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Comment Paper on EC proposal for Regulation on OTC derivatives, CCPs and trade repositories

ISDA (the International Swaps and Derivatives Association), AFME (the Association for Financial Markets in Europe), the Nordic Securities Association (NSA) and Assosim (the Italian Association of Financial Intermediaries) support the legislative proposal on OTC derivatives, CCPs and trade repositories (EMIR). In particular, we welcome the European Commission's recognition

- that central counterparties should be used where they reduce risk in the financial system;
- that though many contracts will be suitable for clearing, some will not (on a prudent basis) and some may cease to be eligible;
- of the role of bilateral risk management as an alternative to central clearing, where central clearing will not reduce risk (and the role of bilateral counterparty risk mitigation tools therein);
- of the importance of regulatory reporting via trade repositories, as a systemic risk tool.
- that some participants in derivatives business should benefit from an exemption from clearing requirements, when considering the risk associated with these activities and the negative (overall) risk and liquidity impacts a requirement to clear/collateralise derivative positions could imply.

The main focus of our comments herein is to make CCPs sufficiently resilient. The proposal is ambitious, but leading market participants who offer liquidity in this business (without which hedgers could not hedge) support CCP use for eligible contracts on prudential and economic grounds.

Other comments herein focus on

- preserving the ability of firms and other derivatives users wishing to manage underlying risks to do so on an safe and cost-effective basis (thereby encouraging them to invest in their activities, with all of the wider economic benefits resulting from that);
- maintaining the world-leading position of Europe's derivatives business and financial market infrastructure business.

We are including a further document in annex (drafted by Clifford Chance), addressing some technical and drafting issues we have identified – based on an assumption that the general policy lines of the proposal are appropriate (we caveat this by adding that we believe there are *some* policy elements of the proposal which *should* be revisited). We observe that as this is a Regulation, it is important that any ambiguities, inconsistencies or conflicts with other regulation should be addressed before adoption.

1. Robust and resilient clearing and a more stable financial system

ISDA, AFME, NSA and Assosim welcome the move to widespread use of CCPs for OTC derivatives, but this move must be managed carefully, given the risk concentration in CCPs (and other post-trade infrastructures) and their limited record in managing OTC derivatives (due to the product's nature, this is more challenging than for other financial instruments). Legislation must be drafted in such a way as to ensure responsible behaviour by CCPs but also by the clearing members and clients whose assets will be risk managed by CCPs. We further believe that regulators must have the means to identify systemic risk as and where it builds in the financial system, and strongly support the development of trade repositories (industry has 'built' several trade repositories) and an internationally coherent framework for their regulation.

Requiring CCPs, clearing members and clients to behave prudently

- We are concerned that the requirement that the ***Risk Committee*** 'advise' the CCP board on 'arrangements that may impact the risk management of the CCP' (Art. 26) may be insufficient. We suggest that those who underwrite the CCP's risk should have a determinative role in these arrangements in Risk Committees – including on contracts that the CCP is capable of clearing and on emergency powers for CCPs. The market participants who would typically underwrite risk management by CCPs with their capital, have a store of experience in risk management of these contracts which should be utilised. This change would address our concerns about the '*bottom-up'* approach, preventing CCPs from chasing market share (compromising financial stability). We support the principle that clients should be *at least* appropriately consulted, given their exposure to the risks managed by the CCP.
- In relation to ***initial capital*** (Article 12), which we understand is to ensure an orderly wind-down or restructuring of the activities of a CCP, we believe CCPs should be required to hold more than €5m in initial capital.
- We suggest that the level 1 regulation address the issue of ***participation requirements*** for CCPs in more detail – as a mitigant against the danger of a 'race-to-the-bottom' among CCPs concerning the terms for clearing membership (Art. 35). We believe that CCPs should be required to ensure that the risk position brought to a CCP by a clearing member is commensurate with the capital provided by that clearing members to underwrite that risk.
- CCPs should only be able to access the ***default fund*** to reduce losses suffered in a clearing member default (skin-in-the game). The default fund should be able to withstand the default *not only of the largest member but of other clearing members too (Art. 40);*
- Article 41 – ***Other risk controls***. We suggest strengthening the requirements for CCP's own funds under 41(1), adding the following: "*own funds of CCPs, the magnitude of which would be proportionate to the risks shared by the CCP and others underwriting risk*."
- The words 'where relevant' cast doubt on whether the layer of the ***waterfall (***Art.42) to be funded by CCP own resources will always precede losses borne by non-defaulting members in the mutualised default fund. We suggest deletion (ensuring CCP 'skin-in-the-game'). We believe CCPs should be required to participate in the default waterfall with an own funds/equity contribution, to be used immediately after a defaulting member's contribution and prior to non-defaulting members contributions. Such equity should be in reasonable proportion to the size of the default funds and no less than 10% of the fund size. This

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properly aligns CCP shareholders, who receive the rewards of operating a CCP, with the aims of prudential risk management by ensuring they have meaningful "skin in the game" ahead of non-defaulting members.

Ensuring that the clearing requirement does not create more risk in the financial system

- We support more detailed definition of '***class of derivatives'*** (Art. 2(4)) to be declared eligible ('contracts that share common, essential characteristics') e.g. many CDS referring to single names (buying/selling protection on debt by single debt issuers) may share common essential characteristics, but there are large differences in liquidity of different single name CDS and assumptions should not be made that they are uniformly suitable for CCPs (some will be; some not).
- We fear that the ***bottom-up*** approach (Art. 4) could encourage CCPs to seek authorisation for clearing of contracts they are ill-equipped to clear (a dangerous outcome). Our understanding is that the ***top-down approach*** is a political statement of intent by regulators to act where they believe there is a serious build-up of systemic risk resulting from a specific set of derivatives that they feel could be cleared, and that it is unlikely that the top-down approach would force CCPs to clear contracts they feel they cannot safely clear (a dangerous outcome). Nevertheless we believe that a sensible safeguard, in the event, would be to allow time for public consultation before any action under the top-down approach is taken. We believe that the criteria mentioned in Art. 4(3) – as well as other criteria (see below) – should be rigorously applied in both approaches, and in periodic review of authorisations and eligibility.
- We believe that ***level 1 legislation*** should reflect that the demonstrated ability of a CCP to risk manage a contract and the ability of clearing members to participate actively and proportionately in a default ***process should b***e ***key criteria for determination of eligibility (Art.4).***
- We strongly advocate the ability for regulators to grant derogations - if clearly justified – to the ***100% mandatory clearing*** requirement for eligible contracts. For example, dealers in derivatives business always try to ensure that their exposure versus other dealers is minimal (thus – counterparty risk positions are balanced). A requirement to put eligible contracts into a CCP in short order could create significant counterparty exposure in the system (as ineligible contracts and other instruments would remain bilaterally managed and one of the firms could be 'out of the money' on those contracts) where there was none before. Even with allowance for such a derogation, we expect over 95% of eligible contracts to be cleared.
- We welcome the recognition in the proposal of the need for exemptions from the scope of clearing requirements, where it does not reduce risk (See point 2).
- We believe that **FX swap*s and forwards - simple exchanges of currency that are*** nevertheless key to the payment system and management of currency risk - should be treated differently from "derivatives" and should not be mandatorily cleared:
    - The FX market differs from the OTC derivative markets in that (a) FX has many more participants and transactions (b) the transactions are much simpler and short term.
    - CCPs bring little benefit: as FX transactions typically involve exchanging cash flows, the key counterparty risk to manage in the financial system is settlement risk. CLS Bank has been created to manage this risk. ***Mandated clearing will distract from***

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the priority of addressing remaining FX counterparty settlement risk in the global financial system.

- ***FX CCPs will introduce systemically important concentration risks***. In a crisis, the FX market could gravitate to the CCPs that appear to be backstopped by the largest pools of taxpayer funds. As the FX market is concentrated in the EU, the EU is a natural home for a global FX CCP, if mandated, forcing EU taxpayers into the role of de facto guarantors of the world's largest market, an exposure they do not currently have.
- The critical nature of FX market infrastructure to the world's financial system is underlined by the fact that CLS' regulation by the US Federal Reserve with the active support of all major central banks. Nothing similar is proposed for FX CCPs.

Ensuring that regulators have a clear view of systemic risk in OTC derivatives business

- We welcome the recognition of the possibility in the European Commission's proposal for trade repositories based in 3rd countries to be able to provide services to entities based inside the EU, subject to recognition that they are regulated in a manner 'equivalent' to that in the EU. We observe that, like for CCPs, the equivalence process for trade repositories may be complex.
- We believe there may be grounds to review the text to ensure there is sufficient consistency and clarity on allocation and prosecution of responsibilities for reporting of clearing-related or other transactions, including whether or not the statement on primacy of this Regulation over other legislation regarding client disclosure applies beyond reporting to repositories (e.g. to regulators?).
- We believe that EU decision-makers should consider whether Art. 67 should ensure
  - that only regulators that have a legitimate interest in the course of their supervisory and oversight functions should be able to access information from trade repositories.
  - that entities receiving information from trade repositories are required to provide written undertakings that they will abide by a confidentiality requirement relating to the information that is provided, before receiving it.
  - that any public reporting of derivatives market activity, aggregated or otherwise, does not cause inappropriate or commercially sensitive information to be disclosed which could undermine the safe and effective performance of financial markets (for example impeding the ability of dealer firms to hedge large block trades in equity markets (as permitted under MIFID).
- For some types of firm and contract, the T+1 reporting requirement may be challenging e.g. for some very structured contracts, subject to long negotiations, it may not be clear when T arises.
- We would propose that the text should reflect that compliance with direct and indirect reporting, disclosure and data sharing obligations within the context of the Regulation, whether to connected or regulatory or other authorized bodies, is permissible and forms an exception to the obligations under the Data Protection Directive 95/46EC and other related EU and national legislation.

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Ensuring stability in securities settlement

- With an increasing number of CCPs operating in EU, the issue of ***risk linked with settlement agents and payments agents*** is ever more important. Those CCPs use agents for the settlement of the cash and securities legs of transactions. If those agents are subject to stress, under difficult market conditions, it is not clear what will happen with the cash and securities held by such agents – a concern that has arisen at points during the financial crisis. As such, we believe that the meaning of the word "steps" in art. 47 should be clarified by adding a provision stating that "for cash equities, as soon as settlement is made in commercial money, the commercial bank should provide for segregation and protection against insolvency of the settlement and payment from the moment that the instruction is entered into its payment and settlement systems. "

2. <u>Allowing companies to hedge on a reasonable cost and risk basis (encouraging investment)</u>

Companies' ability to hedge is key in giving them confidence to invest, with benefits for economic growth and employment. Regulation and costs associated should be appropriate and risk-proportionate.

- ***Banks should be able to gauge levels of credit risk appropriate to dealings with clients*** (as part of a wider relationship beyond derivatives business). Article 8 of the text proposes that the EC should impose minimum levels of collateral for exchange in derivative contracts – but this would be to isolate derivatives from this wider relationship, and could impose unwelcome and inefficient liquidity and investment costs on European corporations. At present, most derivatives dealers take collateral by way of ***title transfer arrangements*** and segregation is not generally a feature of such collateral arrangements as the collateral provider transfers all rights to the collateral to the collateral takers for the duration of the holding. We are therefore concerned about Art. 8: segregation of initial margin would create a material liquidity cost, while segregation of variation margin (even if possible) would impose a disproportionate liquidity cost. We also question whether there is significant client interest in such a provision (in light of the extra costs implied). If it is not the intention to propose segregation of variation margin in Article 8, we believe that this should be made clear. While we are open to the suggestion that segregation could be offered to clients as an option, we caution that any such option has a cost associated with it, which would be passed on to clients. We strongly believe that any mandatory segregation requirement – in particular of variation margin - would have important unintended consequences, and believe the financial (liquidity) impacts therein should be measured before any such proposal is considered. We would propose the following wording for the last paragraph of Article 8.1, replacing the current last paragraph:

'For the purposes of point (b), the value of outstanding contracts shall be marked-to-market on a daily basis and risk management procedures shall require the timely and accurate exchange of collateral or the proportionate holding of capital, in each case where appropriate and in respect of net exposures between the parties'.

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- We are concerned that Art. 37(4) as drafted may mean that clients whose assets are cleared or held at several current CCPs for OTC derivatives may not qualify for the zero (or low) risk weight charge as it is theoretically possible that they could be exposed to default of a clearing member. We believe that to the extent that the client is not exposed to the default of the clearing member through which it has access to the CCP, it should benefit from the zero charge. This provision has obvious cost implications. We believe that clients should be allowed to choose the level of cost and segregation they deem appropriate for their assets when clearing at CCPs. We also believe that CCPs should be able to offer a variety of segregation models, and that national bankruptcy laws should not be an obstacle to the ability of clients to retrieve their assets in event of default. We therefore support the intent of Art. 37(5). The intention behind Art. 37(5) should also apply if a CCP defaults (appropriate segregation should be in place to facilitate porting of trades to another CCP (Art.39(4)).More clarification is required of Article 37(1) which fails to distinguish margins posted in relation to house trades from those posted in relation to client trades – the latter should be segregated and capable of being ported (if clients so choose).
- ***Non-financial end users:***
    - We welcome the European Commission's recognition of the need for some form of exemption for non-systemic commercial end users of derivatives contracts.
    - OTC derivatives play a vital role in the efficient management of financial risks faced by non-financial end users. Ill-defined or disproportionate mandatory clearing requirements will introduce unacceptable levels of uncertainty and risk in their underlying businesses, increase costs, reduce investment and put jobs at risk. End users will choose to hold un-hedged risks on their balance sheets – effectively transferring risk away from the financial system and into the real economy.
    - We suggest that the application of a quantitative threshold to determine whether end users should be subject to mandatory clearing obligations should be driven by the level of systemic risk posed by their activities rather than a simplistic test based on gross exposure. The mandatory clearing obligation should only capture those derivative positions that are capable of creating significant counterparty exposure that could have serious adverse effects on financial stability. As is recognised in the Commission's proposals, positions that are designed to mitigate underlying commercial risks should not be considered as presenting systemic risk.
    - In addition to the existing provisions applicable to non-financial end users, we propose that supervisors are given the ability to apply discretion concerning these exemptions and thresholds, based on a consideration of whether associated counterparty exposures may have serious adverse effects on financial stability. In this regard, we would envisage ESMA taking a coordinating role in ensuring consistent interpretation and application.
- We make the observation that the ***requirement that non-financial end users clear all of their contracts if surpassing relevant thresholds*** (rather than a subset of contracts e.g. those that surpassed the threshold or seemingly 'speculative' contracts) seems a disproportionate and (possibly) systemically risky one ('jump' to clearing).
- ***Requirements of financial institutions transacting with exempted end users***: Our understanding is that the clearing requirement is not intended to apply to contracts entered

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into by financial institutions, facing an exempted end user. However we ask that the text include more clarity on this point (Art.7). More clarity is also needed on this issue in Art. 8 (as to whether financial institutions would have to mandatorily post collateral with exempted end users (we don't believe this is the intention, based on recital 14, and on a reading of section 5 of the European Commission's consultation document of June 2010[1]).

- ***Limited, proportionate exemptions for non-systemic financials:*** We believe that the level 1 text should explicitly recognize the possible justification of limited, proportionate exemptions for some non-systemically important financial firms. We are concerned that requiring these non-systemic end users to use CCPs will have liquidity effects which are insufficiently understood at present, and, given the way that derivatives are used to manage overall portfolio risk, may artificially and inefficiently isolate derivatives components from the rest of these portfolios, requiring posting of high levels of margin on derivatives and not net exposures. This could, for example, have significant effects on savings and pensions.
- ***Exemptions for intra-group transactions:*** We would propose that there should be allowance for an exemption from the clearing obligation (and possibly the reporting obligation) in relation to transactions with affiliates. For example, this will be important as in many cases there may be legal requirements that affect which group companies can face counterparties through but the risks may be hedged or managed in another group company, so that it will need to be possible to transfer risk intra-group.
- ***Mandatory clearing of existing contracts***: We suggest that – at a minimum - market participants be given sufficient time to transition to full or very high levels of clearing of in-scope contracts (phasing in). In this regard, we note that the US legislation allows for exemption of the stock of existing contracts, subject to mandatory reporting to trade repositories within 90 days. If EU legislation requires clearing of existing contracts, huge amounts of capital will have to be tied up in CCPs, with effects for market liquidity and access to finance, as well as Europe's competitive position versus the US (and other jurisdictions).
- We agree that ***interoperability is inappropriate for OTC derivative products at this time***: derivatives clearing is not fragmented along national lines but centralized and international, and the tailored nature of the product compared to more standardized cash asset classes makes it less suitable for interoperability. ***However we support the proposal to give securities market CCPs the right to interoperate and right of access to relevant data and systems – and believe this could help to bring clearing costs down for end users*** - providing the additional risks arising from interoperability are properly managed. In addition to the requirements proposed in Art. 49 (Risk management) and Art. 50 (Approval of interoperability arrangement) we propose the inclusion of requirements:
    - that CCPs should be transparent vis-à-vis their members on the proposed interoperability arrangements;
    - for a maximum timeline for affected stakeholders to process interoperability and/or access requests; and
    - for a timed and Competent Authority overseen appeal mechanism where interoperability and/or access is denied.

[1] http://ec.europa.eu/internal_market/consultations/docs/2010/derivatives/100614_derivatives.pdf

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- In the context of risk management between interoperating CCPs (see Article 39) we are concerned that the proposal that a CCP 'fully collateralizes its exposures' may hard-wire a very inefficient model of inter-CCP risk management into EU legislation. To ensure progress on CCP interoperability, all relevant stakeholders (regulators, CCPs and their members) have agreed – though sub-optimal - to support in principle an inter-CCP risk management model based on the full collateralization of exposures through margin exchange. Providing there is no negative impact on inter-CCP risk management, EU legislation should not preclude future efficiency improvements agreed with relevant competent authorities.

3. Maintaining Europe's leading position in derivatives business – including derivatives clearing – in a coherent international regulatory framework

Competitiveness of European companies; a world-leading EU derivatives business

We do not believe that restrictions on the ***location of CCPs*** are justified on prudential or commercial grounds, and authorization should not depend on location, provided other requirements are met (Article 10):

- ***Access to central bank money***: Central banks in different currency zones commonly arrange currency swap procedures giving access to each other's currencies: this is typically the means through which CCPs could get access to this liquidity if not located in the currency zone of the central bank of issue of a currency. If a crisis emerged, we do not believe that the question of whether or not a CCP has a bank license would be the key one in deciding whether or not a central bank would provide temporary support – whether or not the CCP is regulated as a bank (note: inclusion of relevant central banks in the supervisory colleges of CCPs could ensure that where temporary liquidity support from a central bank was required, it would already have direct access to all relevant data and involvement in the oversight of that infrastructure). The proposal also acknowledges the value of access to reliable commercial bank liquidity.
- ***The EU market is the world leading centre for derivatives business, benefiting from an 'open' approach and would be hurt by retaliatory actions by other jurisdictions***:
    - 64% of global OTC derivatives business is booked in the Europe (BIS). EU CCPs are world leaders in the derivatives business. Retaliatory action from other jurisdictions would undermine clearing at LCH Swapclear (the world's leading OTC derivatives CCP, clearing contracts in dollars, inter alia), ICE (most commodity derivatives contracts are denominated in dollars) and Eurex (25% of the different contracts eligible for clearing refer to non-EU issuers or are denominated in non-EU currency).
- ***Proliferation of CCPs (in event of similar location requirements elsewhere) would exponentially increase the cost of clearing*** (by multiplying required levels of margin and undermining netting[2] economies of scale), ***therefore vastly increasing the cost of hedging***

[2] Netting is the settlement of obligations between two parties that processes the combined value of transactions. It is designed to lower the number of transactions required. The development of a framework for netting that works at global, regional and national level has been a key part of the ISDA mission.

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for companies (financial or otherwise that are required to clear). This would disincentivize investment, affecting growth and reducing employment on a global scale.

Equivalence of 3rd country CCPs (Art.23)

- We welcome the recognition of the possibility for 3rd country CCPs to be authorized to clear contracts under EU legislation but observe that ***getting such approval will be challenging***. In general, we would suggest that compliance with international standards (such as CPSS-IOSCO) by other jurisdictions could be a key test for assessing equivalence. We are concerned that any equivalence determination methods should not be seen as protectionist by other jurisdictions (we understand that this is certainly not the intention), in particular because the consequences of this perception could include EU firms being cut off from accessing well-supervised markets.

Global operational standards for CCPs

- We think it is important that CCPs adopt global standards in terms of operational process and connectivity/communication (i.e. reporting). As different CCPs have different requirements, firms looking to join them face many issues & additional costs (i.e. handling different reporting mechanisms and frequencies, different margin calculations, different names for the same definitions etc).

Uncertainties in the text concerning territorial scope

- Currently the draft regulation seems to include non-EU banks and MiFiD investment firms - including those established outside the EU – within scope. We suggest that the ***legislation should clearly state that entities that are both EU-established and EU-regulated should be in-scope***. ***Clarity is needed on what is meant by 'established'*** in this context (presumably the legislation would not apply to EU branches of non-EU financial institutions?). If our presumption is correct, it may be worth considering competitive implications.
- We believe the Regulation (including clearing or reporting obligations) should clarify that it ***does not apply to activities conducted by EU financial or non-financial counterparties through branches in non-EU jurisdictions*** (if those activities are conducted with persons outside the EU). Article 23(1) should not restrict non-EU CCPs providing services to branches outside the EU of EU firms (or there could be a risk that non-EU branches of EU firms will be subject to incompatible obligations deriving from the Regulation and local law, adversely affecting their ability to operate outside the EU).
- Further clarity is needed (in Art. 3(1)) in relation to ***requirements of financial counterparties when they enter into eligible contracts with any third country entity***. While within the EU financial counterparties are only subject to the clearing obligation when they enter into eligible contracts with other financial counterparties, the draft Regulation appears to require all dealings with all types of counterparty in eligible contracts to be cleared. Clarification is needed herein. Of note, requiring EU financial counterparties to clear transactions with non-EU entities will place EU counterparties at a competitive disadvantage if local laws do not impose similar restrictions on local dealers. It may be appropriate to allow for exemptions

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from the clearing requirement in cases where the local law would not require local dealers to clear the transaction. Similar issues may arise with regard to use of bilateral risk mitigants in dealing with 3rd country entities, under the Regulation.

- We would make the general observation that it is important that the EU and US authorities continue to work together during the EC legislative process and the US regulators' rulemaking period (until mid-2011) to ***ensure that the interface between the EMIR and the Dodd-Frank legislation and rules – and indeed with those in other jurisdictions - is coherent***. We believe there is currently a real danger that these different frameworks will not work coherently together, creating considerable legal uncertainty and a danger of different outcomes in different jurisdictions.

  Please note that the legal analysis by Clifford Chance accompanying this document deals with all of these issues and others (including other extraterritorial concerns) in more detail.

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The International Swaps and Derivatives Association, or ISDA, was chartered in 1985 and has over 820 member institutions from 56 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify sources of risk in the derivatives and risk management business and reduce those risks through: documentation that is the recognized standard throughout the global market; legal opinions that facilitate enforceability of agreements; the development of sound risk management practices; and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information please visit the AFME website, www.AFME.eu.

The Nordic Securities Association (NSA) represents the common interests of member firms in the Nordic securities dealers associations towards external stakeholders primarily in the Nordic market but also on European and international issues of common interest. Members of the NSA are the Danish Securities Dealers Association, the Finnish Federation of Financial Services, the Norwegian Securities Dealers Association and the Swedish Securities Dealers Association.

ASSOSIM (*Associazione Italiana Intermediari Mobiliari*) is the Italian Association of Financial Intermediaries, which represents the majority of financial intermediaries acting in the Italian Markets. ASSOSIM has nearly 80 members represented by banks, investment firms, branches of foreign brokerage houses, active in the Investment Services Industry, mostly in primary and secondary markets of equities, bonds and derivatives, for some 82% of the total trading volume.

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