "hold capital against exposures": an unregulated entity does not typically allocate capital for specific purposes. The BCBS-IOSCO Paper has no comparable requirement. As stated above, the BCBS-IOSCO Paper describes the 50M Threshold as a way of managing liquidity risks and this rationale does not support a requirement that capital be held against such exposure.

Finally, we recognize that Art. 11(4) of EMIR provides that FCs will hold an appropriate amount of capital to manage the risk not covered by the appropriate exchange of collateral. However, the regulatory requirements applicable to FCs will address capital requirements for uncollateralized exposures if such a requirement is appropriate. Art. 11(4) does not require capital to be addressed in an agreement between the parties. In addition, Art. 11(4) does not impose any requirement on NFC+s.

#### **(iii) Both Thresholds should apply when one of the counterparties is a non-EU entity.**

Under the language of the Draft RTS, neither the 50M Threshold nor the 8B Threshold is clearly applicable to transactions with non-EU entities. This is because the 50M Threshold only applies to OTC-derivatives with "financial or non-financial counterparties" (Chap.1, Art. 2 GEN, para.3 (page 23)) and the 8B Threshold only applies where "at least one of the counterparties" meets the relevant conditions (Chap. 5, Art. 1 FP, para. (3) (page 46)). The term "counterparty" is defined to mean FCs and NFC+s (Chap. 1, Art. 1 DEF, para. 1(a) (page 21)) and thus excludes non-EU entities.

For the reasons given above in section I(A)(i) on Scope and non-EU entities, FCs should not be required to collect IM from non-EU parties if the required amount of IM is below the 50M Threshold or if the non-EU party is below the 8B Threshold. The release accompanying the Draft RTS indicates (p. 7) that EU entities would not have to collect margin from non-EU entities below the 8B Threshold, but this is not reflected in the language of the Draft RTS. The Thresholds should not be restricted to transactions with parties that are established in the EU. This would not be consistent with the BCBS-IOSCO Paper.

(iv) **The Threshold calculations should exclude Exempt FX OTC-derivatives and indirectly cleared transactions.**

- **Exempt FX.** Chap. 5, Art. 1 FP, para. 5 (p. 46) of the RTS provides that counterparties must include non-centrally cleared foreign exchange ("**FX**") trades in the calculation of the 8B Threshold. We do not believe this is appropriate, as there is no requirement to deliver IM for specific types of FX trades ("**Exempt FX**"), which are explicitly permitted to be excluded from the IM requirements by the Draft RTS (Chap. 1, Art. 2 GEN, para. 2 (p. 23)) and were also excluded in the BCBS-IOSCO Paper (p. 6). This exclusion is a recognition that Exempt FX have unique characteristics that distinguish Exempt FX from other OTC-derivatives. The same characteristics that justify excluding Exempt FX from the IM requirements also justify excluding them from the Threshold calculations. Including Exempt FX could have illogical results: for example, a counterparty that enters into Exempt FX trades in very large volumes and other derivatives only in small amounts would be required to post and collect IM on the non-FX derivatives, even though the risk from the non-FX exposure is minimal. In addition, due to the short dated nature of most FX it is market practice to execute a second trade in order to close the risk of existing trades, rather than cancel or novate such trades. Therefore, the gross notional can be much larger than the net risk position on FX than for other classes. This will exacerbate the accidental capture of less risky counterparties.
- **Indirectly cleared transactions.** The RTS do not clearly address the treatment of indirectly cleared OTC-derivatives under the Thresholds. Indirectly cleared transactions are not generally viewed as uncleared for regulatory purposes. We therefore interpret the RTS to exclude such indirectly cleared derivatives from the Threshold calculations but this should be clarified in the RTS.

(v) **Inter-affiliate trades should be excluded from the 8B Threshold calculations.**

We ask the ESAs to clarify that inter-affiliate OTC-derivatives are not included in the 8B Threshold calculation whether or not such inter-affiliate transactions meet the requirements to qualify as intragroup transactions under Art. 3 and Art. 11(5) of EMIR. Inter-affiliate OTC-derivatives should be excluded because the 8B Threshold is determined on a group-wide basis for a party. The release accompanying the Draft RTS explains (p. 7) that the 8B Threshold "reduces the burden on smaller market participants, while still achieving the principle objective of a sizable reduction in systemic risk". The implication is that the 8B Threshold is intended to ensure that the margin requirements only apply to market participants that pose the greatest amount of systemic risk. The volume of intragroup transactions is not a good indicator of systemic risk. The special treatment of intragroup transactions by EMIR, including the

exemption from margin requirements, implicitly recognizes that such transactions cause less risk than transactions between groups.<sup>9</sup> As a result, inter-affiliate transactions should not be included in determinations as to whether a group is required to post IM.

**(vi) We request that the ESAs clarify the application of the 8B Threshold exemption.**

The Draft RTS do not address how the aggregate notional amount of non-centrally cleared derivatives is to be determined for purposes of the 8B Threshold exemption. Parties should have flexibility to set applicable parameters, such as currency exchange rates and time periods, to calculate the 8B Threshold. This would improve the ability of parties to anticipate changes in relevant notional amounts and thereby manage the risks of moving above or below the 8B Threshold over time.

Further, the ESAs should allow parties to rely on representations made by their counterparties as to the counterparty's status in relation to the threshold, with no additional due diligence required by the party receiving the representation. It should be the responsibility of the counterparty making the representation to immediately provide updates of any change to its status.

**B. The definition of a corporate "group" is most appropriately determined by the relevant party under applicable accounting standards.**

The Draft RTS provide that the Thresholds for IM are calculated with respect to entities which are in a "group" (Chap. 1, Art. 2 GEN, para. 3 (p. 23) and Chap. 5, Art. 1 FP, para. 5 (p. 46), although only Art. 2 explicitly refers to the EMIR definition of a group).<sup>10</sup>

The EMIR definition of "group" is not always appropriate when determining whether related entities are a "group" for the purposes of the Thresholds. Instead "group" should be defined by reference to the consolidated group determined under the accounting standards applicable to the ultimate parent of the group. If this approach is followed by other jurisdictions, it will enable counterparties in different jurisdictions to apply the thresholds to groups of entities on a consistent basis.

In many cases, FCs and NFC+s will not have independent access to the information to be able to determine whether their counterparties are part of the same "group" according to the definition in EMIR. Counterparties, especially those outside the EU, may not be familiar with the definitions in EMIR and may find it difficult to apply those definitions, particularly across a multinational group. However, those counterparties are more likely to be willing to confirm whether or not particular entities are included in the same group using the accounting standards applicable to the ultimate parent.

Therefore, as an alternative to applying the EMIR definition of a group, FCs and NFC+s should be able to determine that entities are only in a "group" if they are included (on a full basis) in a

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<sup>9</sup> We recognize that intragroup transactions are included in the calculation of the clearing thresholds. (ESMA Q&A, p. 15) However, in the clearing context, EMIR specifies how the threshold is calculated (EMIR, Art. 4), whereas EMIR does not specify how the 8B Threshold must be calculated.

<sup>10</sup> EMIR defines a "group" by reference to the definition in Directive 83/349/EEC (now replaced by reference to Directive 2013/34/EU) or Directive 2006/48/EU (now replaced by reference to Regulation 2014/575/EU).

consolidation in accordance with IFRS, US GAAP or other generally accepted accounting principles applicable to the parent of the relevant group.

### **III. IM MODEL**

#### **A. Models should not be required to capture main non-linear dependencies.**

The RTS should not require that the IM model capture main non-linear dependencies ("MNLDs") (Chap. 2, Art. 5 MRM para. 1(h) (p. 31)). Requiring models to capture all potential MNLDs would, when the requirement first takes effect, require an excessively complex model because such a model would potentially need to include second (if not higher) order sensitivities for all pairs of risk factors. This could exponentially increase the number of factors that must be incorporated in the model. In addition, it may be difficult for counterparties to agree on the relevant MNLDs for a particular transaction, adding to the difficulties of implementing the IM requirements. We also note that the BCBS-IOSCO paper did not require IM models to include MNLDs.

Moreover, after the IM models are in use, non-linear dependencies can be included in the IM model as they are discovered or revealed by examination of the models over time. Remediation, including inclusion of appropriate dependencies, should be done as part of governance and recalibration.

ISDA is currently developing a standard initial margin model ("SIMM") (as further described in the ISDA SIMM White Paper<sup>11</sup>). This model, and any other commercially viable model, must address concerns as to simplicity, speed and transparency. Requiring the IM model to capture MNLDs would make it significantly more difficult to address these concerns. The SIMM (and other comparable models) will also be extensible and will be remediated periodically on the basis of ongoing monitoring of portfolios. Before any recalibration, the SIMM (or another comparable model) would be extended to include any new factors or newly isolated second order sensitivities of existing model risk factors based on the ongoing monitoring and investigation of margined portfolios. We submit that this approach sufficiently addresses the risks anticipated by the RTS while preserving the essential characteristics of the standard IM model.

We therefore request removal of the general requirement to capture all MNLDs in the IM model.

#### **B. Market participants should have flexibility in recalibrating IM models to reduce pro-cyclicality and make other appropriate adjustments.**

The Draft RTS require the model to be recalibrated every six months and requires transparent and predictable procedures for adjusting margin requirements. (Chap. 2, Art. 3 MRM paras. 7 and 8 (p. 30)).

Market participants should have flexibility in adjusting their models to minimize pro-cyclicality, subject to the governance procedures described below. Otherwise, a period of market dislocation

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<sup>11</sup> ISDA, "Standard Initial Margin Model for Non-Cleared Derivatives" (December 2013, updated March 2014). Available at: <http://www2.isda.org/attachment/NjM3Nw==/SIMM%20for%20Non-Cleared%20Paper%20&%20Appendix.pdf>.

would generally result in an increased demand for margin. Such an increased demand could create a spiral that causes counterparties to demand larger amounts of collateral, causing distressed markets to become even more illiquid. In a paper recently issued by the Bank of England, the authors stated that "the analysis [in the paper] suggests that model calibrations which give higher weight to recent data are more pro-cyclical".<sup>12</sup>

Consequently, IM levels should not be explicitly linked to market levels or volatility, nor should scenarios automatically update with time. Instead, we propose that the model be recalibrated annually, subject to a review by a governance structure of the market participant that (i) monitors the coverage of the model through conducting quantitative impact studies (QIS) after the execution of each recalibration, (ii) determines if an update to the model is needed, and (iii) recommends a phase-in schedule for changes to the model affecting posted IM amounts. Moreover, any increase in IM requirements should be subject to the discretion of regulators, acting on a coordinated global basis, who may at a time of stress find it more prudent to phase-in, in discrete steps, a calibration increase.

The "transparent and predictable procedures" described in the Draft RTS can and should accommodate the process described above for recalibration. The Associations' members would welcome the opportunity to work with the ESAs in designing such a process.

### **C. The Draft RTS requirements for the components of models are too rigid and detailed.**

The Chapter 2 MRM provisions on IM models are too detailed and prescriptive and will prevent market participants from designing effective models in the time available for compliance. One example is the requirement for the use of six maturity buckets. (Chap. 2, Art. 5 MRM para. 1(b) (p. 31)) For different asset classes, this number of maturity buckets may not be appropriate and relevant data may not be available. We therefore propose that the RTS set general minimum standards, rather than specific rules, and provide for appropriate supervisory oversight. These general minimum standards should be the nine criteria listed below, which are discussed in greater detail in the White Paper.<sup>13</sup> The criteria are:

- Non-pro-cyclicality
- Ease of replication
- Transparency
- Quickness of Calculation
- Extensibility
- Predictability
- Reasonable Cost
- Governance
- Margin Appropriateness

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<sup>12</sup> Financial Stability Paper No. 29 – May 2014, "An investigation into the procyclicality of risk-based initial margin models"; by David Murphy, Michalis Vasios and Nick Vause, issued by the Bank of England.

<sup>13</sup> ISDA SIMM White Paper, p. 3.

#### **D. Permit risk classification.**

The RTS provide that IM models must assign each derivative contract to an underlying class (interest rates/currency/gold; equity, credit; and commodity/other) for the purpose of calculating IM and accounting for diversification, hedging and risk offsets. (Chap. 2, Art. 4 MRM, para. 1 (p. 30)).

We propose instead that parties be permitted to determine IM based on risk sensitivities of the portfolio. Such a determination would be made by aggregating each type of risk (for rates; equity, credit; and commodity) across the portfolio and then aggregating the total amount of risk. Market participants may prefer use of risk sensitivities because it aligns IM closer to the portfolio's economic risk, thus providing appropriate incentives for risk management. Using risk to silo different types of risk in the portfolio is consistent with the goal of avoiding over-modeling correlations between disparate types of risk factors. Because risk factors are clearly identifiable as belonging to a single asset class, use of risk factors would be practical, would maintain risk management incentives and produce clear and well-defined netting sets for modeling purposes.

In contrast, classifying derivatives by asset classes rather than risk sensitivities raises a number of issues, including:

- It may be difficult to determine the appropriate asset class for a trade. For example, a derivative with significant exposure to both equity and rates needs to be classified as either “Equity” or “Rates & FX” at trade inception. Even if the parties to the derivative agree on a particular classification, they may disagree with other market participants. As a result, a party may end up using different classifications for the same trade type if it is facing different counterparties.
- The appropriate classification may change over time. For example, a derivative with exposure to equity and rates, the principal source of risk may shift over time such that the initial classification as either “Rates & FX” or “Equity” may cease to be appropriate. The same trade type may end up being classified differently depending on when and in what market conditions it was executed. The overall view of risk becomes distorted if what was classified as a “Rates & FX” trade becomes in essence an “Equity” trade but remains in a “Rates & FX” silo.
- Use of asset classes could impede effective portfolio hedging. For example, a trade classified as “Equity” may significantly contribute to overall FX risks in a portfolio. Simple direct FX hedges can reduce FX portfolio risk. However, IM will most likely be increased by such a hedge and parties will be disincentivized from a prudent hedging action.

Due to these concerns, we submit the RTS goals would be better met if parties are permitted to use either risk factors or asset classification.

**E. Parties should be permitted (but not required) to include non-derivative assets in the model.**

Counterparties often have exposure to the same risk factors in multiple markets. Therefore, we submit that IM models would be most effective if they are allowed to capture parties' exposure with respect to risk factors across various types of assets, including non-derivatives. In order to permit netting among such assets, the assets would have to be a part of a netting set as defined in the Draft RTS. In addition, certain products may be viewed as derivatives in one jurisdiction but not in another, and parties should be permitted to include such products to achieve global consistency. For instance, if two parties have exposure to equity risk to each other, one by way of equity options, and another by way of equity swaps, the parties should be able to take this into account in the models. This type of modeling would present a more accurate reflection of the actual exposure of each counterparty with respect to certain risk factors, and would eliminate the posting of redundant margin, which would only decrease liquidity in the derivatives markets.

**F. Margin period of risk should be calculated from the last collection of VM and should not be dependent upon liquidity, size and concentration of positions.**

The Draft RTS propose that the margin period of risk ("MPOR") for calculating IM be at least 10 days and take into account the time from the "last collection of the margins" and the "level of liquidity, the size and concentration of the positions in relation to the markets where such positions are traded". (Chap. 2, Art. 2 MRM, para. 2 (p. 29)) We propose that the ESAs specify that the MPOR starts from the time of the last collection of VM, rather than the "last collection of the margins". In addition, MPOR should not depend on liquidity, size and concentration of positions and we request that the ESAs delete sub-paragraph 2(b) of Chap. 2, Art. 2 MRM.

**G. Requirements for the internal ratings models raise significant implementation issues.**

The Draft RTS require a collateral taker to assess the credit quality of certain items of collateral using approved internal rating based ("IRB") approaches or ratings of a registered credit rating agency. Chap. 3, Art. 3, Para. 1 (p. 34).

Parties will therefore need to use the IRB approach if an item of collateral is not rated by a credit rating agency. Yet use of the IRB approach would raise issues because IRB models are complex and often proprietary.

The complexity of IRB models may mean that it would be impossibly onerous to create IRBs for all non-rated collateral. Without a separate IRB specifically for collateral, parties may have difficulties using existing IRB models. Existing IRB models typically apply to counterparty obligations which are non-marketable (such as loans) and which may have a different seniority and recovery level than securities posted as collateral.

The proprietary nature of some IRB models would prevent a party from making its model transparent to a counterparty and explaining changes in the model which could result in changes to margin requirements. Such lack of transparency will make it difficult to resolve disputes: a party using a proprietary IRB model would not be able to fully disclose the reasons for its credit assessment to its counterparty.



The RTS requirements should therefore be redrafted to make the IRB approach viable as a means of credit quality assessment. The Associations would welcome an opportunity to further discuss the IRB approach with the ESAs.

#### **IV. COLLATERAL REQUIREMENTS**

##### **A. The eligibility and haircut requirements are not consistent with the BCBS-IOSCO paper.**

The Draft RTS propose extensive requirements for the eligibility and haircutting of collateral, including specific eligibility requirements, concentration limits, credit quality assessments, and limits on wrong way risk. These requirements are significantly more onerous and detailed than the requirements in the BCBS-IOSCO Paper and will add significantly to the operational complexity of implementing the margin requirements. Market participants have strong incentives, outside of regulation, to request collateral in sufficient amounts and of sufficient quality because the collecting party will suffer a loss if the posting party defaults and the collateral is inadequate. We therefore strongly urge the ESAs to adopt general principles for adequate levels of collateral and then exercise on-going supervision to ensure that those principles are met. We offer the following specific comments:

##### **(i) Concentration Limits:**

- **No Specific Percentages:** The Draft RTS should not impose specific percentage concentration limits on IM or VM. As discussed above, market participants have strong incentives to request adequate collateral to protect themselves against counterparty insolvency. This would include ensuring sufficient diversity in the collateral. Moreover, diversification will not always strengthen the position of the collateral taker. For example, equity derivatives are often stand-alone transactions secured by the relevant underlying stocks in order to maintain a correlated hedge at all times. Introducing an obligation on the parties to diversify collateral in this context will have the effect of increasing, rather than mitigating, the risks of collateral takers by generating a discrepancy between moves in the mark to market of the relevant transactions and moves in the value of uncorrelated collateral and by potentially disrupting the collateral takers' hedge positions. Also, diversification will increase the types of collateral that need to be transferred and such increase will result in additional settlement and operational risks and the burden of implementation for all parties.

We suggest a general supervisory requirement, as proposed in the BCBS-IOSCO Paper (Section 4.4), that parties should ensure that collateral is not overly concentrated in terms of an individual issuer, issuer type, and asset type.

- **Sovereign Debt:** If the ESAs do not accept our proposal above to remove specific concentration limits entirely, we request that sovereign debt be exempted from the specific percentage concentration limits. In many jurisdictions, sovereign debt is the main form of collateral used for derivatives. Sovereign debt does not generally have the same credit issues that apply to corporate debt and therefore should not be subject to the same concentration limits.

- **Equity Derivatives:** If the ESAs do not accept our proposal above to remove specific concentration limits entirely, we request that equity derivatives collateralized by the relevant underlying equities be exempted from the specific percentage concentration limits. These transactions in which collateral consists of the relevant underlying shares should also be exempted from the eligibility requirement that collateral in the form of equity must be included in main indexes. (Chap. III, Art. 1 LEC, para. 1(q) (P. 34))
- **Concentration Threshold:** We suggest that concentration limits should not apply to margin that falls below a specified threshold. As the Draft RTS points out (p. 38), if concentration limits apply to small amounts of margin, the posting party would need to diversify into multiple smaller lots which could pose significant operational burdens relative to the size of the collateral and exposure. In addition, the liquidity considerations that concentration limits are designed to mitigate are not applicable to small portfolios because the liquidation of small amounts of margin should not have a significant impact on the market. For these reasons, we submit that the introduction of a threshold for the application of concentration limits is appropriate and suggest that the threshold be set at EUR 100 million.

(ii) **Wrong Way Risk:** Wrong way risk for sovereign debt should only apply to derivatives with the relevant sovereign as a counterparty. Many sovereigns have direct or indirect ownership stakes in various market participants. It would be a severe restriction on such market participants if they were unable to post bonds issued by the government that carried a stake in such market participant. This restriction is not appropriate given that there is little wrong way risk in, for example, a bank with partial government ownership using that government's bonds as collateral.

(iii) **Close Links:** The concept of "close links", which can mean as little as 20% common ownership, is used in both the concentration limits and the wrong way risk section of the Draft RTS. It is extremely difficult for parties to know who has 20% stakes in the issuers of the relevant collateral. In addition, a 20% stake will not necessarily be an indication of a relationship that justifies including the owner in a concentration limit or wrong way risk test. This is an area in which the collecting party should have the discretion to determine what collateral is acceptable.

(iv) **Group:** The concentration limits and the wrong way risk requirements assume that FCs and NFC+s accepting collateral will always be able to identify whether issuers are part of the same "group" within the meaning of EMIR. This raises similar issues to those discussed above in determining "groups" for purposes of the Thresholds, except that in this case the FC or NFC+ will not have a direct relationship with the issuer of the collateral and so will not be able to obtain appropriate representations. If collateral requirements use "group" status for concentration or wrong way risk, then the "group" determination should be based on accounting determinations which will be more readily available from the issuer of the relevant item of collateral.

(v) **UCITS:** The Draft RTS require analysis of a UCITS' underlying assets in order to determine whether units or shares in the UCITS are eligible as margin. Chap. 3, Art. 5 LEC,

paras. 4 and 5 (p. 37). This eligibility condition will not be workable in some cases because UCITS may not make the relevant information available.

**B. As proposed, compliance with concentration limits may be excessively burdensome for some counterparties.**

The RTS require counterparties to post margin subject to concentration limits. However, certain types of counterparties are particularly constrained in their ability to meet concentration limits. In particular:

- **Emerging market entities:** Many emerging market counterparties are only able to post sovereign debt of their national jurisdiction and cash. In many such jurisdictions, the corporate bond and repurchase markets are either undeveloped or not sufficiently robust to permit them to source other types of eligible collateral. Requiring such parties to comply with concentration limits may make it uneconomical for them to enter into derivatives with EU counterparties.
- **Pension plans and insurance companies:** Pension plans and insurance companies tend to be fully invested in the securities that best meet their objectives and applicable regulatory requirements. If pension plans or insurance companies enter into derivatives, it is most efficient for them to post the securities in their portfolios. However, the concentration limits in the Draft RTS would, in many cases, require pension plans or insurers to use the securities other than the ones in their portfolios. As a result, under the Draft RTS, pension plans and insurers would potentially need to obtain cash or other securities if they wished to hedge their risks through OTC-derivatives. This would pose significant costs to pension plans and insurance companies, and disincentivize hedging. Because pension plans and insurance companies are already subject to extensive regulation, it seems particularly onerous to impose additional costs on them in connection with hedging.
- **Funds:** Certain funds have narrow investment scopes or specific investment concentrations that do not contemplate the holding of a significant amount of eligible assets. Since such funds would not have a ready pool of eligible collateral, they would find it particularly difficult to post margin in a cost effective manner.

Given these additional complications we urge the ESAs to relax the concentration limits, especially with respect to sovereign debt.

**C. In lieu of using the 8% FX haircut, parties should be allowed to develop alternative means to address any FX mismatch between exposure and collateral.**

The industry should be allowed to develop alternatives to the 8% FX haircut because of the risks and inefficiencies described below. Specifically, we propose that parties should be allowed to include the risk of collateral, both VM and IM, with the portfolio of uncleared derivatives when measuring the portfolio risk in the IM calculation. In so doing, collateral will fall naturally into its respective asset class risk category: VM cash collateral naturally reflects currency risk and falls into the FX and Rates class; IM collateral will naturally fall into its respective risk class,

e.g., corporate bonds will fall into the Credit class. Additionally, we propose that FX risk on trades within asset classes other than the FX and Rates class should be considered together in the FX and Rates class.

An additional method of addressing the FX mismatch would be to use a "transport currency", which is part of the mechanism developed by ISDA in its 2013 Standard Credit Support Annex. Under this mechanism, each party calculates net exposure per currency for a counterparty. The party then conducts FX trades for the net exposure amount between the relevant VM currency exposures and the relevant "transport currency", which is one of the G7 currencies selected by the parties. The FX trades may be performed in the way that the receiving party wishes (i.e., as many individual FX trades or as a small number of net FX trades across multiple transport currency flows that may occur across counterparties on a given day.) The parties settle the relevant amounts in the transport currency, thereby avoiding Herstatt risk. The parties pay each other interest at the overnight rate for each currency amount as if the actual currency amounts (rather than the transport currency amount) had all been paid and received.

Neither approach described above will necessarily address all FX risks so it may be appropriate to use both approaches in combination or to use other approaches as well. We propose that ISDA and its members present alternatives to the ESAs at a later date.

The 8% FX haircut in the Draft RTS will create the following risks and inefficiencies:

- i) Any counterparty that does not post VM in the currency of its exposure will have to post more VM than its mark to market ("**MTM**") position. Since the VM is not segregated, the collateral poster will have credit risk on the collateral recipient for the amount over-posted. The long-run credit exposure might be between 4 and 6% of the aggregate MTM of current trades, and we estimate the aggregate MTM to be in excess of 1 trillion USD. This outweighs the decrease in risk achieved through the adoption of the proposed new VM rules.
- ii) FX risk will be double counted if the collateral does not match the currency of the exposure. The FX risk inherent in a trading position will be captured in the IM calculation. As is always the case, this will be measured against the base currency. Thus, an 8% FX haircut will take the FX risk into account twice: first through the 8% FX haircut and, second, through the IM calculations.
- iii) FX risk will also be double counted when trades in different asset class buckets have offsetting currency exposures. This will result in zero risk positions requiring IM, causing a funding requirement for a firm even though it has no residual risk.
- iv) If firms do decide to collateralize in the same currency as the exposure, this will dramatically increase the number of margin movements that take place between two entities on a single day. This will result in significant operational and settlement risks.
- v) Operationally, the 8% FX haircut will not function as haircuts currently do, and therefore will require an additional IM-like calculation being built in parallel to building the IM calculation for trades. The 8% FX haircut differs from other haircuts in that the FX haircut is a function of both the MTM and the currency of the underlying exposure and

collateral, necessitating both to be reassessed dynamically on a daily basis. As a result, setting up and maintaining the FX haircut will require extensive technical and operational capabilities.

- vi) Because ISDA members currently do not collateralize in this way, existing agreements do not account for the 8% FX haircut. Hence, the operational burden for putting VM in place will be significantly increased: ISDA members will need to revisit existing CSAs and will face added complexity in signing up new ones.

We will provide examples that are too detailed for this paper and submit them to the ESAs. We would then welcome the opportunity to discuss the examples and possible approaches to addressing the FX mismatch.

**D. Collateral treatment requirements should not apply to margin that is not required to be collected under the Draft RTS.**

The eligibility and other requirements of the RTS should not apply to the collection of margin that is not required by the RTS. Chap. 5, Art. 1 FP, paras. 3 and 4 (p. 46) explicitly recognize the principle that counterparties should be able to post collateral greater than the minimum requirements of the RTS. In particular, paragraph 3 states that, where one party is below the relevant threshold, the parties may agree that IM will not be collected "in accordance with the procedures described in this Regulation", thus making it clear that, in those circumstances, the parties may exchange IM on a different basis than that set out in the RTS if they so choose.

We request that the RTS explicitly recognize that the same principle applies in other cases where the RTS permits parties to agree not to exchange margin. For example, an FC or NFC+ is permitted to opt out of margin arrangements with an NFC- or parties exempt under Art. 1(4) or (5) of EMIR. If the parties voluntarily agree to post IM or VM, this IM or VM should not be subject to the requirements of the RTS. If an NFC- chooses to provide collateral, the NFC- should not be limited to collateral that is eligible under the RTS. Similarly, the RTS should explicitly recognize that even where an FC or NFC+ is required to collect IM or VM, it may accept additional collateral (beyond the amount required under the RTS) otherwise than in accordance with the procedures described in the RTS. The RTS should also recognize that the margin requirements do not extend to collateral collected against non-derivative products.

Imposing the eligibility and other requirements of the RTS on collateral posted voluntarily would have very significant consequences for all collateral arrangements. Credit support arrangements with NFC-s, for example, would have to be extensively re-negotiated even though NFC-s are given an exemption under the Draft RTS. In many cases, it may not be feasible to maintain voluntary collateral in accordance with RTS requirements, thereby restricting the ability of parties to negotiate additional protections where necessary to address credit risk in an appropriate way. Given the absence of discussion of this topic in the Draft RTS, we do not believe that the ESAs intended to propose such far-reaching consequences.

Therefore, we propose including the following in Chap. 1, Art. 2 GEN:

"The requirements of this Regulation (including, but not limited to, eligibility, collateral management, segregation and rehypothecation) do not apply to collateral that is not required to be collected as initial margin or variation margin under this Regulation."

## **V. INITIAL MARGIN**

### **A. Collection of IM is subject to the time required to deliver the collateral.**

Chap. 1, Art. 1 EIM, para. 3 (p. 27) of the Draft RTS requires counterparties to collect IM within the business day following the execution of a new contract. We note, however, that actual delivery of IM is subject to the time required to arrange delivery of the relevant asset. For example, for parties in the EU, delivery of Asian securities will require more time than transfers of Euros. Subject to the discussion on how frequently delivery of IM is required (see below), we ask the ESAs to clarify that IM must be called for on a regular basis and delivered promptly after the call.

### **B. A longer period for calculation of IM should be permitted.**

We support the requirement for a regular call for IM, but the business day following the relevant trade is not an operationally practicable timeline. IM is generally more difficult to calculate than VM due to complex calculations and trade reconciliation. In addition, many counterparties have offices and branches in different jurisdictions and transact with counterparties located in different jurisdictions and different time zones. A proper calculation of IM required to be collected can only be made when the books of all market participants are closed, which for most global market participants will only occur on weekends. This is especially critical because IM thresholds are calculated on a group basis, so all branches and offices of a counterparty must be closed in order for the calculation to be correct. For these reasons, IM should be required to be called for on a weekly basis.

## **VI. VARIATION MARGIN**

### **A. The RTS should give market participants flexibility in valuing exposures and VM.**

The Draft RTS provide (Chap. 1, Art. 1 VM, para. 2 (p. 27)) that VM must be based on valuations calculated in accordance with 11(2) of EMIR and Arts. 16 and 17 of Regulation 149/2013.

We propose that VM collection be based on an appropriate measure of current credit exposure, as agreed between the parties. The requirement that VM needs to be calculated in accordance with the EMIR mark to market or mark to model methodology is too prescriptive. Because of the wide variety of possible derivative structures, an overly specific requirement for valuation could lead to inappropriate selection of exposure metrics and mis-management of VM relative to risk. Flexibility in valuation procedures is particularly important for trades that are illiquid, for which there is no "market", and for which the parties' models do not generate the same result. In such cases, the valuation and/or a general valuation mechanism would need to be agreed between

the parties. We request that the ESAs confirm that parties can rely on others to value exposures and collateral.

**B. The frequency of calls for VM should be flexible.**

The Draft RTS require VM to be collected at least daily. (Chap. 1, Art. 1 VM, para. 1 (p. 27)) Subject to the discussion below regarding delivery of VM, we request that some flexibility be built into the requirement for markets for which daily VM margining would pose significant operational hurdles. Such a flexible standard would be consistent with the BCBS-IOSCO proposal (para. 2.1, p.9), which provides that parties "must exchange ... the full amount of variation margin ... on a regular basis (e.g. daily)." This flexibility is particularly critical for parties outside the EU. Under the draft RTS, non-EU parties (subject to some exceptions) will have to exchange VM with EU counterparties which may simply not be possible to arrange for on a daily basis by 2015. We therefore propose that the rule provide that VM will be called for on a regular basis, subject to regulatory review.

**C. Collection of VM is subject to the time required to deliver the VM.**

The Draft RTS require counterparties to "collect variation margins at least on a daily basis starting from the business day following the execution of the contract". (Chap. 1, Art. 1 VM, para. 1 (p. 27)) However, the delivery of collateral constituting VM is subject to the time required to settle the transfer of the assets. Therefore, we request the ESAs clarify that the timing requirements for VM are with respect to calls for collateral rather than actual delivery, and that actual delivery of VM will be subject to the time required to deliver the relevant asset.

**D. Confirmation that VM is not subject to segregation requirements.**

It is our understanding, based on the absence of any prohibition in the Draft RTS, that VM is not subject to any segregation requirements and may be freely transferred, used or rehypothecated by receiving parties. We would be grateful if the ESAs confirm this interpretation.

**VII. IMPLEMENTATION TIMING**

**A. Implementation of requirements should be recalibrated.**

The Draft RTS require VM and IM (for the derivative counterparties that exceed the relevant Thresholds) to be collected starting December 2015.

We request that the requirements do not become effective until at least two years from the date on which final rules are adopted in all of the US, Europe and Japan. In addition, the implementation date should occur in February, or a month other than December or January when financial institutions are generally going through the year-end book closing process.

We estimate that market participants will need a minimum of two years from the time when final rules are adopted to the time when market participants are required to exchange VM and post IM. Compliance with the margin requirements will entail significant time and investment related to technological and other operational requirements. For example, risk management systems must be recalibrated and models and output will need to undergo rigorous testing before

implementation. In addition, the regulatory process for model approval is likely to be time-consuming, especially for the initial approvals, which will occur simultaneously for many entities and with many regulators.

Counterparties will be required to make changes to their credit support and custodial arrangements, which will require significant amounts of time to negotiate. Each custodian will have its own form of documentation and parties may well have to enter into agreements with multiple custodians. The custodians will not be subject to a direct regulatory obligation to reach agreement by the deadline for the margin requirements. It is our members' experience that even in the current environment it frequently takes six months or more to negotiate and establish a tri-party custodial arrangement for derivatives trading, and that related technology build-outs usually take at least nine months. Following adoption of a margin rule, this time period is likely to increase as custodians respond to a very significant volume of document requests. The limited number of custodians will exacerbate this challenge.

Counterparties will also need to consider the different sets of rules issued by regulators from various jurisdictions. Due to the global nature of the margin requirements, market participants will need to ensure that new documentation, models and technological and other operations are consistent with the requirements set forth by all regulators. It is difficult for the Associations to formulate a full response to the RTS without first reviewing the proposed rules from the US and Japan, which will be crucial to the efforts to implement a global margin architecture.

In light of the above, we request that the requirements do not become effective until at least two years from the date on which final rules are adopted in all of the US, Europe and Japan. This will allow market participants to begin developing systems and preparing for compliance with the rules prior to their effective date. In addition, delaying the implementation of IM for some time after the effective date of the VM requirements would reduce the burden on the markets by allowing a step-by-step implementation and will permit market participants to prepare for margin requirements on an incremental basis.

#### **B. Include a phase-in period for VM.**

If the ESAs do not set the effective date for IM and VM requirements at least two years from the date on which final rules are adopted in all of the US, Europe and Japan, we request there be a phase-in period for VM. While it is true that many parties currently post VM, especially in the inter-dealer market, this practice is far from universal. For example, in certain jurisdictions with less developed derivatives markets, VM posting is not typical. These markets may not have well established collateral protection schemes or sufficiently well developed operational procedures to handle daily collection of VM. In addition, large numbers of counterparties do not post VM, because of operational demands and costs, documentation requirements or availability of acceptable collateral.

Implementation of the VM requirements as proposed in the RTS will also require fundamental changes to existing VM arrangements. The haircuts, eligibility requirements and documentation requirements will require extensive new operational and documentation arrangements. These arrangements will need to be agreed bilaterally: for the legal agreements, for example, it will not be possible to adopt a one-size-fits-all agreement to govern all exchanges of VM in the market.



Differences will arise because different parties will have different types of available collateral, different market sensitivities and different legal concerns.

One large dealer, which the Associations believe to be representative of other large dealers, estimates that it has 11,000 credit support arrangements ("**CSAs**") covering 98% of current mark to market risk. It would need to negotiate and implement another 14,000 CSAs to eliminate the remaining 2% of mark to market risk. This is not practical or cost effective and the most likely result is for smaller market participants to be unable to continue trading with the dealer.

As a comparison, the additional risk that would be created by the proposed FX Haircut would be 4% to 8% of the mark to market (two to four times the amount of risk reduced by more than doubling the number of CSAs).

To avoid the situation where market participants with non-systemic levels of risk are forced out of the market by not being able to meet VM operational and documentation requirements a mechanism needs to be established to exclude them. We suggest two alternative mechanisms:

(1) Phase in VM with zero thresholds in line with the IM phase-in using the 8B Threshold, except that an expedited schedule would be used for VM: decrease the threshold level (EUR 3 trillion, 2.25 trillion, 1.5. trillion, 0.75 trillion, 8 billion) in two month increments beginning on the date of implementation. This would ensure all market participants of systemic importance would eventually pay daily VM while non-systemic market participants would not need to post; or

(2) Allow the 50M Threshold to apply to the combination of VM and IM. Market participants of non-systemic importance should therefore be able to trade without a credit support arrangement unless they reach a mark to market of EUR 50 million (whereupon they would need to execute a credit support arrangement or cease further trading).

**C. Discussion.** ISDA would welcome the opportunity to work with regulators to devise the alternatives described above to ensure that market access is maintained while ensuring capture of systemic risks for all counterparties.

**D. Non-Netting Jurisdictions.** For countries where satisfactory netting opinions cannot be obtained, market participants typically do not employ collateral as a risk mitigant. Without enforceable netting there is the risk that the administrator will "cherry-pick" from posted collateral to be returned in the event of insolvency which results in an increase in the risk in posting collateral.

Moreover, requiring collateral collection diminishes the incentives to accept more effective alternative mitigations such as using limits to contain exposures, re-pricing trades, selling options and using short dated trades.

As a result, a phase-in period should be applied to posting VM with counterparties in non-netting jurisdictions in order to avoid the risk of forcing participants to employ collateral collection where it is ineffective.

## VIII. SEGREGATION

### A. "Immediate availability" of IM is not practically feasible and should be replaced with a requirement for prompt access to IM.

Chap. 4, Art. 1 SEG, para. 4(a) (p. 42) of the Draft RTS provides that, under the applicable IM segregation arrangements, the IM must be immediately available to a collecting entity where the posting counterparty defaults.

We support the creation of robust segregation regimes, but the "immediately available" standard will not be possible to apply in practice. Many jurisdictions impose stays or other restrictions on the availability of IM upon bankruptcy of the posting party. For example, under the EU Bank Recovery and Resolution Directive, the resolution authorities will have the power to suspend the enforcement of security interests for a period ending at midnight on the business day following publication of the notice of the taking of resolution action.<sup>14</sup> Similarly, in the US, derivative counterparties of a bank insured by the FDIC are subject to a stay in exercising termination rights until 5:00 pm on the business day following appointment of a receiver.<sup>15</sup> If the ESAs impose an "immediately available" standard without regard to local bankruptcy stays, then EU entities would be effectively prohibited from entering into derivatives with counterparties in any jurisdictions that prevent immediate access to collateral upon a bankruptcy.

In addition, for IM held at a third party custodian, IM will only be available to the collecting party after the custodian goes through its required procedures. These procedures include the necessary operational steps for transferring the IM and may include verification of the legitimacy of the collecting party's claim for IM. Custodians may also insist on payment of their fees before releasing collateral from custodial liens. In addition, the parties may also agree that the posting party has a right to object to release of the collateral by the custodian if the posting party can claim that the demand is not appropriate. Imposing an "immediately available" requirement would conflict with these operational and verification processes which serve a useful purpose in safeguarding the IM, as well as standard custodial liens.

Art. 194(4) of the Capital Requirements Regulation recognizes these practical issues by providing that institutions may only recognize "funded" credit protection in the calculation of credit risk mitigation where the lending institution has the right, in the event of the default of the obligor, to liquidate or retain the "funded" collateral "in a timely manner". The RTS should also recognize that realization may take place in any of the ways specified in the Financial Collateral

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<sup>14</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, Art. 70. Available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>

<sup>15</sup> 12 U.S.C. §1821(e)(10)(B).

Directive<sup>16</sup> but should allow for other possible methods of realization in the event that the arrangements are governed by another system of law.

As a result, we propose that Chap. 4, Art. 1 SEG, para. 4(a) (p. 42) be re-phrased as follows:

"the relevant agreements must provide that the collecting party has the right to realize (by sale, appropriation, set-off or otherwise) the initial margin, in a timely manner, upon the default of the posting counterparty;"

**B. Other segregation structures bear additional consideration.**

We strongly support the creation of a regime for the protection of margin. However, because some entities lack the ability to create certain types of security interests, flexibility is required. Structures other than the one proposed in the Draft RTS merit further consideration by the ESAs so long as they achieve the goal of significantly mitigating counterparty risks. For instance, title transfer and charge-back of margin is a structure that is commonly used in the market and provides protection to counterparties. In addition, some parties, such as trustees of pension schemes, may not be able to create financial collateral arrangements with respect to IM. Other entities may be limited by the nature of their assets. For these reasons, the RTS should permit more flexible segregation arrangements, so long as they sufficiently mitigate counterparty risk.

**C. Segregation of cash IM will meet the segregation requirements if such cash is segregated from the proprietary assets of the collecting party.**

Chap. 4, Art. 1 SEG, para. 1 (p. 42) requires IM to be segregated from proprietary assets on the books and records of a third party holder or custodian, or via other legally effective arrangements. In addition, Chap. 4, Art. 1 SEG, para. 3 (p. 42) requires cash IM to be segregated individually, unless other legally effective arrangements are in place to segregate it from proprietary assets.

Several additional clarifications of the segregation criteria for cash IM would be helpful. First, the RTS should clarify that segregation from proprietary assets means segregation from the proprietary assets of the *collecting party*. Cash IM held by a custodian should meet this test so long as the cash IM is held in an account that is not the property of the collecting party.

In addition, the RTS should make clear that cash IM will be deemed appropriately segregated if it is held in an account at the collecting party that is protected in the event of insolvency by a regulatory regime that protects client money or other legal means. We note that Chap. 4, Art. 1 SEG, para. 1 (p. 42) permits segregation of IM "via other legally effective arrangements", while Chap. 4 Art. 1 SEG, para. 3 (p. 42) permits non-individual segregation of cash IM so long as "legally effective arrangements are in place to segregate it from proprietary assets". We submit that these requirements will be satisfied if the cash IM is held in a legally effective arrangement for segregation from proprietary assets. This should include holding cash IM in an account of the collecting party, so long as the collecting party and the posting party have a reasonable legal

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<sup>16</sup> Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, as amended.

basis for the view that such IM would be segregated from the collecting party's proprietary assets.

#### **D. Legal opinions.**

Chap. 4, Art. 1 SEG, para. 5 (p. 42) requires the counterparties to obtain legal opinions to confirm that a segregation arrangement meets the requirements of Chap. 4, Art. 1 SEG, paras. 3 and 4 (p. 42). While we support the requirement for obtaining proper legal advice with respect to segregation arrangements, we believe the Draft RTS requirement for legal opinions should be altered as follows:

##### **(i) Legal opinions/advice should only address segregation.**

Under the language described above, the Draft RTS require opinions as to the following matters: (i) that cash IM is segregated from proprietary assets if the cash IM is not subject to individual segregation, (ii) that IM is immediately available to the collecting party, and (iii) that the posting entity is "sufficiently protected" if the collecting party becomes bankrupt. Neither "immediate availability" nor "sufficient protection" are legal concepts, but rather determinations made by counterparties after taking into account operational issues and any relevant risk tolerance. In particular, the notion of "sufficient protection" is especially unclear from a legal perspective, as it is not clear what standard such sufficient protection is required to meet. "Immediate availability" is also problematic, as it would necessarily be subject to insolvency stays, potential legal actions and operational matters. As a result, legal opinions cannot address "immediate availability" or "sufficient protection."

We propose that the opinions (or views, as discussed below) should address segregation directly. Thus, we would suggest that the legal opinion (or view) that should be required is that the IM will not become part of the proprietary assets of the collecting party in an insolvency proceeding of the collecting party.

##### **(ii) Parties should be required to have a well-founded legal basis rather than opinions.**

Rather than requiring opinions, the RTS should instead require counterparties to have a well-founded legal basis that IM is segregated. The segregation arrangements may vary between different counterparties and may vary over time. Obtaining a formal legal opinion for each different arrangement would be extremely expensive and time-consuming. A party should be able to establish basic segregation parameters, subject to legal advice, so that the party can have a well-founded legal basis that operations within those parameters will achieve segregation. In many cases, the internal lawyers and the staff overseeing the IM arrangements will be much better placed than outside lawyers to determine compliance with segregation requirements. Either party will, of course, have the option of requesting an opinion of external or internal counsel, but it should not be required.

##### **(iii) Parties should be able to rely on industry-wide legal advice.**

The Draft RTS should make it clear that counterparties may rely on standard industry-wide legal advice developed by market participants. Counterparties should not be required to obtain bespoke legal advice with respect to each new segregation arrangement, which could prove time

consuming and expensive. If industry-wide legal guidance is available with respect to certain standard segregation arrangements, such arrangements will be faster to implement and easier for both counterparties and regulators to analyze. ISDA currently works to provide derivatives markets with certain industry standard opinions, including netting opinions on insolvency, and similar standardized industry guidance will enhance the efficiency of the derivatives market with respect to segregation arrangements. In addition, counterparties should be able to rely on suitable opinions obtained by service providers such as custodians.

**(iv) Opinions are not required to be refreshed for each trade.**

The Draft RTS require market participants to obtain legal opinions "at the inception of the transaction and at regular intervals thereafter". Our understanding of this requirement is that such legal opinions must only be obtained at the inception of the custody arrangement rather than each individual trade subject to such arrangement. We would appreciate clarification by the ESAs that appropriate legal advice would only be required at the time the segregation arrangements are established, rather than at the inception of each trade.

**(v) Market practice to be considered in the context of netting opinions.**

The Draft RTS defines a "netting set" (Chap. 1, Art. 1 DEF, para. 1(j) (page 22)) by reference to Art. 272(4) of Regulation (EU) 575/2013, which defines it as "a group of transactions between an institution and a single counterparty that is subject to a legally enforceable bilateral netting arrangement." While some jurisdictions have well established netting regimes and corresponding opinions, this may not be true with respect to certain markets. In such instances the determination of whether a netting agreement is legally enforceable is properly considered in the context of market practice. For instance, if the market has taken a consistent view on the procedures and enforceability of netting in a certain jurisdiction, counterparties should be able to establish netting sets based on such views. Otherwise, such jurisdictions would be closed to EU counterparties if no netting sets are recognized. For these reasons, we urge the ESAs to consider market practice with respect to the determination of whether a netting arrangement with respect to a netting set is enforceable.

**E. Appropriate rehypothecation should be permitted.**

Chap. 4, Art. 1 REU, para. 1 (pp. 42-3) prohibits the rehypothecation or re-use of IM. We believe that a model for rehypothecation that would meet the requirements of the BCBS-IOSCO Paper could be developed for use by counterparties. We do not believe it is necessary to forestall a development of such models by prohibiting the rehypothecation of IM. The Draft RTS should instead provide that rehypothecation would be acceptable if the relevant model were to meet the BCBS-IOSCO Paper requirements with appropriate modifications as agreed by the ESAs. In addition, we note that other regulators, including ones in the US, may permit rehypothecation, and if so, a prohibition in the EU would create a competitive disadvantage for EU market participants.

Rehypothecation is particularly important for intermediated "prime brokerage" transactions which provide liquidity and price advantages for swap customers. In a prime brokerage transaction, a customer enters into a trade with an "executing dealer" which then "gives up" the

derivative to a credit intermediating dealer (a “prime broker”). As a result of the "giving up" of the derivative, the customer enters into the derivative with the prime broker rather than the executing dealer. Contemporaneously, the prime broker (which has a credit line for the customer) enters into a substantially equal and opposite derivative with the executing dealer (which does not have a credit line for the customer). As principal to both the customer and the executing dealer, the prime broker must pass any IM it receives from one party to satisfy the demand for IM from the other party; without such transfer, the economics of the transaction will fail. Since the customer and the executing broker are the ultimate recipients of all IM, an appropriate rehypothecation regime that requires the customer and the executing broker to segregate that IM can be established. Without the ability to rehypothecate IM between the customer and the executing broker, prime brokerage transactions will not be economically viable and customers will lose the liquidity and pricing provided by intermediated access to the executing dealer.

**F. Alternative custody accounts should not be required.**

Chap. 3, Art. 2 LEC, para. 1 (c) (p. 34) of the Draft RTS requires alternative custody accounts for all asset types if the collateral is maintained with the collateral provider and para. 1(e) requires cash accounts to be deposited with a party other than the collateral provider.

We propose the deletion of these two requirements. Banks that are swap counterparties may also wish to offer custodial services to hold the collateral. For purposes of VM, because such collateral can be rehypothecated, there is no policy reason to prevent the bank from being both a collateral provider and providing deposit services for the VM. For purposes of IM, if the bank's accounts meet the requirements for segregation discussed above, then again there is no reason to specifically prohibit the bank from maintaining such accounts.

**IX. INTRAGROUP**

**The intragroup exemption should include a general exemption for IM and should interpret the procedural and substantive requirements flexibly.**

**A. General exemption for IM.**

We propose that intragroup transactions should receive a general exemption from IM requirements. Intragroup transactions simply do not raise the same systemic and counterparty risk issues that are raised by derivatives with third parties. The financial health of any group member is very closely linked to that of other group members, and as a result the critical issue for mitigating systemic and counterparty risk is protection against potential exposure to the group overall. The draft RTS implicitly recognize that corporate groups, rather than individual corporate entities, should be the focus of risk analysis for IM because the Thresholds are determined based on group exposure rather than on the exposure of individual entities.

In addition, in the absence of a general exemption for IM, it is not clear how the 50M Threshold will apply to intragroup transactions. The 50M Threshold must be applied at a group level and assumes that the parties to the transaction are members of different groups. It is not possible to calculate the Thresholds at a group level where the parties to the transaction are members of the same group.

This exemption from IM should be available even where the conditions specified under Art. 3 and Art. 11(5) to (10) of EMIR have not been met. Imposing a requirement for VM should be sufficient mitigation of risk on intragroup transactions where those conditions are not satisfied.

## **B. Procedure.**

**(i) Transition period while equivalency is under review.** Under EMIR, intragroup transactions only benefit from the exemption from Art. 11(3) where the conditions in Art. 3 and Art. 11(5) to (10) are met. ESMA's questions and answers on the implementation of EMIR make clear that the intragroup exemption is not available for transactions between an FC or NFC+ and a counterparty established in a non-EU country unless and until the Commission has adopted an implementing act on equivalence in relation to that non-EU jurisdiction under Art. 13(2) of EMIR.

There have been considerable delays in finalizing the equivalence assessments under Art. 13(2) of EMIR even in relation to the initial group of non-EU countries on which ESMA has already delivered technical advice to the Commission. It is also clear that it will be some time before such an equivalence assessment can be adopted by the Commission for many countries as this will be dependent on their rate of progress in implementing the G20 derivatives agenda. In any event, FCs and NFC+s engage in derivatives transactions with group companies in a very large number of non-EU countries and there are limited resources at ESMA and the Commission to address all of these in the limited period of time available before 1 December 2015.

In addition, it is currently unclear whether equivalence assessments under Art. 13(2) of EMIR will include provisions for partial or conditional determinations of equivalence as envisaged by ESMA's advice and whether or how any such determinations will affect the intragroup exemption. Counterparties will need additional time to adjust to any additional requirements imposed as a result.

The Associations are therefore very concerned that only intragroup transactions between group entities located within the boundaries of the EU will qualify for the definition of intragroup transactions by the time these standards are being applied, as no such implementing acts will have been adopted.

Unless consideration is given to the timing of adoption and application of different EMIR technical standards in this context, this would be a major concern for international financial, non-financial and mixed groups who wish to be able to continue both to invest in Europe and to prudently manage related business risks. Requiring the clearing and margining of such transactions executed within groups (and not with external counterparties) is not only unjustified in counterparty risk terms, but may actually be damaging in terms of creating new counterparty and operational risk (because so many group entities would be forced to deal with clearing houses, for example) and a disincentive to such investment and hedging decisions. Put simply, it provides another reason for such groups not to invest in Europe (note that our concern here goes beyond 'US'-headquartered groups and focuses also on groups from other, fast-growing jurisdictions).

Therefore, we propose that the RTS provide an additional transitional period for transactions between an FC or NFC+ and a member of its group that is established outside the EU as follows:

"This Regulation shall not require a financial counterparty or a non-financial counterparty referred to in Art. 10 of Regulation (EU) No 648/2012 to have the risk management procedures described in this Regulation with respect to OTC-derivative contracts with an entity established in a third country which is a member of its group until the earlier of 1 December [2018] or one year after an implementing act adopted by the Commission under Art. 13(2) in respect of that third country has come into force."

For these purposes, the definition of "group" should follow the definition in the Regulation, as discussed above, applicable to the Thresholds and the concentration and wrong way risk determinations.

**(ii) Limit objection period under EMIR Art. 11(10).** Under EMIR Art. 11(10), the competent authority for an NFC in one member state may object to an intragroup margin determination by the competent authority for an FC in another state. We propose that the RTS limit the objection period to one month. Otherwise, parties will have no ability to determine whether and when an objection may be raised.

**(iii) Immediate notice of change in circumstance.** Under Chap. 5, Art. 1 IGT, para. 8 (p. 45), parties must immediately notify the competent authority of any change in circumstance that would affect fulfillment of the intragroup sections of EMIR. We propose that "immediately" be changed to "immediately upon becoming aware." Parties cannot give notice until they are aware of the relevant circumstance.

### **C. Practical and legal impediment.**

We propose that the definitions of "practical" and "legal" impediment in the Draft RTS (Chap. 5, Art. 3 IGT, paras. 1 and 2 (p. 45)) be clarified.

**(i) Legal impediment.** We suggest that a legal impediment should only be found if there is a material affirmative legal prohibition on payment between the parties, which does not include (1) a general constraint on payments such as a general corporate or regulatory requirement that dividends not be paid in excess of certain levels, or (2) an anticipated limitation such as a restriction on payment if an entity were to be subject to insolvency proceedings in the future. If legal impediment is defined more broadly, then it will simply be impossible for intragroup transactions to meet the test. For example, the draft RTS suggest that legal impediments will include anticipated restrictions stemming from insolvency. Because all entities can theoretically go bankrupt and because all bankruptcies may involve restrictions on payments, this language, if read literally, could indicate that all entities are subject to legal impediments (and hence fail the test).

**(ii) Practical impediment.** We suggest that the definition of practical impediment in Chap. 5, Art. 3 IGT para. 2 (p. 45) be altered so that it reads: a "practical impediment ... shall be deemed to exist where sufficient assets of the counterparty are not freely available to the counterparty in order to satisfy such transfers when scheduled or repayments when due, as a result of obstacles stemming from operational, financial or commercial systems, processes or



practices." It is critical that only current rather than possible future impediments are considered practical impediments, because all transfers are hypothetically subject to possible future impediments. Also, practical impediments should be those arising from "systems, process or practices" rather than any possible constraint limiting the transfer of funds.

#### **D. Exemption for group restructuring**

We propose that intragroup derivatives be exempt from the margin requirements if such derivatives are entered into as part of a wholesale restructuring of a corporate group. Without such an exemption, such restructurings will become significantly more costly and in some cases may not be economically feasible.

### **X. OTHER ISSUES**

#### **A. Margin rules and requirements should be consistent among different jurisdictions.**

In order to ensure the efficient functioning of the global derivatives market and to eliminate operational risks, we strongly support a harmonized and consistent set of rules across jurisdictions. We encourage national regulators to harmonize their margin rules. Otherwise, the market will become fragmented and its liquidity impaired as counterparties struggle to meet inconsistent margin requirements of various international regulators. Moreover, for margin requirements, inconsistent rules will potentially be incompatible in practice: for example, if the IM model requirements for one jurisdiction establish different levels of IM than those in another jurisdiction, then parties would face a very difficult determination as to which IM levels should apply. International consistency will also prevent regulatory arbitrage and lead to a more level playing field between competitors in different jurisdictions.

In particular, the Associations are aware that there could be some differences regarding the scope of instruments covered by EMIR and by the rules of other jurisdictions. Such differences could be detrimental to both European and non-European firms. Therefore, for global consistency purposes, we propose that the ESAs explore a way to phase in the collateral requirements for these instruments covered by EMIR but not covered by the rules of other major financial jurisdictions.

#### **B. The minimum transfer amount should apply to IM and VM separately.**

Under the Draft RTS, the minimum transfer amount (EUR 500,000) applies to the total amount of IM and VM.

We request that the minimum transfer amount of EUR 500,000 apply separately to IM posted by each party and to VM. These amounts will be calculated separately, potentially with different frequencies, and will be subject to different reconciliation and netting requirements. As result, the processes for determining and settling IM and VM will be separate. It will therefore pose significant operational difficulties for the minimum transfer amount to be calculated for both IM and VM together. In addition, IM or VM with a value of less than EUR 500,000 will not pose systemic issues that need to be of concern to the regulators. As a result, we propose a minimum transfer amount of EUR 500,000 for IM posted by each party and the same, but separate, minimum transfer amount for VM.

### **C. Covered bond transactions should be exempt from margin requirements.**

We support the Draft RTS provision that would permit covered bond issuers not to post margin to counterparties. However, some of the conditions required to meet this exemption need to be carefully considered. For example:

- Chap. 1, Art. 3 GEN, para. 1(a) (p. 25) requires that the derivative may not be terminated in case of default of the covered bond issuer. However, there may be circumstances where the termination of the derivative may be appropriate.
- Chap. 1, Art. 3 GEN, para. 1(b) (p. 25) requires that "the derivative counterparty ranks at least pari-passu with the covered bond holders". This requirement should clarify that the pari-passu requirement is only applicable so long as the derivative counterparty is not a defaulting party or an affected party under the relevant derivative contract.
- The RTS should also clarify that covered bond issuers are not required to collect margin in accordance with the procedures set out in the RTS as these would be atypical for the covered bond market.

We understand that the European Covered Bond Council ("**ECBC**") will submit a letter to the ESAs commenting on the Draft RTS. We support the positions taken by the ECBC with respect to swaps with covered bond issuers.

### **D. Securitization SPVs should be exempt from margin requirements.**

We encourage the ESAs to include provisions in the RTS addressing the treatment of SPVs that are of the type commonly used for securitization, financing or other bona fide risk or liquidity management purposes. While these SPVs would not typically be FCs, they may be NFC+s (or non-EU entities which would be NFC+s if they were established in the EU) subject to requirements to collect or post collateral, for example, if they are part of a group which includes other non-financial entities whose aggregate relevant positions in OTC-derivatives exceed the clearing threshold.

Securitization SPVs do not have ready access to liquid collateral that can be transferred back and forth to a counterparty in the manner generally required for IM and VM. These SPVs typically have specialized credit support arrangements (such as a pledge of the assets of the SPV) that protect derivative counterparties without use of VM or IM. SPVs would potentially be forced to exit the derivatives market entirely if they had to post or collect IM and VM in the manner contemplated by the RTS and such a forced departure would cause significant harm to securitization and other financial markets.

We understand that the Association for Financial Markets in Europe ("**AFME**") will submit a letter to the ESAs on the Draft RTS and the Associations support the arguments made by AFME for special treatment of securitization swaps.

**E. Exclude amended trades, novations and new trades resulting from portfolio compressions from scope of RTS.**

The explanatory text on pages 24-25 of the Draft RTS provides that "only new contracts at the time of entry into force of these RTS will be subject to the requirements", so that derivatives entered into prior to the entry into force of the RTS ("**Legacy Derivatives**") are excluded. Therefore we request that the ESAs extend this explanatory guidance to Legacy Derivatives that are amended in a non-material manner, novations and new derivatives that result from the portfolio compression of Legacy Derivatives.

The RTS should exclude Legacy Derivatives that are subject to non-material amendments. So long as such amendment does not create any new significant exposure under the Legacy Derivative, the act of amending the derivative (or the occurrence of a life-cycle event) should not bring it within the scope of the margin rules. This is also consistent with the Draft RTS explanatory text.

A novation of a Legacy Derivative that has all the same material terms as the Legacy Derivative (except the new counterparty) should be excluded from the margin requirements. Such a novation is a continuation of the Legacy Derivative, and should be exempt from the margin requirements on the same grounds that Legacy Derivatives are exempt.

Portfolio compression is designed to reduce complexity in the derivatives market and has been generally encouraged by regulators. However, if the result of portfolio compression of Legacy Derivatives would cause the resulting trades to be subject to margin requirements, it would severely reduce the incentives of market participants to run portfolio compression. In addition, excluding such new trades would be consistent with the Draft RTS, since the exposure with respect to the new derivatives would be no different than that under the Legacy Derivatives, which are excluded from the margin requirements.

**F. Exclude uncleared trades with CCPs.**

While the Draft RTS only apply to non-cleared derivatives, they do not contain an exemption for non-cleared derivatives entered into by counterparties with CCPs. Such trades typically arise in the context of customer position management upon the insolvency of a clearing broker. These trades will be subject to extensive CCP requirements, which will in turn be subject to review by the ESAs. These derivatives are also part of the process of constructing robust and efficient risk management processes for CCPs. Therefore, it would be appropriate to add uncleared trades with CCPs to the list of trades that may be excluded in Chap. 1, Art. 2 GEN, para. 4 (pp. 23-24).

**XI. DOCUMENTATION**

**A. Documentation requirements may be overly burdensome.**

The Draft RTS require many agreements between counterparties to be entered into in writing. For instance, Chap. 1, Art. 2 GEN (pp. 23-24) of the Draft RTS requires agreements in writing with respect to:

- exclusion from collection of IM for FX trades;

- election to use the 50M Threshold;
- election to use the 500K minimum transfer amount;
- election of an NFC not to post or collect margin; and
- election not to collect margin with respect to indirectly cleared derivatives.

Other provisions of the Draft RTS require additional provisions and elections to be documented as well. While we strongly support the development of contractual architecture, we believe requiring an excessive amount of elections and exceptions to be documented will be burdensome and costly for counterparties. It would be more efficient for the RTS to include exemptions from certain requirements (such as uses of Thresholds) and clarify that if counterparties did not wish to make use of such exemptions, they could document any such modified arrangements in writing. This would reduce the amount of documentation required and increase efficiency for counterparties. We urge the ESAs to be mindful of excessive documentation requirements when preparing the revised draft of the RTS.

**B. Counterparties should not be required to enter into credit support documents with NFC-s.**

Chap. 4, Art. 1 OPE, para. 1(d) (pp. 40-1) of the Draft RTS requires parties to enter into agreements regarding exchange of collateral with all counterparties, including NFC-s. We do not believe this is necessary. As NFC-s are not required to collect or post collateral, there should be no requirement to enter into agreements with them pursuant to which no collateral would ever be exchanged. As noted above, negotiation of credit support documentation is expected to be one of the biggest operational challenges for market participants. Requiring parties to negotiate such agreements with counterparties that will not be exchanging margin will only exacerbate this problem, for little or no benefit. ISDA intends to develop protocols to address margin documentation, but such protocols will not solve all documentation issues. Many NFC-s are not familiar with ISDA protocols and have relatively few resources to devote to derivative documentation. This issue is exacerbated because of the large number of NFC-s. To ensure a smooth transition to the requirement to exchange and post margin, entry into credit support documentation with NFC-s should not be required.

**C. Margin documentation should not be required to contain operational provisions.**

Chap. 4, Art. 1 OPE, para. 1(d) (pp. 40-1) of the Draft RTS requires credit support agreements to include operational provisions, including procedures for settlement of margin calls. We do not believe this is necessary. The market currently has procedures in place that govern the exchange and settlement of collateral with respect to margin calls without requiring detailed provisions in the relevant documentation. Contracts in other financial markets, such as repurchase and securities lending agreements similarly do not require detailed operational and settlement details. As noted above, negotiating credit support agreements will entail a significant strain on the resources of market participants, and such agreements should not be required to include provisions that are otherwise determined by the parties pursuant to market standards without difficulty.

## **XII. COLLATERAL MANAGEMENT**

### **A. Access to a liquid sale and repurchase market in stressed conditions is not within a counterparty's control and should not be required.**

Chap. 3, Art. 2 LEC, para. 1(d) (p. 34) of the Draft RTS requires counterparties to have "access to an active outright sale or repurchase agreement market with a diverse group of buyers and sellers even in stressed market conditions" as part of their risk management procedures. We propose deleting this requirement. The availability of an active and liquid repurchase market in stressed conditions is not within a counterparty's control. For example, in times of market stress, even the most active dealers may not have access to liquid markets. This condition should be removed.

### **B. IM should be transferable despite being subject to standard liens such as clearing system liens.**

Chap. 3, Art. 2 LEC, para. 1(g) (p. 34) of the Draft RTS requires counterparties to put into place arrangements to ensure that collateral is "freely transferrable, without any regulatory or legal constraints or third party claims...that impair liquidation or the return to the collateral provider on default of the collateral taker." The requirement that there be no regulatory, legal or third party constraints should be removed. In typical transfers of collateral there are standard liens such as the liens of a clearing system pursuant to which that collateral is delivered. In addition, it is unclear what could constitute legal or regulatory constraints on transferability, so it would be difficult to comply with the requirement. For these reasons, the prohibition on regulatory or legal constraints or third party claims should be removed.

### **C. Counterparties should be able to agree to allow substitution of collateral without the other counterparty's consent.**

Chap. 4, Art. 1 OPE, para. 3(a) (p. 42) of the RTS requires both counterparties to consent to the substitution of IM and VM. The requirement for joint consent to substitution should not be mandatory. Both prior to and after the substitution, the collateral delivered by the posting entity must comply with the requirements of the RTS, including quantity and collateral quality. So long as these requirements are still met, and the collateral delivered in substitution is of a type permitted under the relevant agreements (and the RTS), including with respect to concentration limits, the protections contemplated by the RTS would be met. While parties should be free to contract for mutual consent to any substitution, they should also be free to permit substitution without consent, so long as all other regulatory and legal requirements are complied with.

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The Associations appreciate the opportunity to provide this letter to the ESAs. We would welcome the opportunity to assist the ESAs in their efforts to revise the Draft RTS and implement the rules therein. Please feel free to contact us or our staff at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "S. O'Connor", with a long horizontal flourish extending to the right.

Stephen O'Connor  
Chairman  
ISDA

A handwritten signature in black ink, appearing to read "K. E. Bentsen, Jr.", with a long horizontal flourish extending to the right.

Kenneth E. Bentsen, Jr.  
President and Chief Executive Officer  
SIFMA