

ISDA response to ESMA's consultation paper on regulatory standards the requirements for Post-Trade Risk Reduction services for the purpose of the clearing obligation exemption under EMIR¹

Executive Summary

ISDA welcomes ESMA's approach to the exemption of transactions arising from post-trade risk reduction (PTRR) exercises. With regards to the description of eligible PTRR services, we emphasize the importance of keeping principles-based definitions to allow for ongoing innovation. We agree with ESMA's approach to setting out the conditions on market risk neutrality and risk reduction. On safeguards to avoid circumvention of the clearing obligation, we note that existing requirements to benefit from the exemption, in terms of risk reduction, market risk neutrality, and existing reporting under EMIR Article 9 already act as de facto safeguards, such that we do not see the need for any specific limitations to be added. With regards to requirements on PTRR service providers, we suggest that reporting and record-keeping requirements should avoid duplication and leverage the Exercise Performance Report. On governance, conflict of interest and compliance requirements, we note that PTRR service providers are already subject to requirements on these matters as MiFID investment firms.

Responses to questions

Q1: Do you agree with the description and analysis of PTRR services, portfolio compression, portfolio rebalancing, and basis risk optimisation? If not, why?

We agree with ESMA's observation in paragraph 102 that *"ESMA proposes to consider compression, rebalancing and possibly basis risk optimisation, as examples of PTRR services, but to not exclude other portfolio PTRR services which may be developed"*.

As noted in our response to IOSCO's consultation on PTRR services,² PTRR services are being developed and improved continuously, and it should be expected that the demand for new types of PTRR services will arise.

Although the PTRR services definition needs to be specific enough to give regulators comfort, it also needs to be principles-based to allow for further development and improvement of PTRR services over time. With that in mind, we welcome the statement under paragraph 104

¹ [ESMA74-1049116226-877 Consultation paper on regulatory standards on the requirements for post-trade risk reduction services for the purpose of the clearing obligation exemption under EMIR](#)

² [ISDA-response-to-IOSCO-PTRRS-consultation-0324.pdf](#)

that “ESMA stands ready to consider these new types of PTRR services in the future.” We would suggest adding this point in the recitals of the proposed RTS.

The definitions of rebalancing and basis risk optimisation requires that “no existing trade in the portfolio is terminated or replaced”. This is unduly restrictive. Portfolio rebalancing can lead to the termination of the rebalancing trades from previous runs. The purpose of this is not to add unnecessary notional in banks’ portfolios.

In addition, services are constantly evolving in order to address client risks and therefore this element of these two definitions might be unduly restrictive. We also note that EMIR Article 4b(3)(g) sets out that a PTRR service shall “take the form of a compression, rebalancing or optimisation exercise or a combination thereof”. Combination of types of exercises (e.g. compression and rebalancing), which is possible under Article 4b(3)(g), may lead to termination of existing trades. This is acknowledged by ESMA under paragraph 89, where it is noted that when combination occurs, “some trades are then terminated to achieve the desired risk reduction”.

The key criteria defining those services should be risk reduction. Too much specificity on how exactly this is achieved will constrain service development and innovation, reducing competitiveness over time.

In light of the above, we suggest amending the drafting of Articles 2 and 3 of the draft RTS, as follows:

Throughout this response, ISDA’s suggested edits to the draft RTS are in ~~strikethrough~~ and underlined

Article 2

Portfolio rebalancing

Transactions resulting from a portfolio rebalancing are eligible for the exemption from the clearing obligation set out in Article 4b of Regulation (EU) No 648/2012 when in the PTRR exercise counterparty risk is reduced in an existing portfolio of trades by adding new non-price forming trades and where ~~no existing trade in the portfolio is terminated or replaced and~~ the notional is increased rather than decreased.

Article 3

Basis risk optimisation

Transactions resulting from a basis risk optimisation are eligible for the exemption from the clearing obligation set out in Article 4b of Regulation (EU) No 648/2012 when in the ~~PTRR~~PTRR exercise basis risk is reduced in an existing portfolio of hedged trades by adding non price forming trades and where ~~no existing trade in the portfolio is terminated or replaced and~~ the notional is increased rather than decreased.

Q2: Do you know other types of PTRR services? Please elaborate.

As noted above, PTRR services are developed and improved continuously, so it should be expected that other types of PTRR services emerge. For now, and for the purpose of the exemption from the clearing obligation, we agree that the focus should be on portfolio compression, rebalancing and basis risk optimization.

Q3: Do you agree with ESMA proposal on market risk neutrality? If not, why?

We note that under Article 5 of the draft RTS, ESMA defines that *“a PTRR exercise is market risk neutral when before and after the PTRR exercise is performed the market risk of all the portfolios submitted to the PTRR exercise remains the same or within the tolerances set by the participants in the PTRR exercise.”*

We agree with this: the total impact of all the transactions across all portfolios is market risk neutral. Overall market-risk exposure is not materially changed by these exercises.

Q4: Can you please provide information on how are tolerances usually set in a PTRR exercise, and what is their level, if possible? Do you think some criteria should be set to identify appropriate risk tolerances?

Paragraph 2 of Article 5 of the Draft RTS sets out that *“A PTRR service provider shall ensure that the tolerances set by the participants in the PTRR exercise are minimal and do not affect significantly the overall exposure of their portfolios towards market risk”*.

On how tolerances are usually set: market participants pre-define minimal tolerances before participating in an exercise. Each participant can set its maximum tolerances ahead of each PTRR run. Examples of tolerances are delta risk tolerances (portfolio compression) and counterparty credit exposure tolerances (portfolio rebalancing). The PTRR algorithms ensure that the resulting PTRR transaction package fulfils all participants’ tolerances. Each participant also verifies that its PTRR transaction package fulfils its submitted tolerances.

ISDA is not able to elaborate on the level of tolerances, as we cannot discuss business practices.

On whether some criteria should be set to identify appropriate risk tolerances: we do not suggest adding some criteria to identify appropriate risk tolerances. The requirement for these to be “minimal” already appropriately captures the practice. In addition, the risk reduction requirement also embedded in the RTS prevents that tolerances be set at a non-minimal level. Relatedly, we note that the proposed requirement under Article 5 of the draft RTS that the PTRR service provider *“ensures”* that participants’ tolerances *“do not affect significantly the overall exposure of their portfolios towards market risk”* is unnecessary: because the tolerances are required to be minimal, the consequence is that they should typically not affect participants’ overall exposure. In addition, PTRR service providers would

not be able to “ensure” the absence of a significant impact on market participants’ overall portfolio towards market risk, given that they do not have full sight of market participants’ overall portfolios.

In light of the above, we suggest amending Article 5 as follows:

Article 5

Market risk neutrality

...

2. A PTRR service provider shall ensure that the tolerances set by ~~the all-~~ participants in the PTRR exercise are minimal. ~~and do not affect significantly the overall exposure of their portfolios towards market risk.~~

Q5: Do you agree with ESMA analysis and proposal on risk reduction by PTRR services? Do you think any additional criteria should be used to determine risk reduction in PTRR services?

We agree with ESMA’s observation, as formulated under paragraph 122, that “*the ability of PTRR services to reduce risk, while improving capital use and liquidity, qualifies them as a valuable tool for enhancing the resilience of the OTC derivatives market.*”

In paragraphs 125 and 126, ESMA notes that “*as a result of a portfolio rebalancing run a market participant may reduce its risk to its counterparties overall (lowering initial margin requirements), while at the same time potentially increase its exposure to one counterparty or introduce a new exposure*” and “*Similarly, basis risk optimisation by adding transactions (potentially also with new counterparties) may introduce new counterparty risk*”. We agree with this. Risk towards individual counterparties can be increased for the benefit of achieving an overall risk reduction across all counterparties.

Article 4 of the draft RTS sets out that “*risk reduction is achieved when the PTRR exercise fulfils all of the following conditions:*

- (a) it reduces the overall risk of each portfolio submitted to the PTRR exercise;*
- (b) specific types of risk contributing to the overall risk are increased only within the tolerances set by the participants to the PTRR exercise specifically for each exercise;*
- (c) it does not increase the aggregate net uncleared risk in any of the portfolios submitted to the PTRR exercise.”*

We agree with these conditions.

Q6: Do you agree with ESMA proposal relating to the safeguards to avoid a circumvention of the CO? Would you add specific limitations regarding the composition of the portfolios

subject to the exercise (e.g. uncleared portfolios only for compression)? Please justify your answer.

In the draft RTS, Article 14(3) sets out that *“in order to detect circumventions of the clearing obligation, the PTRR service provider shall ensure that the PTRR exercise do not increase the aggregate net uncleared risk in the portfolio of any participant in a PTRR exercise.”*

We do not suggest adding specific limitations regarding the composition of the portfolios. The requirements in terms of risk reduction and risk neutrality within tolerances already ensure that the exercises cannot be used to circumvent the derivatives clearing obligation.

Also, with regards to the *“specific measures and targeted ongoing checks”* that the PTRR service provider would be required to perform, further to Article 14: we would note that where all the ex-ante conditions that apply on PTRR exercises are met, the exemption can legitimately apply and there can be no circumvention.

In addition, we note that ESMA and NCAs will be able to monitor how the exemption is used through EMIR Article 9 reporting. In that regard, ISDA members subject to EMIR Article 9 reporting would welcome an indication on how the ‘Clearing Obligation’ field should be populated, for PTRR transactions that benefit from the exemption.

Instead of specific measures and targeted ongoing checks as foreseen under Article 14, one option could be to require the PTRR service provider to confirm / attest on an annual basis rather than report on preventative measures, as it is not clear what such measures could be.

Q7: Do you agree with ESMA proposal on the independence of the provider from the parties to the OTC derivatives contracts included in the exercise?

We agree with the condition that the provider should be independent, ensuring no possibility to use the exemption for purposes other than risk reduction.

Q8: Do you agree with ESMA proposal on the information to be provided to clients?

In the draft RTS, Article 9 sets out some requirements in terms of the information that PTRR services providers should provide to clients. We note the requirement under the third subparagraph of Article 9(2) that the PTRR service provider shall specify *“that participants remain free to not take part to a run if the outcome is not in line with their risk reduction targets or management”* might not be reflective of current practice. In any case, the outcome would always be *“in line with”* participants’ tolerances. However, a specific participants’ own risk reduction targets or management is not an input factor in the run. Therefore, we would suggest amending the drafting of this sub-paragraph, either to set out that the run would not take place if *“the outcome is not in line with tolerances”*, or to simply

delete this requirement, as it is by design that the PTRR outcome will respect market participants' tolerances.

Article 9

Transparency

...

2. When providing information on the PTRR service, a PTRR service provider shall ensure that participants in the PTRR exercise are aware that:

(a) the exercise is open for participation only to entities that initially submitted a portfolio to the PTRR exercise; and

(b) each exercise shall be accepted in full and, as a result the participant in the PTRR exercise shall not be able to choose which trades to execute under the PTRR exercise.

~~When providing such information, the PTRR service provider shall specify that participants remain free to not take part to a run if the outcome is not in line with their risk reduction targets or management.~~

Q9: Do you agree with ESMA proposal on the obligations of the PTRR service providers concerning the algorithm?

In the draft RTS, Article 7 sets out that the algorithm should be designed to meet the conditions set out for the exercise (i.e. risk reduction, market risk neutrality, non-discrimination among participants). We agree that algorithms should meet those objectives.

We note that Article 7 refers to the market risk neutrality condition by reference to Article 4 and the risk reduction condition by reference to Article 5. However, Article 4 covers risk reduction and Article 5 covers market risk neutrality. The references should be modified as follows:

(a) it is market risk neutral, as specified in Article 4.5 of this Regulation; (b) it achieves risk reduction, as specified in Article 4.5 of this Regulation

Q10: Do you think that the draft RTS should require PTRR service providers to adopt other specific measures to detect potential misuse or circumvention of the CO?

We do not see any other specific measures that should be added to detect potential misuse or circumvention of the CO. The conditions in terms of risk reduction, market risk neutrality within pre-defined tolerances, and the requirement that the exercises do not result in any

increase in uncleared risk already act as robust safeguards against any misuse or circumvention of the derivatives clearing obligation.

We note that in any case, market participants entering into new transactions exempt from the derivatives clearing obligation as part of PTRR exercises will have to report these under EMIR Article 9, such that authorities will also be able to monitor how the exemption is used.

Q11: Do you agree with the proposal regarding the requirements of the PTRR service agreement, the PTRR exercise elements and their management? Do you think that any requirements should be added or removed?

In the draft RTS, Article 10 sets out specific requirements for the PTRR agreement, and Articles 11 and 12 set out requirements on the exercise elements and their management. We have one comment on the drafting of Article 10(2), which we would suggest amending as below, reflecting points made above on exercises that may lead to termination or replacement of existing trades.

With regards to Article 11, which sets the requirement that the PTRR service provider verifies the eligibility of portfolios and integrity of the submitted data, we would note that PTRR service providers can only perform eligibility checks based on the information shared by market participants. We therefore suggest editing Article 11, as below, to reflect this. Our proposed edits are in line with the language used under EMIR Article 4b(4)(f).

With regards to Article 12, as noted in our response to Question 8 in relation to Article 9(2) in relation to the all-or-nothing nature of these exercises, we would suggest to amend Article 12(2) as below, making a reference to the PTRR service agreement, which will specify the process for acceptance of the output proposal, and which might differ by type of service.

Article 10

PTRR service agreement

...

2. The agreement referred to in the first paragraph shall include all relevant legal documentation describing how and when derivatives submitted for inclusion in the PTRR service are terminated and/or replaced by other derivatives and how and when new derivatives are added, as applicable, as part of the PTRR exercise.

Article 11

Preliminary phase of the PTRR exercise

Prior to the execution of the algorithm, a PTRR service provider shall execute all of the following steps:

(a) verify the eligibility of the portfolios submitted by participants to providers for the PTRR exercise and the integrity of the submitted data, to the extent possible based on the information shared by market participants to the PTRR service provider; and

...

Article 12

PTRR exercise output proposal

...

2. A PTRR service provider shall only validate the PTRR exercise output once ~~all participants have agreed to the PTRR exercise output proposal and within a pre-defined timeframe. it has been accepted in full by the participants in the PTRR exercise, according to the process set out in the PTRR service agreement.~~

Q12: What do you think of the possibility of adding derivatives eligible for termination or reduction after the PTRR exercise output proposal? Should this possibility be introduced, do you think it would enable PTRR participants to influence the outcome of the exercise?

ESMA refers to Art 17 of the MiFIR RTS in CDR 2017/567 on conditions of portfolio compression for the purpose of the exemption from the derivative trading obligation, transparency requirements and best execution under MiFIR. Art 17 Paragraph 5 *“allows providers to grant participants additional time, even after the exercise output proposal, to add derivatives eligible for termination or reduction, in order to adjust the compression to the risk tolerance set by the participants and to maximise the efficiency of the portfolio compression.”*

If the intention is to allow the addition of new trades after the output proposal and without re-running the exercise, then we do not see how this would work in practice: it is a basic principle of PTRR exercises that participants must either accept or reject all trades and participants need to know what they are signing off on. Therefore, we do not think it would be helpful to provide for the possibility of adding derivatives eligible for termination or reduction after the PTRR exercise output proposal has been issued.

Q13: Do you think that other safeguards concerning the obligation not to influence the result of the PTRR exercise should be considered in the RTS?

We do not see the need for any other safeguards concerning the obligation not to influence the result of the PTRR exercise.

Q14: Do you see the need to further specify in the draft RTS the requirement for PTRR providers to undertake regular compression exercises where PTRR exercises result in new PTRR transactions as set out in point (c) of paragraph 4 of Article 4b of EMIR?

The service provider's obligation to undertake regular compression exercises where PTRR exercises result in new PTRR transactions should be subject to customer demand. For PTRR exercises where the number of transactions is small or maturity is short-dated, customers may not want to prioritize doing compression.

Q15: Can you confirm that the Exercise Proposal and the Exercise Performance Report contain the described information, and, in particular, the information required by the record keeping obligations under EMIR and the draft RTS? If this is not the case, please describe their content, highlighting the data which is missing in comparison to what is requested by EMIR and the draft RTS.

Draft RTS Article 12 sets out information points that should be included in the PTRR exercise output proposal. Draft RTS Article 9(3) sets out the information that should be included in the report transmitted to participants after the performance of the exercise, noting that it should include all the information required for the purpose of record keeping, set out under Article 15.

Under Paragraph 284, ESMA notes that *"to limit unnecessary regulatory burden on PTRR service providers, ESMA would encourage the use of the Exercise Performance Report to comply with the records keeping obligation set out in EMIR and in this draft RTS, provided that the required information is included. The Exercise Performance Report should be made available upon request, without undue delay, to the relevant competent authorities and to ESMA."*

We agree with this approach.

Q16: Do you agree with the draft RTS proposal on record keeping, including the proposed retention period?

Article 15 sets out the information points that should be kept, and Article 16 sets out that this information should be kept for 10 years. We agree with this approach.

Q17: In addition to the requirements described in the proposal, is there any other requirements which you would consider necessary to be further specified in the RTS? If yes, please detail the requirement and provide arguments supporting your answer.

We do not consider any other requirements as necessary. To the contrary, we would note that some of the requirements in the RTS in terms of the PTRR service provider's organisation and governance, as set out under Article 13 and 14, and conflicts of interest

under Article 6, may appear superfluous. PTRR service providers operate under the status of MIFID investment firms, which makes them subject to requirements on capital, governance, independence, product development and conflict of interest.

We also note that Article 17 of the draft RTS introduces a requirement for the PTRR service provider to submit to their NCA a report, on a yearly basis, including information on *“any changes in the provider’s rules, methods and algorithms used to provide the PTRR service referred to in Article 8 and in the methodologies to develop and test them”*, per subparagraph b. We would suggest amending this subparagraph, requiring only information on *“any **material** changes”* to be included in the yearly report. Algorithms are continuously fine-tuned to improve results for PTRR services users, but this does not mean there is a change in the fundamental structure of the algorithms. Including all changes to the algorithms regardless of materiality would crowd out information in the yearly report. Instead, the report should only include material changes, as a summary of those already reported on an ongoing basis per Article 17(6).

Q18: Do you agree with the recommendation made regarding record keeping under MiFIR?

In Section 5, ESMA includes some considerations on the transactions to be recorded for the purpose of the exemptions under MiFIR, recommending, under para 312, *“to include in the record keeping obligation under MiFIR the information displaying the market risk neutrality of the PTRR exercise, its risk reduction objective and the non-price forming nature of the transactions used to perform it.”* ESMA adds that PTRR service providers could comply with this by including the exercise proposal or exercise performance report also to meet MiFIR record keeping requirements.

We agree with this.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 76 countries. These members comprise a broad range of 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, such as exchanges, intermediaries, clearing houses 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 website: www.isda.org. Follow us on [LinkedIn](#) and [YouTube](#).