ISDA-AFME-BBA-Assosim Response to

ESMA Consultation Paper and Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and. Trade Repositories .

5 August 2012

Executive Summary

- The ‘Signatory Associations’ would like to underline that they support the key aims underpinning EMIR, in particular reduction of counterparty credit risk through clearing and compression, increasing regulatory transparency through trade repositories, and enhanced credit risk mitigation.

- This commitment is clear from industry achievements in enhancing the safety and efficiency of OTC derivatives in recent years. These include: 54% of interest rate swaps are now cleared (interest rate swaps make up of 80% of overall gross notional OTC derivatives activity); trade repositories, operating on a global basis, now exist for credit, interest rate, commodity and equity derivatives (while another is being built for FX contracts); clearing and compression have reduced the size of the CDS market by 75%.

- We welcome the fact that the European Supervisory Authorities (ESAs) have been willing to publicly consult on the mandated technical standards under EMIR a second time. While we believe that longer consultation periods, allowing further consideration of input to regulators, create optimal conditions for sound regulation, we recognise that the tight timeframes to which the ESAs must adhere in drafting these standards are not of their making.

- We underline again that derivatives business is the most global of financial businesses, and urge the European Supervisory Authorities and the European Commission to focus on creation of a regulatory regime in Europe that is both coherent and convergent, in terms of its interaction with other regimes. We believe the G20 commitment to avoid protectionism, fragmentation and regulatory arbitrage is as important as any other. Failure in this regard will affect investment and employment globally, as the cost of risk management increases prohibitively.

- It is important, in this context, that sufficient emphasis is placed not only on interaction of the European regulatory regime with the United States' regulatory regime, but also with other regulatory regimes within the G20 group.

- The signatory associations welcome the ESMA interpretation that an 'equivalent' level of protection under EMIR RTS for indirect clients does not mean availability of the same protective structures particular to the CCP-clearing member-client relationship but that, rather, these structures should be replicated for indirect clients at the level of the clearing member (and not necessarily at the CCP level). However, the relatively inflexible approach as set out in the draft RTS (particularly in relation to individual segregated protections) poses significant problems for firms seeking to offer either direct or indirect clearing services. The apparent obligation on a clearing member to offer indirect clearing if offering any clearing services, for example, is likely to decrease competition in clearing services and disincentivize clearing membership. Other concerns relate to the legal complexity – inadequately addressed in EMIR and not sufficiently recognised in the draft RTS, we believe – faced by firms offering indirect clearing services associated with segregation and portability protections for indirect clients under the prospective regime. We would encourage recognition of a more flexible methodology for meeting the principles-based requirements of indirect clearing as set out in the EMIR text. We are also concerned that the draft RTS does not take into account the apparent difficulties in applying its requirements in the context of clearing members at 3rd country CCPs. We fear that there may not be enough time for all participants in the clearing chain to work through these issues under the current compliance timetable, if these provisions remain as in the current draft.

- We are particularly concerned about the international application of the requirements for indirect clearing set out in the proposed RTS to the extent that they conflict with, or come into conflict with, local regulation for financial intermediaries in jurisdictions outside the EU. This has crystallised as a clear issue for US FCMs where the ability of US FCMs to comply with the requirements for indirect clearing set out in the proposed RTS is uncertain. For indirect clearing, we do not currently believe that FCMs would be able to offer the requisite end-client protections as a result of the legal regime applicable to them in the US. On the other hand, FCMs (or other non-EU CMs as the case may be) will not have the option of offering direct client services across the EU because of local regulatory licensing requirements in many European jurisdictions. We do not see an obvious solution to address these concerns on the basis of the current proposals and the Level 1 text. Nevertheless, it is essential that we deliver an access solution which allows EU entities to use non-EU CMs (including US FCMs) and recognised non-EU CCPs (where they so choose) and meet their EMIR clearing obligation. We would urge continuing close co-operation between the industry and ESMA specifically to explore a solution to this issue and would be happy to have further dialogue on this subject.

- We believe further clarity is needed as to whether or not the clearing obligation for certain classes of OTC derivatives is triggered only by the granting of authorization to CCPs under EMIR, and not by CCPs already authorized under existing national law, or by the submission of an application for authorization. Either scenario is associated with considerable legal uncertainty, but this uncertainty is further heightened if it is not clear which scenario triggers the clearing obligation.

- In relation to the clearing obligation we believe that further clarity is needed on the treatment of FX contracts, and in particular seek reassurance that international convergence will be achieved. We welcome ESMA's decision to delay the preparation of RTS on margin requirements for uncleared derivatives until the international standard-setting process has concluded, and believe that there needs to be a similar drive for convergence in relation to clearing.

- In relation to the public register, the co-signatories believe that it is vital that they can distinguish contracts subject to mandatory clearing from those that are not. There appear to be a number of omissions in the draft RTS regarding information in the register regarding such contracts which EMIR seemed to require e.g. contracts made subject to mandatory clearing under the 'top-down' procedure and remaining maturity (important in the context of potential frontloading requirements). Further clarifications would also be welcome regarding information to be provided on CCPs authorised or recognised to clear.

- In relation to access to trading venues and liquidity fragmentation, we believe that relevant RTS should define measures which would need to be in place in order to prevent liquidity fragmentation, as this leaves less room for interpretation by infrastructures, and would be welcomed by infrastructures and users. We believe that it should be possible for two parties to trade the same product and agree in advance which CCP they will use to clear the transaction and that new parties should not be denied access to a CCP (and the same margin pool) that already clears an existing product. Some fragmentation at trading level is conducive to competition, while in clearing, there is a concern that where only one CCP is clearing a specific contract, there is a risk of monopolistic behaviour. We would welcome clarification regarding the consistency of article 1(6) of ESMA's proposal with article 8.4 of the EMIR text which indicates that: "Access of the CCP to the trading venue shall be granted only where such an access would not require interoperability or threaten the smooth and orderly functioning of markets in particular due to liquidity fragmentation and the trading venue has put in place adequate mechanisms to prevent such fragmentation": ESMA's proposal gives the impression that in certain cases interoperability for OTC derivative products would be authorized.

Additionally, indirect clearing is one potential tool for access to clearing but its mandatory availability is not, in our view, the solution to ensuring access to all for those institutions needing to comply with the mandatory clearing obligation. The Level 1 text makes no such reference and we note that (correctly) no equivalent obligation to take on direct clients exists. We think that these concerns derive more from the timing of the introduction of the mandatory clearing obligation and are more appropriately dealt with by the discretion afforded to ESMA through the Level 1 text in relation to the phased introduction of the mandatory clearing obligation.

- While we welcome the improvements in the approach regarding non-financials and hedging definition since the 1st Discussion Paper, we still have a number of further concerns:
  - We believe that financials and non-financials exceeding the clearing threshold (NFCs+) should be able to rely on assertions from non-financials that they have not exceeded the threshold – or, at the very least, guidance should be given as to how financials and NFCs+ could reasonably be expected to understand (otherwise) whether they have exceeded the clearing threshold.
  - We maintain that commercial hedges of transport, storage, commodity, credit and equity risk – which would seem not to count towards the clearing threshold based on reading of some parts of the relevant draft RTS – should be explicitly referred to alongside hedging of FX, inflation and interest rate risk, as legitimate commercial hedges and therefore exempt from inclusion towards the calculation of the clearing threshold.
  - We believe that the guidance addressing hedge accounting that can be used to satisfy the 'objectively measurable…' criterion should be amended to permit the use of local accounting rules of the relevant EU member state as a means of satisfying this criterion in cases where the NFC has no requirement to report under IFRS. If this approach is not adopted, additional and significant reporting burdens will be placed on NFCs not only to satisfy the requirements of hedge accounting under "local GAAP", but also to show that their hedges meet this criterion.
  - We believe clarification is needed of the term 'proxy hedging' – and – perhaps - addition of the term 'macro hedging'.

- We question whether Article 1 NFC sub-paragraph 2 should include references to 'trading' and 'investment' as these words are sufficiently broad in meaning that they could exclude legitimate hedging activities by NFCs from benefiting from the exemption they are intended to benefit from. This sub-paragraph should probably end with the word 'speculation.'
- As Special Purpose Vehicles (SPVs) used in securitizations and other structured finance transactions commonly enter derivatives trades as part of their commercial activity, we believe that they should benefit from EMIR exemption but would ask ESMA to confirm our reading of the rules**.** We note that securitisation provides an important source of funding in Europe for real economy assets and we encourage ESMA to guard against outcomes which could indirectly reduce the viability of the asset-backed market.

- Concerns in relation to the ESMA draft RTS addressing the clearing threshold include
  - The much more onerous consequences resulting from breach of the clearing threshold in one asset class by a NFC – including the requirement that derivatives in all asset classes would have to be cleared by the NFC – than apparent under CFTC rulemaking, where only derivatives in the asset class where the threshold was breached would have to be cleared. It is not clear to us from reading the EMIR text that ESMA is prevented from altering this approach. We support further alignment with the CFTC approach herein.
  - We do not believe the gross notional represents a measure of risk – which should be the key concern in addressing whether a clearing requirement should apply – and believe the clearing threshold should instead (or alternatively) be expressed in net exposure terms.
  - We would favour clearer definition of asset classes (for compliance purposes).
  - We would welcome clarification of whether or not short-dated FX contracts will count towards the clearing threshold (again for compliance purposes).
- In relation to non-margin bilateral risk mitigants:
  - Further clarity would be helpful on some of the terms used in relation to confirmation requirements including: what qualifies as a 'confirmation'; what is meant by 'concluded'; what is meant by 'same business day'.
  - We don't believe it is proportionate that a portfolio reconciliation requirement be applied to intragroup trades, and also believe that – though firms should act in good faith to procure the cooperation of counterparties in the portfolio reconciliation process – the rules should recognise that – given reliance on counterparties' cooperation in order for such processes to be effected - 100% compliance may not be achievable.

    - Portfolio compression processes are not available or suitable to some types of counterparty (e.g. NFCs) and some types of contract/asset class (e.g. short tenor products or equity derivatives).

- In relation to the notification to regulators on intragroup transactions, we would welcome: guidance on the meaning of 'practical and legal impediments' – which although likely to be addressed in work in late 2012 or early 2013 by ESMA – is important for firms seeking to comply with the draft RTS as it addresses intragroup transaction notifications; harmonization of the types of information that regulators could ask of firms (for compliance and commercial confidentiality purpose). We also have some concerns about the provision of commercially-sensitive information regarding intragroup transactions to regulators and the public and burdens associated (particularly with regard to burdens for NFCs).

- We believe that some of the details of the draft RTS addressing recognition of 3rd country CCPs may be unnecessary, where a CCP's home country has already been deemed subject to equivalent regulation (e.g. in this circumstance it is arguably unnecessary for the CCP to have to furnish ESMA with evidence of its financial resources or of its compliance with applicable law in that jurisdiction).

- While the Signatory Associations generally welcome the provisions of the draft RTS which relate to CCP governance as they firmly establish the duties and responsibilities of the board and senior management in regards to risk management, audit and compliance, we call on ESMA to further clarify the risk committee's role in assessing and agreeing whether the CCP model fits the appropriate standard for clearing a given class of derivatives. We also believe the relationship between the Compliance and Risk functions is unclear, with accountability for technical compliance obligations in relation to risk management firmly placed with Risk.

- In relation to organizational requirements for CCPs, ESMA proposals on disclosure establish a firm foundation going forward, however we believe that a CCP's investment policy and account structure should also be made publicly available. Access to a CCP's investment policy is key to prospective members and market participants, while information regarding account structure should be sufficiently detailed to allow market participants to carry out independent due diligence on client asset protection.

- We agree that record keeping is an essential element for assessing CCP compliance with the relevant regulations and a useful tool to monitor clearing members and, where necessary, clients' activities and behaviours. Accordingly, we support the RTS proposals, albeit with minor suggestions on clarity, and remind ESMA that where records are kept offsite, the response time for records requests could be days rather than hours.

- The Signatory Associations support many of the proposed elements of the business continuity requirements including the policy framework, requirement for secondary processing sites and business recovery sites, regular testing, communication and awareness. We do have reservations regarding the proposed 2 hour recovery time for a CCP's critical system, particularly if meeting this target is based on purely technical solutions; in this case, the cost involved in meeting this target may be disproportionate.

- We believe that CCPs - subject to regulatory approval – are best placed to decide on appropriate confidence levels for different products, including OTC derivatives. The rigid difference in treatment (99.5% vs 99%) between OTC derivatives and other types of financial instrument set out in the draft RTS is not justified or risk-sensitive in our view, and exceeds the standard (99%) set out for uncleared trades in the recent BCBS-IOSCO consultation on uncleared margin – which seems to reflect the general direction of policy on clearing at G20 level. It also may have a serious and disproportionately large impact on the amount of initial margin that would be required to be posted by clearing members in order to achieve that additional 0.5% percentage confidence level, potentially disadvantaging EU clearing members against those who are able to satisfy their clearing obligations through CCPs located in other jurisdictions and making EU CCPs less competitive than the rest of the market applying the generally accepted 99% percentage confidence level. We are also concerned about the approach taken on look-back period, which we believe is overly prescriptive, (similarly) not risk sensitive and may have serious liquidity impacts. Finally, as a result of the proposed correlation regulation, portfolio margining for some positions that have a strong theoretical basis would not be permitted, such as for two year vs. ten year interest rate swaps. Likewise, the proposed offset regulation would mean that the IM for two exactly offsetting swaps (or a swap hedging an option) was the same as that for two much less correlated trades.

- We believe Risk Committees should approve CCPs' default fund frameworks. In order to ensure sound, fair and correct use of default funds in event of a clearing member default, fund arrangements should be regularly monitored and tested.

- We would welcome an explicit statement in the final RTS to confirm that EMIR Article 44 does not relate to intraday liquidity requirements for the cash-clearing CCPs operating on a pan-European basis. Consequently, we support ESMA's Policy option choice that the RTS does not provide defined standards, but rather states the factors that should be considered in evaluating concentration risk. We also agree with the preferred option in respect of a criteria based approach which is more flexible, rather than a prescriptive one, when defining appropriate sources of liquidity.

- In addressing the default waterfall, and – in particular – the CCP 'skin-in-the-game' requirement (where ESMA proposes 50% of a CCP's regulatory capital requirements, as calculated under the EBA proposals, from its regulatory capital resources (i.e. share capital and reserves)), we note the importance of achieving a balance of the desire for

CCPs to have "skin-in-the-game" (which is critical to incentivizing CCPs to set adequate margins) and regulation that does not favour a particular CCP ownership structure, with ensuring there are incentives for CMs to bid in an auction of a defaulting CM's portfolio, and the systemic risk associated with member-owned CCPs, where the default of a single larger broker could potentially bring down the CCP or require its recapitalisation at a time when funding may be scarce. We are uncertain as to whether the 50% quantum is the correct balance. We propose variations and alternatives therein and also suggest that ESMA and the EC work with industry on a quantitative impact study on this point.

- We stress the importance of transparency by CCPs regarding their collateral policies, in order for clearing members and clients to be able to gauge associated risks. We believe that cash (in the currency of denomination of the underlying instrument or that in which the relevant transactions are settled, and US Dollars, Euros, Yen and British Pounds) and direct obligations of, or obligations guaranteed by the sovereign of the jurisdiction in which the CCP resides or other highly rated (i.e. 'A' or above) sovereigns are the optimal forms of collateral for CCPs to accept. We recognize that commercial bank guarantees should be allowed as a form of collateral for NFCs (as stated in the EMIR text), but support some of the condition set out for their use in the draft RTS. Conditions (e.g. haircuts) are also appropriate for other forms of collateral.

- Concerning CCP investment policy, we maintain a number of concerns. In particular we remain concerned with (i) the rehypothecation by CCPs of clearing members' non-cash initial margin (we believe such rehypothecation or re-use by CCPs should not be permitted other than to access central bank liquidity in the limited circumstances of clearing member default), and (ii) the posting to CCPs of clearing members' non-cash collateral by way of title transfer (we believe that CCPs should be required to receive clearing member non-cash margin only by way of security interest). Our proposals are aimed at better insulating clearing member collateral from CCP insolvency risk, thereby also facilitating compliance (by clearing members and their clients) with Basel III/CRD IV. In this regard, we would recommend that ESMA consider requiring CCPs to provide reasoned legal opinions to the effect that margin and guarantee fund contributions would not be included in their insolvent estates. This also would go some way to satisfying the "bankruptcy remoteness" legal opinion requirement which clearing members and some clients will need to obtain for Basel III/CRD IV purposes.

- We make detailed suggestions herein for CCP model validation, back testing and stress testing. As a general principle, we believe that Risk Committees should have a key role in devising and overseeing such testing.

- Trade Repositories: We highlight the need for consistency with other international regulators and this not only on the principles-based level but also on the more detailed level. In addition we highly recommend leveraging existing industry standards such as

FpML to cater for changes in specifications due to product changes and facilitate international consistency. At the same time, several data elements requested will be of very limited value (free text formats) or do not leverage structures developed by the industry to properly represent these data points. A high level cost impact survey indicates that the cost of ESMA compliance can triple if consistency and leveraging existing infrastructures are not further achieved.

- We continue to support the idea of reporting collateral/exposures, but believes this should be done via a single "Counterparty Exposure Repository". A purpose-designed Counterparty Exposure Repository would be the optimum solution to provide an aggregated risk view for regulators, which could be created to contain the net mark-to-market exposure for each counterparty portfolio and the corresponding collateral.

Comments on the consultation paper and draft RTS

III.OTC Derivatives

III. I Clearing Obligation (Chapter II)

Indirect clearing arrangements

We welcome the approach taken by ESMA in the draft RTS set out in Annex II, Chapter II of the Consultation Paper in a number of respects: first, as regards the Impact Assessment we welcome the adoption of Policy option 2, which recommends a 'one step lower than the CCP' approach, over Policy option 1, which would have required protections for indirect clients (the '**Indirect Clients'**) to be maintained all the way up to the CCP, subject as stated below that this 'one step lower' approach must facilitate a flexible method of delivery and be supported by an adequate legal framework; secondly, we believe the non-prescriptive approach taken in relation to implementation should make clear that it permits suitable implementing structures, procedures and legal documentation to be developed by clearing members (**CMs**) who facilitate indirect clearing arrangements, clients of CMs (the **Client of CMs'**) who provide indirect clearing services to their clients and CCPs alike; and thirdly, that the draft RTS goes some way to recognising the information flow necessary between these parties as a prerequisite to a workable indirect clearing solution.

However, there are several areas of the draft RTS which give concern to our members as to the viability of the proposed indirect clearing model from a current legal, operational and cost perspective and how the parties involved will in practice be able to achieve the protection standards proposed, in particular for CMs wishing to facilitate this new market structure. We set out these concerns together with some specific drafting amendments below. We believe that these raise complex but extremely important issues for all parties, which may not be resolved fully within the initial timeframe for submission of the draft RTS to the European Commission but which would benefit from an additional period of consultation.

References below are to Chapter II except where indicated.

<u>General Comments</u>

ISDA believes it is useful to summarise the rationale for indirect clearing. ESMA appears to consider this is to address concerns around access to clearing, ISDA disagrees for the reasons elaborated on further below. The rationale for indirect clearing is, in ISDA's view - as set out below - for two main purposes:

- ***i) EU to non-EU clearing*** - to allow European CMs or affiliates of such members to offer access to non-EU CCPs to EU clients that wish to trade a product only cleared on a non-EU CCP (for example CME in the US for OTC credit derivatives) but who wish to face an EU intermediary entity or must face such an entity for regulatory reasons:

- there is likely to be a regulatory requirement (such as local 'passporting' rules covering services related to derivatives business) that will prevent the direct CM on the overseas CCP from facing the Indirect Client, or a fiduciary or operational requirement that prevents the Indirect Client from facing the CM, and therefore necessitates the use of the EU intermediary entity. It would therefore not be possible for the direct CM to perform such duties in the event that the intermediary entity fails.

- this is the most important function that indirect clearing provides, as it provides access to non-European CCPs, and is the most likely method for supporting third country extraterritorial provisions globally, and allowing such EU clients to satisfy their European clearing obligation

ii) **EU regional requirements** - to allow EU regional credit institutions to offer clearing to their EU clients without the costs and risks of direct clearing membership, while providing a distribution channel for direct CM services.

In such cases it is likely that the local credit institution is effectively guaranteeing the risk of the indirect client to the direct CM because the CM does not have a sufficient relationship with the Indirect Client to be comfortable with the counterparty credit risk of the Indirect Client. It would therefore be inconsistent to require the CM to provide services to the Indirect Client. If the CM could form a direct and sufficient relationship with the Indirect Client, it would be more cost effective for the direct CM to provide services directly to that client, and the CM would need to have visibility of and retain control over the risks it takes against an underlying Indirect Client.

The regulation proposes a number of features designed to mitigate this counterparty credit risk, but they are insufficient. Only a full disclosure and analysis of the contingent liabilities that the CM is exposed to, and full rights to refuse to take on such risks, would allow CMs to properly assess and manage such risk if required to offer indirect clearing in this way. We also feel that prudential regulators should be concerned about regulated entities providing services that expose them to unknown contingent liabilities, and we fear that regulatory capital rules would also treat such a regime unfavourably.

Key Specific Comments

1. **'Facilitating' indirect clearing arrangements (Article 4 ICA, paragraph 1)**

The RTS should make clear that CMs who *elect to offer* indirect clearing arrangements for clients of their clients must do so in accordance with the RTS. The current wording suggests that there is an obligation on *all* CMs to offer such arrangements, and without limitation of type of Clients of CMs or Indirect Clients. There are several reasons why we believe this is the correct interpretation:

- Client clearing not a prerequisite of membership: EMIR does not require a CM to offer *direct* client clearing, so it would be anomalous to require CMs to offer *indirect* clearing. CMs must retain the freedom to decide for themselves whether this particular service is one they wish to offer. We believe many will choose to do so, but it might not be appropriate for all CMs. In particular, some CMs may not be permitted under the terms of their authorisation from the relevant competent authority. Alternatively some CMs, although permitted to do so, will not have the systems and risk management capacity to offer any form of client clearing. Obliging them to offer indirect clearing would then actually increase counterparty risk, which would be contrary to Article 4, para. 3 of EMIR which requires that indirect clearing arrangements must not "increase counterparty risk".

- Contrary to good commercial practice: even if the mandate were applied only to those CMs who already choose to offer direct client clearing services, similar arguments apply. Less sophisticated CMs are likely to have good commercial reasons for wanting to offer direct services to certain clients but equally will not have the systems and risk management capacity to offer more extensive services, whether directly or indirectly.

- Commercial disincentive: we expect that many potential CM firms would be disincentivised to become CMs if indirect clearing structures must also be offered in all circumstances as additional investment, specialist expertise, and significant additional risks may be prohibitive

- Effect on competition/risk: requiring all CMs to offer indirect clearing may have the effect of limiting eligible CMs to a few global institutions who have the operational capability and savings of scale to make it a viable part of their business. This could result in a concentration of counterparty risk and would be inconsistent with the EMIR aim of reducing systemic risk

- If applied, the mandate should apply equally to non-EU CMs of non-EU CCPs. For reasons that we elaborate on further below, we do not think that an FCM would be able to comply with the approach taken in the draft RTS. We therefore question the *vires* of the Commission or ESMA to impose such obligations on third country entities.

- While the EMIR text contains language permitting an entity to meet a clearing obligation by the use of indirect clearing arrangements, it does not require such arrangements to be made available or provide for powers to the Commission or

ESMA to do so. We therefore question the validity of any RTS which purports to make this obligatory.

Indirect clearing should not be used as the solution to concerns relating to wider access to clearing. The practical likelihood of any entity wishing to sign up as a Client of CM and not being able to find a willing CM is, in our view, remote (though there may be timing concerns depending on the volume of clients seeking to sign up as a Client of CMs). We would urge ESMA to consider that aspect in any proposal for phase-in of a Mandatory Clearing Obligation. Such timing concerns apply to an even greater extent with indirect clearing models, which the industry has not yet even begun to consider implementing structures for. Consequently, on the basis that the access concerns relate to timing indirect clearing arrangements are no better solution.

Accordingly, we suggest that Art.4 ICA, paragraph 1 be amended to say '***provided that for the avoidance of doubt there shall be no obligation on any clearing member to offer indirect clearing arrangements to its clients or any clients of its clients***' and/or alternatively clarify that where used in the RTS the term 'clearing member' means '***a clearing member which offers indirect clearing arrangements to its clients'***.

2. Levels of Protection to be offered to Indirect Clients

Article 4 ICA, paragraph 3 of EMIR requires that indirect clearing arrangements do not increase counterparty risk and ensure that the assets and positions of the Indirect Client benefit from protections with equivalent effect to those referred to in Article 39 (Segregation and Portability) and 48 (Default Procedures). We think it is helpful to consider the protections under the two main headings which relate to the EMIR text Article 4, paragraph 3 of EMIR, namely a) segregation and b) portability.

a) <u>Segregation</u>

Article 4 ICA, paragraph 2 appears to set out the two types of segregation arrangements which must be offered by a CM as selected by the Client of the CM. We note that paragraph 2a broadly corresponds to the EMIR Article 39, paragraph 2 concept of 'omnibus client segregation' (we will refer to this as Indirect Omnibus Segregation) and paragraph 2b broadly corresponds to the EMIR Article 39, paragraph 3 concept of 'individual client segregation' (we will refer to this as Indirect Individual Segregation). Paragraph 2 also suggests that the standard of distinguishing assets is measured by reference to Article 39(9) of EMIR (namely recording assets and positions in separate accounts, netting across such accounts precluded and no exposure to losses on other accounts).

If this interpretation is correct, then several concerns arise:

- Legal framework: the effect of the above would be to apply to CMs the same standards as are applied to CCPs under EMIR. However, CCPs and their Rules and related market contracts benefit in many jurisdictions from special status by virtue of the CCP being a ‘recognised’ central clearing service providers. This serves to allow their asset protection regime to prevail over contrary insolvency rules. An example would be Part VII Companies Act 1989 in the UK. CMs do not currently benefit from such special status, and therefore it would be vital to create a workable legal framework from contractual principles and ensure that it was effective and supported by appropriate legal opinions in each relevant jurisdiction, in particular the jurisidictions of each of its clients who had Indirect Clients to ensure that the requirements of the indirect clearing obligation are met.. Development of such a framework, which might involve a combination of security interest, trust or agency arrangements would require significant time and expense, as such arrangements are not typically standard in the CMs / Client of CM/ Indirect Client relationship, and may warrant a marketwide or industry body-sponsored development project. In particular, a framework which ensured the efficacy of Indirect Individual Segregation would be complex.

  This divergence from CCP level protection is exacerbated by Article 3 ICA, paragraph 2 which states that a CCP is not required to enter into direct contractual relationships with Indirect Clients. Without such direct relationship up to CCP level, and in the absence of suitable statutory support for the CM, we believe it would be extremely difficult for CMs to offer the equivalent protection of full segregation to the end-client .

  We therefore propose that the two levels of segregation set out in paragraph 2 a and b are alternatives rather than cumulative – the word ‘***or***’ should be inserted at the end of paragraph 2a and the words ‘***one or more of***’ before the words ‘*the following*’ in the first line of paragraph 2. This would still be consistent with the wording of Article 4, paragraph 3 EMIR which requires the protections offered to be of a certain (‘equivalent’) standard, but does not go so far as to require all possible protections to be offered by a CM. This would also be consistent with the right to that of a CM to choose its business model as described above.

- Methods of offering levels of segregation: If ESMA considers that it does not have the scope to treat Article 4, paragraphs 2.a and 2.b as alternatives rather than cumulative offerings, it is even more important that sufficient flexibility should be included in the RTS as to the manner in which the CM makes available the two levels of segregation. Specifically, the RTS should facilitate the possibility that the Client of CM, when dealing with the CM on behalf of a particular Indirect Client, is acting on an agency basis ("client-as-agent model") in bringing the CM and Indirect Client together, rather than the Client of CM acting as principal counterparty to the CM and holding back-to-back exposures with Indirect Clients.

In such a client-as-agent model, each Indirect Client could effectively be treated on the books and records of CM as if it had signed up as a Client of CM electing to receive individual segregation, and therefore receive EMIR-compliant individually segregated protection. Depending on how such a client-as-agent model is designed, the CM might still look to the Client of CM to meet or guarantee margin obligations of an Indirect Client who had selected such an approach, although technically the CM's ultimate counterparty would be the relevant Indirect Client.

Where a CM seeks (or is required, depending on final ESMA RTS) to offer a range of indirect clearing services offering both levels of segregation, the RTS should give clear guidance to the effect that it may comply using a mixture of structures so that, for example, paragraph 2b Indirect Individual Segregation is offered only on a "client-as-agent" basis and other Indirect Omnibus Segregation services may be offered on a "client-as-agent" or a principal basis.

We consider that this is within the letter and the spirit of EMIR and the draft RTS, since it ensures that the Indirect Client continues to have choice, and also transparency as to the protections afforded by the choice it makes. This could be resolved with the inclusion of the following additional sentence at the end of Article 4, paragraph 2, after the two indents for paragraphs a and b:

"*A clearing member may implement one or both of these segregation arrangements by offering an indirect clearing arrangement where the client (i) acts as principal in relation to the CM or (ii) acts as agent on behalf of the relevant indirect client in binding that indirect client to arrangements provided by the CM.*"

- Extra-territorial concerns: As summarised in General Comments above, one of the main purposes of indirect clearing is to allow European CMs to offer access to non-EU CPPs to EU clients through CMs of those non-EU CCPs. Any proposal in the RTS then must be capable of being implemented by the CMs of such non-EU CCPs and not prevented by any legislation that they are subject to. Any proposal that is not so capable of being implemented is in danger of creating an uneven playing field between CMs of EU CCPs and CMs of non-EU CCPs or preventing clients from using non-EU CCPs to satisfy their clearing obligation. This will involve a high degree of due diligence which we have not been able to undertake in the time available. However we would like to highlight one area of immediate concern in relation to the position of FCMs in the US. FCMs would be CMs for the purposes of the RTS. The concern herein is as follows: 17 C.F.R. § 190.07(b)(2)(ix) (2012) provides that an omnibus customer account of an FCM maintained with a debtor shall be deemed to be held in a separate capacity from the house account and any other omnibus account of such FCM. The CFTC has confirmed (in the commentary to the CFTC Rules) that the CFTC's intention is to continue to treat omnibus accounts of a foreign broker clearing through an FCM as a single 'customer' for the purposes of the requirements of Part 22 of the CFTC Rules. 17 C.F.R. § 190.07(b)(2)(ix) (2012) provides that an omnibus customer account of an FCM maintained with a customer constitutes one account. 17 C.F.R. § 3.10(c)(2)(i) (2012) then requires a foreign broker to clear on an omnibus basis through an FCM. Taking these two provisions together, it is difficult to see how an FCM could comply with the requirements of Article 4 in relation to segregation arrangements. Even if the flexibility afforded by the "client-as-agent" model is built as contemplated in the previous paragraph is it difficult to see how an FCM would comply with Individual Client Segregation because this would involve such FCM providing clearing services in the EU potentially in breach of licensing requirements It may be possible to deploy contractual mechanisms to track the positions but this would need further consideration, and specialist solutions in respect of FCMs would need to be found.

- Effect of Recital (4): we support the philosophy described in this Recital, i.e. that the requirements set out in the Regulation on the segregation and portability of positions and assets of Indirect Clients should prevail over any conflicting laws, regulation and administrative provisions of the Member State that prevents the parties from fulfilling them. Even if this provision was moved from a Recital and placed into the body of the RTS, we consider that such wording does not constitute a sufficiently reliable legal basis on which CMs could certify compliance with the standards envisaged by paragraph 2 as mentioned above. We would recommend further study at EU level on how an appropriately supportive legal environment might work.

- Obligation of Client of CM: Article 4 ICA, paragraph 8 should make clear that a Client of the CM must not only offer one or more of the paragraph 2 segregation options but also that it must *implement* the necessary arrangements, in the same way as paragraph 2 requires the CM to implement such arrangements. We suggest adding the words '***and implement the segregation arrangements referred to in paragraph 2***' or similar wording after the words '*paragraph 2*'.

- Operational concerns: one consequence of the draft RTS is that if an Indirect Client asks for Indirect Individual Segregation at CM level, CMs may be expected to ensure such segregation and recognition is reflected even at CCP level. For example, under the current construct, a Client of the CM could simply ask a CM to open several individual accounts one for each of its Indirect Clients. This would mean increased operational cost and impact of supporting client clearing. These would include the costs of increased number of reconciliations, cash bookings and exchanging of collateral for multiple individually segregated accounts. These costs would compound across CCPs, CMs and custodians holding clients' positions.

- Ability of client to define contractual terms: Article 2 para 2 should make clear the parameters within which a client can define the contractual terms of its indirect clearing arrangements, given the obligations placed on CMs in the context of such arrangements on a default of Clients of the CM. At a minimum, these should include an obligation on the Client of the CM to involve the relevant CM and to ensure that the indirect clearing arrangement is legally consistent with the protections being offered by the CM in connection with such arrangement.

b) <u>Porting</u>

Article 4 ICA, paragraph 4 attributes a 'default management' responsibility to the CM offering indirect clearing services. We note that the following paragraphs 5 and 6 supplement this by imposing Indirect Client consent and 'back-up' measures in the event of a failed transfer of Indirect Client accounts.

As with segregation (above) several concerns arise:

- Legal framework: similar considerations apply here as stated in i) above in connection with segregation. CMs do not have any statutory support framework within which to ensure that porting of Indirect Client positions can take place in all circumstances where a Client of a CM faces insolvency, and as a result it is difficult to see how CMs could certify their compliance with the requirements in paragraphs 4, 5 and 6.

  We suggest that paragraph 4 makes clearer as a minimum which assets and positions are being transferred and that the Client of CM must also facilitate the porting. We suggest adding the words '***of the indirect clients***' after '*assets and positions*' in line 3 and adding '***and facilitated by the client of the clearing member***' after the word '*CCP*'.

- Consequences of failed transfer/porting: we do not agree that CMs should be required to hold in an account of the CCP for 30 days the Indirect Client positions, and further question what this achieves for the Indirect Clients, what is meant by 'reasonable commercial terms', what is meant by an "equivalent account" and how this reconciles with the CCP's obligation under Article 3 ICA, paragraph 1 to maintain only one 'omnibus' account for the Indirect Clients of a Client of a CM (assuming that is the obligation), and what is to happen to the positions after the 30 day period. If the regulators view is that this 30 day period is required to provide Indirect Clients with additional time to facilitate porting it clearly provides a better protection to Indirect Clients than the protection afforded to Clients of CMs in the Level 1 text and would extend beyond the equivalent protections required by the Level 1 text for indirect clearing arrangements.

- We do not agree that CMs should be required to facilitate porting of the Indirect Client positions to an alternative Client of a CM or CM of a client's choice. As stated elsewhere, a full legal and statutory support would be needed to facilitate this, and as such, a) this would require the client to already have implemented and have in place prior contractual agreements with the alternative Client of a CM or CM, b) there would be considerable operational costs and difficulties involved in ensuring that each alternative Client of CM or CM was able to accept the trades and c) there would be significant operational infrastructure required to be in place to support the outgoing business of a Client of CM or CM.

If a CM undertakes this potential holding risk, a) the CM would have to treat all of those Indirect Clients as if they were Clients of CM from day one – that is, not just from the point at which the default occurs, but from the moment the CM and the Client of CM establish a clearing relationship. In effect, absent an exemption from regulators, the CM would need to perform all 'Know Your Customer' and 'Anti Money Laundering' requirements for each Indirect Client , thus adding to the costs of indirect clearing and making it look increasingly indistinguishable from being a Client of the CM, b) counterparty credit risk implications and capital risk considerations for the CM would multiply for each Indirect Client exposure, which in turn would be contrary to Article 4, paragraph. 3 of EMIR which requires that indirect clearing arrangements must not "increase counterparty risk" and c) CMs exposure to unknown risks at the point the Client of CM defaults would create a contagion effect. Few CMs would be comfortable with the risk, and this would provide an overwhelming disincentive to utilise indirect clearing to access non-European markets.

In addition, in the FCM context this would entail the Indirect Clients becoming direct clients of the FCM. This potentially will put the FCM in breach of local regulatory licensing requirements in the jurisdictions of such clients which are one of the reasons for indirect clearing in this context (for which see further General Comments (i) above). It is difficult to see how this will work on the basis of the current RTS but again we would welcome the opportunity to discuss this further with you.

Further, CCP rules may permit faster liquidation than bilateral documentation and hence the client transaction may be closed out more quickly in the event of client non-performance than in a typical bilateral transaction. Indirect clearing arrangements should reflect this existing market practice and CMs should not be compelled to hold open positions for Indirect Clients that the CM doesn't know (or has started to know as a consequence of default of its client) for 30 days, as in effect this means that for this period CMs would have a direct relationship to those clients.

- Liquidation: given the above uncertainty about transfer of Indirect Client assets and positions, in practice it is more likely that such positions would be liquidated. We understand that it is the intention that such positions can in the alternative be 'liquidated' by the CM – paragraph 4 refers to the CCP supporting such 'prompt liquidation'. We suggest that paragraph 4 is further amended to make clear that the CM is required to either allow for transfer or allow for liquidation, or both, at its option. We suggest adding the word '***either***' before '*shall allow*' and the words '***or at the option of the clearing member***' before the word '*support*'.

- Consent of Indirect Clients to porting: we understand a CM has a duty under paragraph 5 to ensure adequate consents are in place to facilitate porting of Indirect Clients affected by the transfer of Clients of CMs accounts/positions. For 'omnibus client segregation', we understand this means 'arrangements for obtaining consent of all affected' Indirect Clients. For 'individual client segregation' we understand this means procedures for the Indirect Client to identify to the CM its designated transferee CM or Client of the CM. We note this is to allow the possibility of porting, but again point out that this in effect puts the CM in a position of having to onboard all Indirect Clients which obviates the usefulness of the indirect arrangement.

  We consider that the Client of the CM should bear this duty and should be required to ensure that such consents are provided to the CM or alternatively to it so that it can provide them to the CM directly on a reliable basis. We suggest this could be built into paragraph 7 by adding a sentence at the end '***The client will provide, or arrange for the provision to the clearing member of, the agreements and information required by the clearing member to satisfy its obligations under paragraph 5 above***'.

Our reading of the Indirect Clearing construct is that the CM acts as a CCP to its Indirect Clients. With that, we would expect the obligations of the CM in the case of Client of CM default to be the same as those of a CCP. Article 48, paragraph 5 of EMIR provides "Where assets and positions are recorded in the records and accounts of a CCP as being held for the account of a defaulting CM's clients in accordance with EMIR Article 39(2), the CCP shall, at least, contractually commit itself to trigger the procedures for the transfer of the assets and positions held by the defaulting CM for the account of its clients to another CM designated by all of those clients, on their request and without the consent of the defaulting clearing member. That other CM shall be obliged to accept those assets and positions only where it has previously entered into a contractual relationship with the clients by which it has committed itself to do so. If the transfer to that other CM has not taken place for any reason within a predefined transfer period specified in its operating rules, the CCP may take all steps permitted by its rules to actively manage its risks in relation to those positions, including liquidating the assets and positions held by the defaulting CM for the account of its clients."

We would propose that articles on indirect clearing mirror the same optionality as outlined in Article 39, paragraph 5.

3. Risk evaluation information

We note that paragraph 7 provides for Indirect Client information to flow upstream from Client of CM to CM and that the CM must establish procedures to avoid 'commercially' benefitting from the information – these are disclosable to the Client of the CM and Indirect Clients on request. We note that the Recital (5) refers to 'Chinese walls' for this purpose. It is possible, and in some cases appropriate, for a Chinese Wall to be constructed within a CM between those individuals involved in execution, and those involved in clearing. However it would be impractical to construct such an information barrier between those offering direct and indirect clearing, as the services are essentially the same. In any event, this gives rise to client confidentiality concerns which will need to be addressed by the CM and disclosing Client of CM. We suggest providing in paragraph 7 for a deemed consent by all affected Indirect Clients for the benefit of the CM and the Client of the CM and consideration of whether such consent suffices to override local banking secrecy requirements in the jurisdiction of the Indirect Client.

Disclosure following default by a Client of a CM under paragraph 9 would need to be revised so that such disclosure is automatic upon default, as a defaulting Client of a CM could not be relied upon to make disclosure to the CM who would be looking to action the Indirect Client positions. It is not clear also what the difference would be between the post-default information under paragraph 9 and the pre-default information under paragraph 7. This should be clarified.

In addition to disclosure already indicated in the RTS, it is important to include that CMs would have to have a periodic view into the positions of Indirect Clients, in order to be able understand, monitor and manage potential risk and exposure it may take on in the case of a default of the Client of a CM.

In addition, the CM would need to be protected from liability in respect of any information provided by an Indirect Client which may not be accurate. Currently this would need to be dealt with contractually but CMs would prefer a statutory protection as it should not be expected that the CM accept further liabilities in this respect when it is currently not provided with a structure that provides full access to the information held by an Indirect Client.

In summary, we note that the RTS proposes a number of features designed to mitigate this counterparty credit risk, but they are insufficient. Only a full disclosure and analysis of the contingent liabilities that the CM is exposed to, *and full rights to refuse such risks*, would allow CMs to offer indirect clearing in this way. On the other hand full disclosure, analysis and veto rights would undermine the premise of indirect clearing for other banks.

4. Disclosure obligation imposed on CMs

As regards Article 4 ICA, paragraph 1, public disclosure of ‘reasonable commercial terms’ of indirect clearing arrangement by CMs should not be a requirement on CMs as it may disincentivise investment of resources in development of the clearing models required to support indirect clearing. In addition, as this will be a new market, it will be impossible to benchmark what would be ‘reasonable’ for this purpose. We suggest this requirement is deleted.

5. Guarantee of obligations

We propose that Article 2 ICA, paragraph 2, last sentence is deleted. As drafted it suggests that the CM must guarantee or underwrite performance of obligations as between the Client of the CM and its Indirect Clients. The CM has no knowledge of or privity to such obligations, and it would be extremely problematic from a risk, capital and accounting perspective if that inference were given. CMs obligations post default are strictly limited to facilitating close out or porting in accordance with the RTS, and subject as provided above.

6. Clearing member default

We note that the draft RTS do not deal with indirect clearing arrangements on CM default. We do not think that Recital 3 of the draft RTS is sufficient in this regard. Recital 3 relies on Article 39 of EMIR to provide the requisite protection. However, Article 39 does not provide the porting protection: this is instead provided by Article 48 of EMIR. In any event, neither of Article 39 or 48 contemplate Indirect Clients.

7. Definitional comment

We note some defined terms appear at the start of Chapter II. However the use of ‘client’ and ‘indirect client’ could be confusing. We suggest revising and capitalising defined terms to indicate ‘client of CM’ (e.g. ‘Client of CM’) and ‘indirect client’ (‘Indirect Client’) where relevant (for example Article 4 ICA, paragraph 2, line one could refer to ‘Client of CM’ not just ‘client’).

We understand from paragraph 23 of the Consultation Paper that any Indirect Individual Segregation need not be tracked to the CCP. We do not think that this is clearly reflected in the drafting of Article 3 ICA, paragraph 1 and would suggest that this is clarified to the extent that the current proposal remains.

Note that as a result of amendments suggested to Article 4, paragraph 2 consequential amendments would need to be made to the subsequent paragraphs to reflect and incorporate these amendments.

III. II Clearing obligation procedure (Chapter III)

The Consultation Paper sets out draft RTS in relation to the clearing obligation procedure under EMIR Article 5 in Annex II, Chapter III, Article 1 DET and Chapter IV, Article 1 CRI.

In order to avoid creating legal uncertainty for market participants, the Signatory Associations consider that it is important to clarify whether the clearing obligation procedure under EMIR Article 5 is triggered only by the granting of authorization to CCPs under EMIR, and not by CCPs already authorized under existing national law, or by the submission of an application for authorization.

The Signatory Associations would welcome the inclusion of provisions clarifying these points in the RTS, either by stating clearly that the clearing obligation procedure would only be triggered where a competent authority notifies ESMA that it has completed the authorization procedure and granted authorization to a CCP, or, if ESMA has another interpretation, by providing for adequate transitional measures to allow counterparties to put in place appropriate systems and controls to ensure that they can comply with the clearing obligation.

When is the clearing obligation triggered?

Under EMIR Article 5, OTC derivatives may become subject to the clearing obligation in one of two ways:

- within six months of receiving notification in accordance with EMIR Article 5, Paragraph 1 or accomplishing a procedure for recognition set out in EMIR Article 25, ESMA shall develop RTS specifying the class of OTC derivatives that should be subject to the clearing obligation (the **'bottom up'** method); or

- ESMA shall, on its own initiative, identify and notify to the Commission the classes of derivatives that should be subject to the clearing obligation, but for which no CCP has yet received authorization (the **'top down'** method).

Under the 'top down' method, following its notification to the Commission, ESMA shall publish a call for a development of proposals for the clearing of those classes of derivatives, but it does not have powers to submit draft RTS to the Commission.

However, under the 'bottom up' method, once ESMA has submitted its draft RTS to the Commission, that class of OTC derivatives is likely to become subject to the clearing obligation within three months. As a result, it is critical that firms should have clarity over which OTC derivative contracts are likely to become subject to the clearing obligation under the first option.

We understand that ESMA may only submit draft RTS to the Commission under the 'bottom up' method where it has received notification that a competent authority has authorized a CCP under EMIR, or where ESMA has recognised a third country CCP under EMIR.

EMIR Article 5(1) states that "where a competent authority authorizes a CCP to clear a class of OTC derivatives under EMIR Article 14 or 15, it shall immediately notify ESMA of that authorization". EMIR Articles 14 and 15 relate to authorization of CCPs under EMIR, and extension of that authorization.

As a result, we understand that the notification referred to in EMIR Article 5(1) can only be triggered where a competent authority has completed the authorization process under EMIR. It cannot and should not be triggered where a competent authority has received an application for authorization under EMIR, or where a CCP is already authorized under existing national law.

Although there is a process under EMIR Article 89(5) for competent authorities to notify ESMA of CCPs already authorized or recognised under existing national law, we understand that this notification would not trigger the clearing obligation procedure under Article 5. There is no power under EMIR Article 5 for ESMA to submit draft RTS on the basis of a notification issued under EMIR Article 89(5), and if the clearing obligation procedure was triggered on this basis this would create significant legal uncertainty for counterparties.

Concerns if the notification is triggered by CCPs already authorized under existing national law

If the clearing obligation procedure may be triggered by notification to ESMA under EMIR Article 89(5) that a CCP is already authorized or recognized under existing national law, this may cause significant uncertainty. In particular:

- The RTS specifying which OTC derivatives are subject to the mandatory clearing obligation may come into effect before the RTS clarifying the types of counterparties which trigger the clearing obligation (e.g., the RTS specifying the mandatory clearing threshold for non-financial counterparties). For example, two non-financial counterparties entering into an OTC derivative contract would not know whether that contract might become subject to the mandatory clearing obligation within the life of the contract, or whether one or both of the counterparties might be required to comply with the clearing obligation.

- Third country CCPs which are currently recognised under national law may not meet the requirements for recognition under EMIR (e.g., the legal and supervisory arrangements of that third country may not be determined to be equivalent in accordance with Article 25(6)) at the point when the clearing obligation would come into effect, and may never do so. As a result, a class of OTC derivatives could become subject to the mandatory clearing obligation although it may not be possible for EU counterparties to clear those OTC derivatives.

A third country CCP which is currently recognised under national law may decide that it will not seek recognition under EMIR. This would raise similar issues to those set out above.

Concerns if the notification is triggered by a CCP submitting an application for authorization

Significant uncertainty may also arise where the notification is triggered by a CCP submitting an application for authorization or recognition:

- There is no requirement under EMIR for competent authorities to notify ESMA when they receive an application for authorization under EMIR. As a result, it is not clear that ESMA has the authority to request this information.

- This approach could have the effect that the process for authorizing a CCP and for determining that an OTC derivative contract should be subject to the mandatory clearing obligation would be run in parallel, and that the relevant class of OTC derivative contract may become subject to the mandatory clearing obligation at the same time that the CCP becomes authorized. Unless there are clear transitional provisions, this would not give firms any time to make arrangements for clearing the relevant class of OTC derivative contract. There is no requirement for competent authorities or for ESMA to publish a notice that a particular CCP has applied for authorization or recognition, so firms would only become aware that a CCP was seeking authorization or recognition when it actually became authorized or recognized. It would be necessary for there to be a period of time in between the announcement that a CCP has been authorized or recognised, and the announcement that particular classes of OTC derivatives are subject to the mandatory clearing obligation for firms to amend their contracts to allow for central clearing, put in place arrangements for clearing that class of OTC derivatives through an authorized CCP, and to amend their systems and controls to ensure that all OTC derivatives of the relevant type are centrally cleared.

As discussed above, a third country CCP which seeks recognition from ESMA may never obtain recognition. This could create a class of OTC derivatives which are subject to mandatory clearing but which no authorized or recognised CCP is able to clear.

Again, as discussed above, it is important that counterparties know whether they will be required to comply with the clearing obligation before classes of OTC derivative contract become subject to mandatory clearing, to give them time to enter into clearing arrangements, amend their contracts and adapt their systems and controls. The RTS specifying the clearing threshold for non-financial counterparties should be adopted well in advance of any RTS specifying the classes of OTC derivative contracts which are subject to the mandatory clearing obligation.

In addition, Article 1(5) DET could be read as imposing a further pre-condition for authorization of a CCP under EMIR. If ESMA intends to start the mandatory clearing process from the date on which ESMA is notified that a CCP has submitted an application for authorization or recognition, Article 1(5) DET should be amended to clarify that the process for authorization of a CCP under EMIR and the process for determining that a class of OTC derivatives is eligible for mandatory clearing under EMIR Article 5 are separate, and that a CCP may still be authorized under EMIR even if ESMA determines that the OTC derivatives it clears are not subject to the mandatory clearing obligation.

Details to be included in the notification from the competent authority to ESMA

Article 1(2)(f) DET requires that the notification shall include information on "risk management, legal and operational capacity of the range of counterparties active in the market". This is not information that a CCP or competent authority would necessarily have access to. As a result, in order to give a clear picture to ESMA we consider that the CCP and competent authority should be required to engage in appropriate consultation with the market when preparing this information. We welcome the statement in Recital 7 that ESMA should assess the ability of active counterparties to comply with the clearing obligation without disruption to the market, and consider that it would be helpful to include similar wording in Article 1(2)(f) DET.

We welcome the requirement for the notification to include historical data in accordance with Articles 1(3) and (4) DET. However, we consider that the look-back period of 12 months under Article 1(4) DET is not sufficient, and ask that this period should be set at a minimum of 12 months.

We note that under Article 1(7) DET where ESMA has determined that a class of OTC derivative contracts shall not be subject to the clearing obligation, the competent authority is required to submit a new notification if it becomes aware that the market conditions or any of the information provided in the original notification has changed. We consider that the competent authority which has submitted a notification to ESMA should always be required to submit a new notification if it becomes aware that the market conditions or any of the relevant information has changed, whether ESMA has made a positive or negative assessment regarding eligibility for clearing, and ask that Article 1 DET be revised to reflect this.

ESMA should also be required to publish immediately the details of any negative assessment that it makes under Article 1(7) DET.

Criteria for determining the classes of OTC derivative contracts subject to the clearing obligation

We welcome the statement in Recital 8 that "the fact that a contract is sufficiently liquid to be cleared by one CCP does not necessarily imply that it should be subject to the clearing obligation, and ask that ESMA include a similar statement in Article 1 CRI. In particular, we would welcome confirmation from ESMA that, when taking into consideration the volume and liquidity of the relevant class of OTC derivatives (in accordance with EMIR Article 5(4), it will assess the potential impact on liquidity of making that class of OTC derivatives subject to the clearing obligation, and will not make a class of OTC derivatives subject to the clearing obligation where this would have the effect of reducing the liquidity of that class of OTC derivatives.

Front-loading: The collateral and clearing arrangements under which an OTC derivative trade is executed form a key part of the contract, and can have a significant impact of the value of any such trade, and these same terms determine the impact, which could be positive or negative, of any novation or front-loading.

Mandatory front-loading of executed trades done under bilateral CSAs could be considered equivalent to mandating a post-fact change in eligible collateral, and would generate significant uncertainty in pricing any such trade. The impact of this could only be to reduce liquidity and damage price transparency.

We continue to believe that price transparency and market integrity would be best served by mandating the clearing of only those transactions executed after the ESMA determination has been issued.

III. III Public Register (Chapter V)

The Consultation Paper sets out the details to be included in the public register to be maintained by ESMA under EMIR Article 6 in Annex II, Chapter V, Article 1 PR.

Details of classes of OTC derivative contracts

The Signatory Associations consider that it is crucial that market participants be able to distinguish the OTC derivative contracts which are subject to the mandatory clearing obligation from those which are not. As a result, the Signatory Associations would welcome the amendment of Article 1(2) PR to include any other characteristic required to distinguish a contract in the relevant class of OTC derivative contracts from any contract which does not form part of that class.

In addition, the details in relation to the classes of OTC derivative contracts that are subject to the clearing obligation should include the names and identification codes of the CCPs which are authorized or recognised to clear those OTC derivatives.

Additional details set out in EMIR Article 6(2)

The Signatory Associations understand that Article 1 PR is intended to set out the details to be included in the public register in relation to each of the categories set out in EMIR Article 6(2)(a) – (f). However, it only appears to cover EMIR Article 6(2)(a) – (c). It is not clear why it does not cover Article 6(2)(d) – (f), and the Signatory Associations would welcome either confirmation that the RTS in relation to classes of OTC derivatives would apply to both Article 6(2)(a) and (d), and that the RTS in relation to CCPs would apply to both Article 6(2)(b) and (f), or amendments to Article 1 PR to cover Article 6(2)(d) – (f). In particular:

- *Article 6(2)(d)*: the details provided in relation to the classes of OTC derivatives identified by ESMA in accordance with Article 5(3) should be the same as the details to be provided in relation to the classes of OTC derivatives subject to the clearing obligation pursuant to Article 4. Article 1(2) PR should be amended to clarify this.

- *Article 6(2)(e)*: it is not clear why the draft RTS do not cover the details to be specified in relation to the minimum remaining maturity of the derivative contracts referred to in Article 4(1)(b)(ii). This will be important in working out to which contracts the front-loading obligation would apply.

- *Article 6(2)(f)*: the details provided for the CCPs that have been notified to ESMA for the purpose of the clearing obligation should be the same as the details provided for CCPs authorized or recognised for the purpose of the clearing obligation, with the addition of the date of notification.

In addition, the details provided under Article 1(3) PR in relation to CCPs that are authorized or recognized for the purpose of the clearing obligation should include the classes of OTC derivative contracts that the CCPs have been authorized or recognised to clear, even if these OTC derivative contracts are not yet subject to the mandatory clearing obligation.. This will provide important information to market participants and will also enable ESMA to comply with its obligations under Article 6(3) to remove a CCP from the public register in relation to a class of OTC derivatives when it is no longer authorized or recognised under EMIR in relation to that class.

Publication of notice that a CCP has become authorized or recognised

The date of notification that a CCP has become authorized or recognised to clear a particular class of OTC derivatives is critical for determining which OTC derivative contracts could become subject to the front loading obligation under EMIR Article 4(1)(b)(ii). As a result, we welcome the statement in Paragraph 28 of the Consultation Paper that ESMA intends adequately to inform market participants about any notifications received.

However, we also note the statement in Paragraph 46 that ESMA considers that the register should be dedicated to keeping track of classes of OTC derivatives subject to the clearing obligation, and that it does not consider that the public register is the appropriate instrument for the purpose of including the notification on OTC derivatives not yet subject to the clearing obligation.

EMIR Article 6(2)(f) states that the register shall include "the CCPs that have been notified to ESMA by the competent authority for the purpose of the clearing obligation and the date of notification of each of them". As a result, it seems clear that EMIR requires that the public register should include a list of the notifications that ESMA has received under EMIR Article 5(1) and the date of each notification. As the date of the notification under Article 5(1) is a key trigger for "front loading" under EMIR Article 4(b)(ii), it is critical that ESMA should publish this information as soon as it receives it.

Since the notification under EMIR Article 5(1) will include information on the class of OTC derivatives that the CCP has been authorized to clear, it seems to us that under EMIR Article 6(2)(f) the register should include all the information contained in the notification (and not just the name of the CCP and the date of notification). In any event, we do not consider that EMIR Article 6 prevents ESMA from including additional information in the public register. It clearly requires ESMA to establish, maintain and keep up to date a public register to identify the classes of OTC derivatives subject to the clearing obligation, but does not prohibit the use of the register for other information.

We do not consider that there would be any risk of confusion as a result of including this information in the public register. The different sections of the register should in any event be clearly marked to indicate what information they contain, and this should help to eliminate any potential confusion.

If ESMA does not intend to include in the public register information on the classes of OTC derivatives which a CCP has been authorized or recognised to clear, but which are not yet subject to the mandatory clearing obligation, we would welcome confirmation that ESMA will at least publish this information on its website.

We would also welcome clarification in Article 1 PR that the details listed in that article are not exhaustive, and that the register may include other information as appropriate.

III. IV Access to a trading venue (Chapter VI)

Commentary on Approach

EMIR – on this subject - appears to be derived from the argument that fragmentation is the least favourable option and that consolidation is the optimal state. Our view is that some fragmentation at trading level can ensure a reasonable level of competition. At a clearing level, there is a concern that where counterparties are forced to clear a given class of OTC derivative contracts that only one CCP can clear, a potential risk of abuse of a monopoly or near monopoly position may develop, including the pricing policy, at the relevant CCP.

EMIR Article 8(4), second paragraph reads: "Access of the CCP to the trading venue shall be granted only where such access would not require interoperability or threaten the smooth and orderly functioning of markets in particular due to liquidity fragmentation and the trading venue has put in place adequate mechanisms to prevent such fragmentation."

In our view, the only way that a trading venue could prevent such fragmentation would be to ensure that it has exclusivity with a CCP, such that the CCP could not clear the same product on behalf of a different trading venue. This runs counter to any requirement for competition at the level of trading venues whilst concentrating risk with a single CCP.

We note that where cash markets are fragmented today, it is not proven that fragmentation threatens the smooth and orderly functioning of markets

ESMA is required to draft RTS specifying "the notion of liquidity fragmentation". We agree that it may not be possible to come up with a single threshold appropriate for all markets.

We also agree that the intention of the legislators is for the RTS to consider only liquidity fragmentation within a single venue.

We note that the loss of netting benefits and the fragmentation of a CM's exposure have not been covered under the RTS and ask that ESMA considers the comments initially put forward in the discussion paper on this topic.

<u>Comments on the Legal Text</u>

Whilst we welcome ESMA's flexibility, it appears that a single default CCP would be required for each trading venue. A preferred CCP could also be chosen. If 2 parties trade and use the same CCP, the trade would be cleared there. However, if parties use different CCPs, the trade would be routed to the default CCP. This may require separate pools of margin in different CCPs which appears to be an inefficient use of funds (and eligible collateral, which shall in any event be in short supply across the market).

We support the text in Article 1 LF Paragraph 3 and would like to see regulation that unambiguously allows the following in respect of OTC Derivatives:

a. The ability for two parties to trade the same product and agree in advance which CCP they will use to clear the transaction.

b. A new party should not be denied access to a CCP (and the same margin pool) that already clears an existing product.

According to RTS Article 1 LF Paragraph 2, the above approach would not fragment liquidity since all participants would have access to the same CCP.

For clarity, we do not, at this stage, advocate interoperability of derivative contracts between CCPs, but welcome ESMA's flexible approach that foresees a potential requirement in the future.

III. V Non Financial counterparties (Chapter VII)

<u>**Criteria for establishing which derivative contracts are objectively measureable as reducing risk directly relating to the commercial activity or treasury financing**</u>

Responsibility for Monitoring: ESMA's proposed text does not provide clarity on who will be responsible for monitoring whether a clearing obligation should apply to a non-financial counterparty as a result of any of the clearing thresholds being exceeded. The financial counterparties ("**FCs**") and the non-financial counterparties who themselves have exceeded the clearing threshold ("**NFC+s**") should not be responsible to monitor whether a clearing obligation should apply with respect to transactions with non-financial counterparties

(“**NFCs**”). It would be unrealistic to expect that FCs and NFC+s would be able to monitor an NFC’s derivative activities and any such requirement would be severely burdensome (and may in practice not be achievable) as this would mean that such FCs and NFC+s would have to have a full picture of the NFC's derivative activities. Furthermore, it would require the NFCs to share confidential information regarding its business (that otherwise only a company’s auditor would be allowed to see) with its hedging counterparties**.**

FCs and NFC+s transacting with those who they believe are NFCs need to be allowed to rely on the representations of NFCs in relation to their accurate reporting and classification of hedging transactions and identification of beneficiaries of such hedging transactions. We ask that ESMA’s text recognises that FCs and NFC+s will not be able to monitor such information. This appears to be in line with our understanding of ESMA’s position presented during the public hearing on 12th July 2012, at which it was suggested that a FC (or NFC+) should be able to rely on an assertion from a NFC that they are not over the clearing threshold unless it is “obvious” that such NFC is likely to be exceeding the threshold. We would suggest that ESMA clarifies that unless the NFC asserts in its yearly audited statements that it has exceeded a particular clearing threshold, it shall not be deemed “obvious” that such NFC is likely to be exceeding the threshold if it represents at the time of entering into an OTC derivative transaction that they are not exceeding the clearing threshold at such time.

Without further guidance, it is difficult to derive much comfort from ESMA’s statement in light of the requirement that the clearing obligation applies across asset classes on a consolidated basis. This could lead to an over-cautious market and additional expense for those NFCs who have no systemic relevance, making hedging overly expensive and complicated for such NFCs.

Working Day: We ask that ESMA consider providing a definition of “working day” which is used in Article 10 of EMIR.

Change in the Value: The language used in Chapter III.V Paragraph 56 of the Consultation Paper specifically relates to hedges in which the "objective is to reduce the potential change in the value". This may unintentionally require genuine hedges to count towards the clearing threshold. At issue here is the use of the word "value". It is important to note that much hedging activity undertaken by NFCs, such as fixing of interest rates on floating rate debt or hedging of foreign exchange risks, is actually designed to reduce variability in future cash flows allowing for effective financial forward planning and not to reduce the risk of “potential change in the value” (such hedges of future cash flows can actually introduce value risk). As such, we strongly recommend that the current language is amended to refer to hedges with a primary objective of either reducing the potential change in value or in the variability of expected cash flow or costs.

Types of Exposure: Chapter III.V Paragraph 56 of the Consultation Paper seems to unintentionally limit the type of hedges that can be omitted from the clearing threshold calculation by explicitly referencing interest rates, inflation, and FX rates. By omission, this could imply that hedges of credit risk (e.g. used for hedging counterparty risk in receivables or to hedge funding costs), equity risk (equity hedges are used to hedge risk associated with employee share option plans or repurchase of own shares), transport, storage or commodity risk may not be regarded as objectively reducing risks directly related to commercial activity or treasury financing activity. However, one could argue that such risks would be captured by the first half of Paragraph 56 (i.e. Chapter VII, Art 1. subparagraph 1.a). We therefore recommend that these additional types of exposure are explicitly included.

Hedge Accounting: Recital 14 notes that the hedge accounting provisions of IFRS may be used by NFCs to satisfy the "objectively measureable…" criterion even though the NFC may not be required to report under IFRS. It also states that for those NFCs which report under "local GAAP", the majority of contracts classified as hedges under "local GAAP" are expected to fall within the general definition of contracts reducing risks directly related to commercial activity or treasury financing activity. However, Chapter III.V Paragraph 61 seems to preclude the direct use of hedge accounting under "local GAAP" as a means of satisfying this criterion. We do not agree with this approach and suggest that the guidance is amended to permit the use of local accounting rules of the relevant EU member state as a means of satisfying this criterion in cases where the NFC has no requirement to report under IFRS. If this approach is not adopted, additional and significant reporting burden will be placed on NFCs not only to satisfy the requirements of hedge accounting under "local GAAP", but also to show that their hedges meet the "objectively measureable…" requirement for the purposes of monitoring their position for the purposes of the clearing threshold.

We would suggest that the reference to "hedging contract" in Chapter III.V Paragraph 57 should be changed from "hedging contract" to "***hedging instrument***" to be consistent with the wording used in IAS 39.

Proxy Hedging: We would appreciate a clarification of the term "proxy hedging" used in the Consultation Paper (Chapter III.V Paragraph 59 and Recital 14). This term would usually describe a transaction where the direct hedge against the risk in question, e.g. the credit risk of a debtor, is replaced with some comparable instrument, e.g. an equity option, as there is no (liquid) CDS available. A "macro hedge" on the other hand would for example be based on the perfect instrument, e.g. a EURUSD forward, but hedge several underlying payment streams, among them long or short exposures (i.e. payment receiver or payer position), with one single derivative transaction. This derivative would only cover the net position of the group (a criterion that needs to be added to the clearing threshold section, see further below) and not match all individual underlying payment days. To avoid interpretation issues, we would suggest inserting "***or macro hedging***" where the term "*proxy hedging*" is used.

Contracts Linked to Commercial Activities/Treasury Financing: We are concerned that the interpretation of the references to contracts that are "linked to their commercial activities or treasury financing activities" could be overly narrow. An example of such overly narrow construction is the proposed exclusion of equity hedging of stock option plans (Chapter III.V Paragraph 60). It is important to recognise that this type of hedging is entered into primarily for the purpose of covering a genuine economic risk and is not speculative in nature and therefore it would be inappropriate for it to be counted towards the clearing threshold. The same logic applies to equity options used for the repurchase of a company's own shares as mandated by the general assembly of shareholders. As such, we believe it should be expressly stated that risks which are "linked to their commercial activities or treasury financing activities" can include any genuine hedging of operations (including operating expenses linked to pension and employee plans) and should only exclude speculative trading. Excluding equity hedging from the carve out may encourage NFCs to engage in dangerous behaviour and avoid hedging genuine economic exposures in an effort not to exceed clearing thresholds.

Exclusion of Investment and Trading: We also are concerned by the inclusion in the Art 1 NFC subparagraph 2 of the word "trading", which potentially excludes all of the activities of NFCs, the entities that this exemption is intended to benefit. We suggest removing any reference to "trading". We also think that referring to "investment" in this context is not necessary and brings in lack of clarity as number of transactions that are entered into for hedging purposes could be viewed at the same time as "investments". The paragraph should either end with "… speculation", which would address the understood policy intention or should be amended to refer only to "speculative trading". In addition, Article 1 NFC subparagraph 2 of the draft RTS refers to "a purpose" without defining whose purpose it is, or the degree of significance of the purpose. We believe this should be clarified in the drafting by amending the RTS to refer to a transaction entered into *"**primarily for the purpose of [speculation/ speculative trading]**"*.

Special Purpose Vehicles: Special purpose vehicles used in securitisations and other structured finance transactions will commonly enter into OTC derivatives as part of their commercial activity (which activity will often be comprised of purchasing and owning assets and issuing bonds or entering into other borrowing arrangements). Taking into account the draft technical standards, we consider that such derivatives will be objectively measurable as reducing the vehicle's risks directly related to such commercial activity as their objective is to reduce the potential change in the value of assets or liabilities that the vehicle owns or incurs in the ordinary course of its business resulting from fluctuations of interest rates or foreign exchange rates. In this regard, it should be noted that such vehicles will not be able to carry on their business without such hedge being in place and will not use relevant derivatives for the purpose of speculation, investing or trading. Based on the foregoing, it seems clear that such special purpose vehicles should be able to avail themselves of the "hedging exemption." However, given the significant issues which would arise for such vehicles if this was not the case (in the context of the clearing obligation and/or the risk mitigation procedures relating to the exchange of collateral), confirmation or guidance from ESMA of the availability of the hedging exemption in the context of special purpose vehicles if this venture is necessary to provide essential certainty to the market. We note that securitisation provides an important source of funding in Europe for real economy assets and we encourage ESMA to guard against outcomes which could indirectly reduce the viability of the asset-backed market.

<u>Proposed amendments to draft RTS</u>

ANNEX II - Draft regulatory technical standards on OTC derivatives

RECITALS

(14) In order to establish which OTC derivative contracts objectively reduce risks, counterparties may apply one of the definitions provided in this Regulation including the accounting definition based on International Financial Reporting Standards rules. The accounting definition may be used by counterparties even though they do not apply IFRS rules. Some non-financial counterparties may use local GAAP. It is expected that most of the contracts classified as hedging under local GAAP would fall within the general definition of contracts reducing risks directly related to commercial activity or treasury financing activity provided for in this Regulation ***and transactions satisfying local GAAP hedging requirements should therefore be deemed to fall within the general definition of contracts reducing risks directly related to commercial activity or treasury financing activity***. In some circumstances, it may not be possible to hedge a risk by using a directly related derivative contract i.e. one with exactly the same underlying and settlement date as the risk being covered. In such case, the non-financial counterparty may use proxy hedging ***or macro hedging*** *a*nd use a closely correlated instrument ***or instruments*** to cover its exposure.

(15) While the clearing thresholds should be set taking into account the systemic relevance of the related risks, it is important to consider that the OTC derivatives that reduce risks are excluded from the computation of the clearing thresholds and that the clearing thresholds allow an exception to the principle of the clearing obligation for those OTC derivatives which may be considered as investments. More specifically, the value of the clearing thresholds should be reviewed periodically and should be determined by class of OTC derivative contracts. The classes of OTC derivatives determined for the purpose of the clearing thresholds may be different from the classes of OTC derivatives for the purpose of the clearing obligation. When a non-financial counterparty exceeds one of the clearing thresholds set for a ***particular*** class of OTC derivatives, the clearing threshold should be considered exceeded ***only for that relevant class of OTC derivatives***.

(16) The clearing thresholds are used by non-financial counterparties, they should therefore be simple to implement. For this purpose ~~**they**~~, ***each non-financial counterparty***

should ~~be based~~ ***have the option to determine its position in OTC derivative contracts on the basis of*** the gross notional value of ~~**the**~~***such*** OTC derivative contracts***, provided that nothing should prevent a non-financial counterparty from determining its exposure under any OTC derivative contracts on the basis of a net position within the group to which such non-financial counterparty belongs***.

CHAPTER VII

NON FINANCIAL COUNTERPARTIES

Article 1 NFC

Criteria for establishing which OTC derivative contracts are objectively reducing risks

1. For the purpose of Article 10(3) of Regulation (EU) ~~**N0**~~***No*** X/2012 [EMIR], an OTC derivative contract is objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of ~~**that**~~***any entity or*** group ***of entities within the group to which the non-financial counterparty belongs***, when, whether by itself or in combination with other derivative contracts, and whether directly or through closely correlated instruments, it meets one of the following conditions:

a. it ~~**covers**~~***has the primary objective of reducing*** the risks ***(on an individual entity, group or portfolio basis)*** arising from the potential change in the value of***, or in the variability of the expected cash flows or costs associated with,*** assets, services, inputs, products, ***raw materials, processing materials, transportation (including freight), storage (including bunkering),*** commodities***, counterparty credit risk*** or liabilities that the non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells ~~**or**~~ ***transports, stores or otherwise*** incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling ~~**or**~~ ***transporting, storing or otherwise*** incurring in the ordinary course of its business ***when considered on an individual entity, group or portfolio basis****;* ***a transaction is deemed to satisfy the requirements of this subparagraph (a) if it satisfies hedge accounting requirements under local GAAP of the home jurisdiction of the non-financial counterparty relying on this subparagraph (a);***

b. it ~~**covers**~~***has the primary objective of reducing*** the risks ***(on an individual entity, group or portfolio basis)*** arising from the potential indirect impact on the ***cost of funding, working capital requirements, insurance, reinsurance, cashflow requirements or provision of liquidity to the non-financial counterparty or its group of a potential change in the*** value ~~**of**~~***of, or in the variability of the expected cash flows or costs associated with,*** assets, services, inputs, products***, raw materials, processing materials, transportation (including freight), storage (including bunkering), counterparty credit risk***, commodities or liabilities referred to in subparagraph (a), resulting from fluctuation of ***asset classes including with respect to*** interest rates, inflation rates or foreign exchange rates;

c. It qualifies as a hedging ~~**contract**~~***instrument*** pursuant to International Financial Reporting Standards (IFRS) adopted in accordance with Article 3 of Regulation (EC) ~~N0~~*No* 1606/2002.

2. For the purpose of Article 10(3) of Regulation (EU) ~~**N0**~~***No*** X/2012 [EMIR], ~~**a**~~***an OTC*** derivative contract entered into by a non-financial counterparty or by other non-financial entities within the group to which the non-financial counterparty belongs shall not be considered as objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of ~~**the non-financial counterparty or of**~~ that group if it is entered into ***primarily*** for ~~**a**~~***the*** purpose ~~**that is in the nature**~~ of speculation~~**, investing or trading**~~.

Clearing Threshold

Consequences of exceeding the clearing threshold – comparison with CFTC rules: The signatory associations are particularly concerned regarding the fact that under the draft RTS exceeding a clearing threshold with respect to one class of derivatives would disapply exemptive treatment across all classes of derivatives, including derivatives used for hedging and treasury financing purposes outside the class of derivatives in which the relevant clearing threshold was exceeded. This contrasts significantly with the US approach, which provides a safe-harbour for all the hedging activities of non-financial counterparties in such a way that those activities will be exempted, irrespective of the level of non-hedging activities of a non-financial corporate.

The signatory associations understand that the disapplication of the exemption from the clearing obligation for hedging and treasury financing transactions once the relevant clearing threshold has been breached in respect of a class of derivatives is a Level 1 requirement and that ESMA has little room for manoeuvre on this specific point, however, the combination of the effect of this and ESMA's proposed application of the requirement to clear all classes of derivatives if a single clearing threshold is exceeded could have serious implications.

Under the CFTC proposals to be implemented in the US, exceeding the threshold for one of the two individual categories ("rate" swaps and others) would result in only that respective class of instruments becoming subject to collateralization requirements. ESMA is proposing a requirement to clear all classes of derivatives even if only one clearing threshold is breached. Such requirement is significantly more onerous than that of the equivalent US rules and we strongly recommend that ESMA reconsider this approach, instead providing that a breach of the clearing threshold of a particular asset class shall result in the clearing obligation applying only ~~for~~in respect of that particular asset class. The economic consequences of this difference between the US and EU approach set out in the current draft RTS could be very significant.

To ensure a level playing field on the global derivatives market, we suggest aligning the EMIR clearing thresholds with the thresholds defined by the US CFTC for the "Major Swap Participant" (MSP), especially the calculation of the "potential outward exposure" which we would regard as equivalent to the approach proposed by ESMA, but better reflecting the risk management strategy of NFCs. CFTC standards limit the clearing obligation for derivatives to those of the asset class or classes where the threshold is exceeded (See CFTC / SEC, l.c., p. 574).

ESMA's position (mentioned in at the public hearing on 12th July 2012) appears to be that it does not have any discretion to amend its position on this issue because of the EMIR text. We don't consider this issue to have been clearly settled in the EMIR text and would strongly urge ESMA to analyse the provisions carefully to see what room for flexibility there may be in this area:

1) to ensure that non-financial counterparties in the EU are not seriously disadvantaged in comparison with their counterparties elsewhere and

2) to fulfil the goal of regulatory convergence between the EU and the US.

If ESMA still believes that it is precluded from revisiting its position on the applicability of the clearing thresholds we would welcome it pointing us to the precise wording that **it** believes limits its mandate on this issue.

Please consider our proposed revisions to Art 2 NFC which seek to address this point. Our proposed formulation of the clearing threshold test would be easier for NFCs to monitor than a clearing obligation that is triggered across all asset classes by exceeding a low threshold in a single asset class. It should also be significantly easier for a FC and NFC+ transacting with a NFC to make an assessment (in addition to any assertion made by the relevant NFC) as to whether or not such NFC is likely to exceed the clearing threshold.

Notionals – option to apply net exposure: ESMA proposes to use gross notional value of the outstanding OTC derivative contracts as a measure for determining whether NFCs have exceeded the clearing thresholds (with all of the regulatory consequences that this entails) primarily because the use of "gross" values is viewed as easier to calculate and implement (especially for smaller non-financial companies). We believe this reasoning is flawed. The gross notional value does not represent a measure of the risks underlying the OTC derivatives entered into. This approach may actually result in more NFCs being brought into the scope of costly regulatory requirements applicable to NFC+s than is required or desirable in order to achieve the overall objective of greater market stability.

Exposure calculated by reference to the overall market value would be a more appropriate and accurate measure on which to base the clearing thresholds since such approach would allow for legitimate risk mitigation within a market participant's portfolio and would avoid double counting of exposure where, for example, as is common market practice, positions are closed out with equal and offsetting hedges, rather than being cancelled (thus in practice netting off the exposures). Basing the clearing thresholds on notional exposure on this basis will lead to an inaccurate measure of participants' exposures.

Calculating positions on a net basis would reflect NFCs' exposure to their counterparties in a more realistic way and would better represent the actual systemic relevance of a specific NFC (and its group). We therefore strongly encourage ESMA to consider giving NFCs the option to calculate derivative exposure on a net basis. At the very least, new provisions should be introduced that would specifically allow NFCs to net any intragroup positions and any third party offsetting positions where contracts have effectively closed each other out. This would not conflict with the objective of simplicity of calculation and implementation of the rules for NFCs as expressed in Recital 16.

Clearing Thresholds - present value sensitivity of underlying asset class: Notional amounts can be a very poor estimate of actual exposures due to different tenors and payoff formulae. If notionals are to be used for the purposes of the clearing thresholds, we would recommend that the clearing thresholds in each asset class are better aligned with typical underlying exposures of such asset class. For example, interest rate derivatives have typically much lower present value sensitivity than foreign exchange contracts of the same tenor. However, the thresholds for these asset classes are currently both set to be EUR 3 bln.

Asset Classes – definitions: The various asset classes set out in Art 2 NFC are not defined. We would recommend that ESMA consider defining the asset classes to provide greater legal certainty. In particular, please consider cross-referring to the relevant MiFID classifications from the Annexes to MiFID (and by extension its proposed review, when that comes into force). Given the specific nature of commodity derivative contracts and the size and complexity of the relevant market, commodity derivatives should be given a separate clearing threshold. Art 2 NFC should provide for a separate catch–all category with its own clearing threshold in subparagraph (f).

Asset Classes – multi-asset class derivatives: Since certain derivatives, such as cross-currency interest rate swaps, can exhibit the qualities of several asset classes, we would appreciate guidance on how such derivatives should be considered for the purposes of the clearing thresholds – e.g. should an OTC cross-currency interest rate swap be considered as an interest rate OTC derivative contract or foreign exchange OTC derivative contract?

Short-Dated FX Contracts: We would like ESMA to provide clarity on treatment of short-dated foreign exchange OTC derivative contracts. We have understood that ESMA was considering following the US example of excluding such short-dated FX contracts from the clearing threshold calculations and we would like ESMA to formally confirm such position as this would enable market participants to better plan for compliance and would prevent unnecessary expense being incurred and preparatory work being done in relation to contracts that will not be covered by the scope of the regulation.

Long-Dated Commodity Derivatives Commodity derivatives with longer dated maturities for physical supply of commodities (i.e. 10 years or longer) should also be excluded from the calculation of the clearing threshold where the underlying contract is entered into or the underlying assets are held for commercial purposes by one of the parties to such derivative contract and the other party (NFC) is providing hedging services to the customer that has entered into the underlying contract or is holding the underlying assets for commercial purposes, as such contracts are unlikely to have systemic impact.

Periodic Review of Clearing Thresholds: Given the importance of the clearing thresholds and the implications for market participants of changes to them we suggest that ESMA should commit to a minimum frequency of review (e.g. annual), rather than the current reference to a review on "a regular basis" (Paragraph 66 of the Consultation Document). However, ESMA should not rely on the review process by starting with a clearing threshold that is too low in value and then bound to slowly rise to an appropriate level. Instead, the starting point should be higher with a possibility to lower any clearing thresholds to an appropriately calibrated level for each asset class once better information is available, e.g. after the Trade Repositories have been in operation for a period of time.

Proposed amendments to draft RTS

ANNEX II - Draft regulatory technical standards on OTC derivatives

CHAPTER VII

NON FINANCIAL COUNTERPARTIES

Article 2 NFC

Clearing thresholds

1. **The clearing thresholds values for the purpose of Article 10 of Regulation ~~N0~~No XXX/2012 [EMIR] shall be:**

a. **EUR 1 billion in *[*notional value*]* for credit *OTC* derivative contracts;**

b. EUR 1 billion in *[*notional value*]* for equity *OTC* derivative contracts;

c. EUR 3 billion in *[*notional value*]* for interest rate *OTC* derivative contracts;

d. EUR 3 billion in *[*notional value*]* for foreign exchange *OTC* derivative contracts;e. EUR 3 billion in *[*notional value*]* for commodity *OTC* derivative contracts *(excluding any Long-term Supply Commodity Contracts);* and

***f. EUR [●] billion in [notional value] for all* other OTC derivative contracts not ~~defined~~*referred to* under (a) to (~~d~~*e) (excluding any Long-term Supply Commodity Contracts)*.**

2. For the purposes of calculating the [notional value] of the relevant OTC derivative contracts in respect of each category under Art 2 NFC, the non-financial counterparty shall be permitted to exclude from such calculation all positions that have been closed out by way of entering into off-setting transactions prior to the date of such calculation and shall be permitted to net the [notional value] of the current in-the money and out-of the money transactions that it has (on a single entity basis) with the same counterparty, in the same class of OTC derivative contract under a single agreement or agreements with close-out terms which are the same in all material respects.

3. Only OTC derivative transactions falling within the definition of a "financial instrument" under Annex 1, Section C, paragraphs (4) to (10) inclusive of Directive

2004/39/EC, as may be amended or replaced from time to time, that are not traded on a regulated market or MTF or any other regulated trading venue that may be specified as such under any amendment to or replacement of Directive 2004/39/EC from time to time, shall be taken into account when determining whether a non-financial counterparty has exceeded a clearing threshold test on an individual entity or group basis.

4. Once a clearing threshold is exceeded by a non-financial counterparty in any one of the classes of OTC derivative transactions listed in Art 2.1 NFC (a) to (f) (inclusive), the clearing threshold shall be considered exceeded only for that relevant class of OTC derivatives. A non-financial counterparty shall not be regarded as having exceeded the clearing threshold for any category of OTC derivative transactions in respect of which, either as an individual entity or on a group basis, it has not exceeded the relevant clearing threshold set out in the relevant subparagraph of Art 2.1 NFC.

Please introduce new defined term in Article 2 (Definitions) (3):

'Long-term Supply Commodity Contracts' means OTC derivative contracts that are entered into by a non-financial counterparty in the context of such non-financial counterparty providing hedging services related to the long-term supply of a commodity to a customer or customers of the non-financial counterparty or any entity within its group in circumstances where the underlying contract is entered into or the underlying assets are held for commercial purposes by such customer or customers.

III. VI Risk mitigation for OTC derivative contracts not cleated by a CCP (RTS Chapter VIII)

Timely confirmation (Article 1 RM)

The Signatory Associations recognise the importance of a robust confirmation process. Indeed, ISDA has been very active over recent years leading industry efforts to improve the overall processing environment for OTC Derivatives and in particular the form and timeliness of confirmations. The industry is now meeting or exceeding successive ambitious targets agreed with the OTC Derivatives Supervisors Group ("ODSG"). The Signatory Associations would propose that ESMA continue to leverage the ODSG process to drive improvements in confirmation processing in a controlled manner and over an extended period. Finally, the Signatory Associations note that the proposed RTS do not appear to make reference to confirmable life cycle events (e.g. novations and terminations). We believe this is appropriate as industry has made considerable progress in recent years to develop methodologies and tools that deal with such events and therefore we agree such activities should remain outside the scope of the RTS.

In response to the proposed Article 1 RM of the Consultation Paper we would make a number of specific comments as follows:

Overall, we understand that the RTS relate to the issuance (dispatch) of a confirmation and not to the full legal execution by whatever means that may occur. Furthermore, it is our understanding that the issuance of a confirmation may be in a form that is not intended to be the full legal confirmation for the transaction but may be in any form (i.e. a term sheet) which need not include the exact legal text required for the final confirmation provided it contains all of the core economic terms, or methodologies for determining such terms, of the relevant transaction[1]. Finally, the Signatory Associations would request confirmation from ESMA that the procedures and arrangements set out in Article 1 RM do not apply to intragroup transactions and suggest the text is amended to clarify this point. As such we believe that the technical standards also need to address the following :

- The point in time from which the issuance of a confirmation is measured is unclear. The text currently references the anchor point by use of the word "concluded" however it is not clear what constitutes concluding a trade. Many OTC derivative contracts may be agreed without all of the necessary information required for the confirmation to be generated. For example many investment managers execute a single block trade which is subsequently allocated across their clients. In some cases the investment manager has a legal requirement to obtain sign off from their clients in order to allocate the block trade and such sign off may not be obtained during the same business day. Given the current proposed text we would suggest that a contract is not deemed "concluded" until such time as all relevant allocations and other core economic terms have been agreed.

- The proposed text should make it clear that while the obligation to issue a confirmation may apply to both counterparties to a transaction it is acceptable for one counterparty to delegate its confirmation obligation to the other party, perhaps in compliance with standard industry practice or through an alternative relationship or contractual arrangement. It should be noted that current industry practice which has developed over time and proven to be robust and legally sound may differ across asset classes and relationships. For example, interest rate derivative practice amongst dealers is for both counterparties to issue a confirmation (which is matched) whereas in credit and equity derivatives it is common for one counterparty, based on its role (i.e. buyer/seller) to issue the confirmation which the other counterparty will sign.

[1] It should be noted that in some cases relevant information in respect of the contract is not available immediately. For example initial rates and or prices that are determined by reference to a particular formula or observation time/period and yet such information is required for full confirmation. Care should be taken when referring to all of the terms of a transaction.

Furthermore, in some asset classes (i.e. equity, commodities and FX) and for certain products (i.e. Portfolio Swap Agreements) it is common practice for negative affirmation to be adopted as a means of confirmation. In such cases one counterparty issues a confirmation of trading activity that does not require a signature from the other counterparty which instead has a pre-defined period of time to dispute the terms. We would request that ESMA acknowledge negative affirmation as an appropriate means of confirmation.

- The text in Article 1 RM, Paragraph 2 makes reference to the contract being confirmed "where available via electronic means". The Signatory Associations note that there may be instances where a given product is available on an electronic confirmation platform but other factors, such as local requirements for a contract to be confirmed on paper or in the local language, prevent a given contract from being confirmed electronically. We would request further clarification from ESMA regarding the criteria that constitute a platform being available.

- The same day cut off for confirmation is also unclear. It refers to 16:00 local time but does not indicate, given the counterparties may be in different time zones, which time zone is applicable. Furthermore it does not allow for situations where a counterparty's relevant operating infrastructure is in a different location to its traders. We would suggest amendment that this cut off is triggered by the first time zone of either counterparty, or its operating infrastructure as appropriate, to reach 16:00.

- On a general point we would note that where a non financial counterparty reaches the clearing obligation threshold the RTS as currently written would require such non financial counterparty to comply with a much more aggressive confirmation processing timeline across multiple asset classes and not just the asset class that has caused the change in status. This may require significant changes to the non financial counterparty's operating processes, including the potential need to on-board to multiple confirmation platforms and therefore, we suggest that ESMA consider removing the distinction between non financial counterparties above and below the clearing obligation threshold such that all trades concluded with a non financial counterparty are subject to Article 1 RM, Paragraph 4. Failing this we would suggest that ESMA consider only trades concluded in the asset class that has breached the clearing obligation threshold to be subject to Article 1 RM, Paragraph 2. Finally, in all cases where a non financial counterparty status has changed ISDA believes a suitable phase in period for complying with the new RTS should be available.

As a result of the considerations noted above, we would suggest changes to the text for ***Article 1 RM*** *as follows:*

"2. ***Where*** an OTC derivative contract ***is*** concluded ***between*** ~~***with***~~ a financial counterparty ***and another financial counterparty*** *[*or a non-financial counterparty that meet~~s~~ the conditions referred to in Article 10(1)(b) of Regulation (EU) No xxxx/2012 [EMIR]***]***[2] and ~~***which***~~ is not ***either (i)*** cleared by a CCP ~~***shall be confirmed***~~ ***or (ii) an Intragroup transaction, a confirmation will be sent,*** where available via electronic means, as soon as possible and at the latest by the end of the same business day***. Such confirmation need not be in the form of final legal text but must contain all of the core economic terms, or in the case of certain derived terms describe how such terms will be derived, that relate to such contract."***

"3. Where a transaction referred to in paragraph 2 is concluded after 16.00 local time~~***, or when the transaction is concluded with a counterparty located in a different time zone which does not allow same day confirmation,***~~ ***in the time zone of at least one of the counterparties or its relevant operating infrastructure,*** the confirmation shall ~~***take place***~~ ***be sent*** as soon as possible and at the latest by the end of the next business day."

"4. An OTC derivative contract concluded with a non-financial counterparty ***[***that does not meet the conditions referred to in Article 10(1)(b) of Regulation (EU) N0 xxxx/2012 [EMIR]***]***[3], shall be confirmed as soon as possible and at the latest by the end of the second business day following the date of execution. ***Such confirmation need not be in the form of final legal text but must contain all of the core economic terms, or in the case of certain derived terms describe how such terms will be derived, that relate to such contract."***

Additional Definitions required:

"concluded" means the time at which all of the core economic terms or methodologies for determining such terms, including allocations, of a contract are agreed between the counterparties, whether orally or in writing.

"business day" means a day on which both counterparties to a contract are open for normal business.

We are extremely concerned that, notwithstanding the above, if ESMA's intention is for the confirmation required under Article 1 RM, Paragraphs 2, 3 and 4 to be in final executable form or more importantly fully executed by both counterparties, then the proposed timelines are too aggressive and may have numerous unintended consequences. As noted previously

[2] ***Delete if the distinction between non financial counterparties is removed for purposes of timely confirmation.***

[3] ***Delete if the distinction between non financial counterparties is removed for purposes of timely confirmation.***

the industry, working with the ODSG, has invested significant time, effort and financial cost to develop post trade documentation processes that improve speed of confirmation without compromising accuracy. Industry efforts continue in this regard and are progressing at varying speeds across different asset classes and products primarily driven by relative levels of complexity and the bespoke nature of the asset class/product. While the proposed timelines may be appropriate for issuance of an initial confirmation of the core economic terms or related methodologies as noted above, in the case of a final or executed confirmation there are a number of concerns and considerations which we articulate below:

- The ISDA Operations Benchmarking Survey indicates that, for all asset classes, 100% issuance of non-electronic confirmations does not occur until at least five days after trade date and in some cases not until 10 days after trade date. While we recognise that issuance of a significant proportion of trades occurs within the first one or two days after trade date we are concerned that the small portion that takes longer does so due to complexity and the need for significant negotiation involving multiple parties within each counterparty and/or, in the case of smaller and less sophisticated market participants, externally. For these reasons we would encourage ESMA to adopt a flexible approach and phased implementation based on, amongst other things, asset class, product type and counterparty type. In this regard we would again note the success of the industry working with the ODSG which adopted an approach which varies by asset class and has allowed progress and improvement in a controlled manner. ESMA should also note that in the absence of a full legal executed confirmation industry currently utilises various risk mitigation techniques such as trade date check-out and post trade verbal affirmation as well as portfolio reconciliation to ensure both counterparties recognise the core terms of the contract. These procedures significantly reduce the likelihood of mismatched trade terms while the full confirmation process is completed.

- In many cases a Master Agreement (“MA”) or Master Confirmation Agreement (“MCA”) may need to be signed between the counterparties to the contract. Whilst these agreements tend to follow standard industry forms there is an inevitable level of bilateral negotiation that is required. Such negotiation can on occasions take significant amounts of time given the agreement’s broader coverage than just a single contract. However, much of the relevant information in the agreement can and is incorporated into the individual contract by way of a deemed MA or MCA and acknowledgement between the counterparties that the contract will be governed by the negotiated MA or MCA once executed. We respectfully suggest that ESMA acknowledges this as an appropriate approach and allows for the execution of such agreements to operate on an alternative appropriate timeline.

- Consideration needs to be given to the fact that a counterparty may not be subject to EMIR and therefore would not be required to comply with the proposed timelines. As such, firms could find it particularly difficult to comply with the proposed RTS.

The Signatory Associations would also suggest that Article 1 RM, Paragraph 5[4] be amended to make it clear that the requirement to report on a monthly basis is a snapshot at a particular point in time (i.e. last calendar day of the month) and is based on the relevant activity (i.e., dispatch). Furthermore, we would request that ESMA confirm that the period of 5 days commences from the deadline for the activity to have occurred (i.e. the date the contract is concluded, +1 or +2 business days as appropriate).

*We would therefore suggest changes to the text for **Article 1 RM, Paragraph 5** as follows:*

*"*5. Financial Counterparties shall have the necessary procedure to report ***~~on a monthly basis~~*** ***once per calendar month*** to the competent authority designated in accordance with Article 48 of Directive 2004/39/EC the number of ***~~unconfirmed~~*** OTC derivatives transactions ***~~referred to in paragraph 1 to 2 that have~~*** ***where the relevant obligation referred to in paragraphs 1 to 3 has*** been outstanding for more than five business days ***after the relevant obligation deadline.****"*

In addition we would respectfully suggest that amendments be made to Recital 17 on page 64 of the Consultation Paper as follows:

17 – Delete the final sentence since as noted above industry employs additional legally sound processes to confirm OTC derivative transactions.

Portfolio reconciliation (Article 2 RM)

ISDA strongly supports the concept of portfolio reconciliation and agrees with the ESMA requirement to reconcile portfolios at or above the 500 trade level as frequently as possible, and would even support expanding the daily reconciliation threshold down to the 300+ trade level as per the response to the ESMA DP. However, the following concern needs to be addressed:

- On the requirement for intra-group transactions. For intra-group transactions, we believe it appropriate that the reconciliation of these trades is best performed internally within each individual firm either, as a reconciliation or as part of the

[4] The Consultation Paper includes 2 paragraphs both labelled as paragraph 3, re-labelling the text should result in this section being labelled as paragraph 5 and our comments are submitted accordingly.

General Ledger control processes. Moreover, reconciling intra-company trades would also not fulfil the primary risk mitigation purpose of reconciliation – which is to help quickly identify the trades at the source of any collateral dispute between external counterparties.

In addition, the Signatory Associations believe that portfolios with less than 300 trades do not generally represent systemic risk and the decision to regularly reconcile these portfolios should be left to individual firms and be based on the risk profile of the counterparty and the trades themselves. We also believe that the ESMA requirement to reconcile portfolios with less than 300 trades at least monthly is overly burdensome from a cost perspective when considering the regulatory convergence with dispute resolution whereby firms will be required to have in place procedures required to resolve a collateral dispute which would require portfolio reconciliation as a first step in the process.

We consider there to be a lack of clarity with regard to when and how often portfolio size is measured in terms of determining how often to reconcile portfolios. The Signatory Associations recommend that portfolio size, for the purpose of compliance with ESMA recommended reconciliation frequency, be measured on a quarterly basis.

We believe it unnecessary for counterparties to agree in writing or other equivalent means as to the terms on which portfolios should be reconciled given the specificity which ESMA has provided regarding portfolio size and reconciliation frequency.

It must be recognized the portfolio reconciliation is an inherently two-sided process - both parties need to provide their data, otherwise there is nothing to reconcile. Given the fact that unregulated entities may not be subject to any statutory or regulatory requirement to exchange portfolio data, it would be impossible to compel such a party to provide their portfolio data in order to perform a reconciliation. Therefore, the rules applicable to regulated firms must recognize that compliance is not fully within the control of those firms, and therefore that <100% compliance will be achieved. It is, however, appropriate that they make a good faith and commercially reasonable effort to procure the cooperation of their counterparties in the portfolio reconciliation process.

Proposed amendments to ***Article 2 RM***

1. Financial and non-financial counterparties to an OTC derivative contract shall agree ~~***in writing or other equivalent electronic means***~~ with each of their counterparties on the terms on which portfolios shall be reconciled. ~~***Such agreement shall be reached before entering into the OTC derivative contract.***~~

b. otherwise, at an appropriate time period based on the size and volatility of the OTC derivative portfolio of the counterparties with each other and at least:

i. ***~~once per month~~ as often as deemed appropriate by individual firms*** for a portfolio of fewer than 300 OTC derivative contracts outstanding with a counterparty;

5. Certain OTC derivatives contracts shall be excluded from the provisions of Article 2 RM, including intra-group transactions.

Portfolio compression (Article 3 RM)

The Signatory Associations recognise the benefits of portfolio compression as a mechanism to control systemic risk by reducing the number of outstanding trades both at an individual firm portfolio level as well at the "macro" level of the market as a whole. It should however be noted that while the portfolio compression processes currently employed by firms are primarily focused on the very beneficial aim of reducing the trade count of a firm's portfolio of outstanding OTC Derivative contracts, they have limited direct impact on the level of counterparty credit risk associated with the portfolio. Separately, industry is currently exploring alternative solutions that look to reduce overall levels of counterparty credit risk exposures by balancing trades that reduce or flatten exposures among and between (i) bilateral and (ii) CCP relationships.

It is also important to note that portfolio compression is more suitable for certain asset classes where the products are standardised, global and liquid. Given these criteria are amongst those that make a product suitable for clearing we would anticipate that the opportunities for bilateral portfolio compression will significantly decrease over time. Indeed industry is already experiencing a reduction in the number of trades being unwound in each bilateral compression cycle due to the majority of trade now being sent to clearing. For eligible Interest Rate products the majority of volume is now compressed in LCH, while all active CCPs in the credit derivative market offer some form of netting. Furthermore, in commodities notional amounts are relatively low so portfolio compression may yield minimal benefits. Netting approaches vary with frequency of cycles verging from weekly to daily compression. Some offer clients the ability to select netting on an ad-hoc or scheduled basis. CCPs actively seek to run compression cycles where there are netting and risk benefits to be gained.

We would also like to note a couple of additional points which we believe are important when considering regulation of portfolio compression in the context of the RTS:

- Existing industry tools that facilitate portfolio compression are not easily accessible to all segments of the market. It is important to note that success of portfolio compression to date is partly due to it being limited to a relatively small and homogenous group of participants. Encouraging greater participation may have a negative effect on the overall success rate of compression cycles, as where an individual participant is unable to complete the cycle due to internal system issues the whole cycle would need to be terminated for all participants.

- As noted above portfolio compression is more suitable for certain asset classes where products are standardised, global and liquid. The following are some examples of asset classes and/or trade categories that are less suitable for portfolio compression:

  - Short tenor products.

  - Equity Derivatives: These are broadly positional in nature, often hedged with physical securities and/or listed derivatives and have lower levels of product standardisation. Also a more diffused institutional user population.

  - Some commodities trade types: Comparatively low notional amounts for many products within the asset class.

  - Back to back hedging transactions carried out for internal risk management purposes.

We acknowledge that the proposed RTS calls for firms to analyse portfolio compression *suitability* and do not impose a *per se* compulsion in respect of undertaking compression, As such, the Signatory Associations maintain that it would be more appropriate for ESMA to issue best practice guidelines in respect of portfolio compression. Such guidelines should differentiate between products that are most suitable for portfolio compression (i.e. standardised, global and liquid) and those that are less suitable (i.e. those listed above).

Finally, would like to note that it is important for any offset OTC contracts and any new compressed trades that result from the compression exercise to be terminated and or executed on the same day and ideally no later than when the compression exercise is finalised. We therefore suggest that Article 3 RM, Paragraph 3 is deleted and replaced with the following:

"(3) Financial and non-financial counterparties shall have procedures in place to terminate each fully offset OTC contract and execute any compressed contracts that result from a compression exercise on the same day."

Dispute resolution (Article 4 RM)

We broadly welcome ESMA's approach to dispute resolution. In particular we agree that it is helpful to build upon industry standard contracts to satisfy the requirement and the extent to which the industry is afforded flexibility to determine whether they will establish procedures by reference to existing industry standards. The ESMA consultation paper reflects what we consider to be a meaningful and appropriate view of "dispute resolution". We appreciate that ESMA has considered the existing work, through the ODSG process, that the industry has put into documentation of appropriate procedures for the resolution of collateral disputes in a timely manner. We also feel that the ODSG process, developed as a result of public and private sector collaboration, more readily lends itself to evolution as circumstances require.

As indicated in our prior commentary, we support the widespread adoption of procedures designed to identify, record, monitor and resolve collateral disputes in the most rapid possible timeframe. Our interpretation of the language articulated by ESMA in Annex II, Chapter VIII, Article 4 RM, Paragraph 2 (c) is that disputes not resolved within a 5 day timeframe must be subject to some resolution protocol. The Signatory Associations believe that the dispute resolution documents that have been drafted by ISDA and market participants fulfil this ESMA requirement. Moreover, we suggest that the specific reference in Annex II, Chapter VIII, Article 4 RM, Paragraph 2 (c) to third party arbitration and/or market polling elevates these resolution options over all other potential resolution options and could give the impression that these resolution options are favored over others which maybe more appropriate. We suggest that the specific references to these two options be removed from the consultation paper language.

Finally, we support the ESMA requirement to report disputes to the competent authority, but the Signatory Associations suggest that ESMA follow the existing standards currently set via the ODSG process which requires disputes USD 15 m or greater and outstanding for 15 days or more to be reported on a monthly basis. However, the reporting requirement and short timeframes for resolution may encourage early and potentially inappropriate settlements given that only FCs and not NFCs are subject to this requirement. The text should be clarified that all timeframes should relate to the procedure of dispute resolution rather than achieving settlement with disregard to the appropriateness of the settlement. As regards disputes over exchanges of collateral, we ask ESMA to be clear that the EUR 15 million applies to the disputed portion and not the entire amount of collateral being called. It would be helpful if the text is clarified in relation to frequency of reporting. We have previously recommended that a monthly report would be appropriate.

*Proposed amendments to **Article 4 RM***

2. In order to identify and resolve any dispute between counterparties, financial counterparties and non-financial counterparties, shall, when concluding OTC derivative contracts with each other have ~~***agreed***~~ detailed procedures and processes in relation to the following matters:

a. identification, recording, and monitoring of disputes relating to the recognition or valuation of the contract and to the exchange of collateral between counterparties. Those procedures shall at least record the length of time for which the dispute remains outstanding, the counterparty and the amount which is disputed;

b. ***the deployment of formal methodologies which are intended to ensure the*** resolution of disputes in a timely manner;

*c**. the deployment of additional methodologies which are intended to ensure the*** resolution of disputes that are not resolved within five business days, including***, but not limited to,*** third party arbitration or a market polling mechanism.

Market conditions that prevent marking-to-market (Article 5 RM)

As noted in the Discussion Paper commentary, we believe that the ESMA definition of market conditions preventing marking-to-market is reasonable when considering the appropriate European accounting rules related to situations where Level 3 inputs are used.

However, as previously noted, in order to avoid multiple definitions and guidance to assess whether a market has become inactive, the Signatory Associations believe that ESMA should align its guidance with paragraph B37 of IFRS13 (indeed, consistency should be sought with the whole fair value hierarchy approach in paragraphs 67-90 and B36 to B47 of IFRS13 and its US equivalent FASB 157). Also, the market conditions in which marking-to-model in place of marking-to-market may be used should be sufficiently flexible to take account of the different factors across more and less mature and more and less liquid markets that may affect the reliability and utility of mark-to-market pricing. For example marking-to model may be sensible if a reliable mark-to-market price isn't available, namely:

- if, in the case of uncleared OTC derivative trades, the parties' (or Reference Dealers' (as defined under the ISDA Master Agreement) or reference brokers', if used) assessments of the mark-to-market valuations differ so widely that they're not reliable;

- if a market is sufficiently illiquid in terms of either volumes traded or frequency of trades or the number of market players means that a party could essentially trade in that market in order to manipulate the mark-to-market price that is available; or

- where use of marking-to-market in illiquid markets without adequate flexibility could lead to uneven pricing (e.g. in emerging markets with limited numbers of players).

Proposed amendments to **Article 5 RM**

1. For the purpose of Article 11(2) of Regulation (EU) x/2012 [EMIR], market conditions prevent marking-to market of an OTC derivative contract when:

a. the market is ***~~inactive~~ illiquid***; ***and/***or

b. the range of reasonable fair values estimates is significant and the probabilities of the various estimates cannot reasonably be assessed.

2. A market for an OTC derivative contract is ***~~inactive~~ illiquid*** when quoted prices are not readily ~~and~~ or regularly available and***/ or*** those prices available do not represent actual and regularly occurring market transactions on an arm's length basis.

3. Quoted prices are not to be regarded as readily or regularly available and/ or not representing actual and regularly occurring market transactions on an arm's length basis where one or more of the following is the case in respect of such market:

   a. if the valuation assessments of the mark-to-market valuations by both counterparties to an uncleared OTC derivative trade (and valuations received from reference dealer or brokers as part of any contractual fallback in the case of a difference in the valuations between the contracting parties) differ so widely that they are not reliable;

   b. if a market is sufficiently illiquid in terms of either volumes traded or frequency of trades or the number of market players means that a party could essentially trade in that market in order to manipulate the mark-to-market price that is available; or

   c. ***where use of marking-to-market in illiquid markets without adequate flexibility could lead to uneven pricing.***

Criteria for using marking-to-model (Article 6 RM) [The Signatory Associations believe that the stated criterion is complete. However, we ask that in relation to "accepted economic methodologies", ESMA should be clear that such methodologies are subject to the interpretation of the financial institution in question. It is requested that the text be clarified to confirm that in relation to UHNWIs over the clearing threshold, such entities can rely upon third parties. For example, it is unusual for private banking divisions to rely upon their affiliates to perform valuations on their behalf, unless appropriate governance checks and balances are in place. We also seek clarity on what ESMA interprets as a division independent from the division taking the risk. In addition, in circumstances where an arm's length third party is providing the marking-to-model the main concern of the party relying on such calculation is that the basis of the calculation of that "model" should be transparent. One important question, especially for NFCs (and also FCs in non-banking groups) who will often be in the position of relying upon third party mark-to-model valuations in circumstances where these need to be used is what model will those third party's actually use? In illiquid markets VaR may not be available or accurate. If HVaR is to be used, we suggest that at least the relevant period used should be transparent. Market participants may find it helpful to have clarity on this point and would suggest that ESMA considers issuing guidance or generally accepted standards around this to ensure that whatever basis is used for calculation, it is transparent and, so far as possible, consistent whilst retaining sufficient flexibility to reflect the specificities of the market and class of OTC derivative contract concerned.

Intra-group transaction notification details (Article 7 RM) and Intragroup transaction – Information to be publicly disclosed (Article 8 RM)

We broadly welcome the content of the draft RTS on these points.

<u>Notification to regulators</u>

We welcome the time limits set out for counterparties to submit to competent authorities and for competent authorities to respond. However, we note that in certain instances (for example, in any intra-group exemption application made pursuant to EMIR Article 11(6)), the time limits for a competent authority to respond are not as definitive as other instances (for example, any intra-group exemption applications made pursuant to EMIR Articles 11(8) and (10) which requires a competent authority to respond within 2 months)). Where a decision is required from a competent authority in respect of any intra-group exemption application, we would suggest that ESMA set down clear deadlines by which competent authorities are required to make and communicate decisions.

We have a number of concerns in relation to the notification process, however:

It would be useful, and relevant, to understand what is meant by 'practical and legal impediments', for the purpose of carrying out the notification. We hope that the (possible) hiatus between the adoption and application of RTS on non-cleared margin and non-margin risk mitigants (including this notification) may nevertheless be helpful in allowing firms to carry out the notification and to have it evaluated before mandatory margin requirements are/are not imposed for intragroup trades (including between entities inside and outside of the EU). However without guidance on this matter, counterparties will not understand the meaning of required disclosures to regulators.

We further comment – in relation to Article 7 RM (3) – that it is not clear how broadly the requirement to provide "legal opinions or summaries, copies of documented risk management procedures, historical transaction information, copies of the relevant contracts between the parties" will be interpreted by the competent authorities. It may be the case that risk management policies apply to an entire corporate group and that each intra-group counterparty may not have its own risk management policies. We believe it would be unduly onerous if intra-group counterparties were required to obtain legal opinions in respect of each intra-group counterparty.

There do not seem to be any restrictions on further information that regulators may demand. This may create some legal certainty. Ideally, there would be some harmonization therein;

Further to this point (and the points regarding public disclosure, below), we have concerns regarding the commercial confidentiality/sensitivity (as set out on contracts) of information demanded by regulators in this context.

We consider that the notification to competent authorities of the intention to apply the intragroup exemption should cover transactions in any derivatives or in particular classes of derivatives, including future transactions. The counterparty making the notification should provide the relevant competent authority with confirmation that they meet the criteria for the exemption, and should notify the competent authority promptly upon the criteria ceasing to be met.

In relation to the requirements in EMIR articles 11(6), 11(8) and 11(10) for counterparties to apply for a positive decision from the relevant competent authorities, again, we consider that the application should cover transactions in any derivatives or in particular classes of derivatives, including future transactions. Each counterparty seeking a positive decision should apply to the relevant competent authority providing confirmation that they meet the criteria for the exemption, and should each notify the relevant competent authority promptly upon the criteria ceasing to be met.

In any event, we consider that the regulatory technical standards should clarify that the exemption will cease to apply as soon as one or both counterparties cease to meet the criteria.

Public Disclosure

In relation to public disclosure (Article 8 RM), the signatory associations question the proposal that quantitative data should be provided in 'notional aggregate' as – given that the contract(s) in question may hedge non-OTC derivatives exposures - this may not give useful information. Indeed, we question whether publicly disclosing information on notified intragroup transactions provides meaningful benefit in risk and transparency terms, albeit that the EMIR Regulation mandates some disclosure, and the ESAs to make proposals on the detail therein. We suggest that:

- Such public disclosure should be largely descriptive in nature;
- Counterparties should not be required to disclose commercially sensitive information;
- Consideration should be given to whether the disclosure could be undertaken at parent company level.

We would also like to understand what ESMA has in mind regarding methods of public disclosure e.g. would company websites and annual accounts be fit for purpose? We note the previously expressed view of ESMA[5] that such statements could be made on an annual basis.

We note an inconsistency between the terminology in Article 7(2)(b) RM and Article 8(b) RM and suggest that the latter should also refer to the ‘corporate’ relationship between the counterparties.

Other NFC-specific points relating to intragroup transactions

Under the EMIR Regulation Article 3, a transaction may only be treated as an intra-group transaction in relation to a non-financial counterparty when the transaction is subject to ‘appropriate centralized risk evaluation, measurement, and control procedures’. The EMIR text, however, does not provide for further technical standards to be produced by any European supervisors that would provide guidance on demonstrating that the counterparties are subject to such procedures. As the intra-group exemptions available under EMIR are likely to be crucial for corporate groups that seek to manage group risk through derivatives, we recommend ESMA issue formal guidance that would provide counterparties with greater certainty regarding which procedures would be considered appropriate. In our view, group transactions should be considered as subject to the centralized risk evaluation, measurement and control procedures when the risks inherent in the transaction can be analysed and managed centrally by a group risk function.

We also believe that ESMA should not import requirements of bank regulation, such as those in the Capital Requirements Directive to NFCs generally in assessing the appropriateness of these centralised procedures.

Interaction of non-cleared margin rules and equivalence decisions with intragroup transaction exemptions

[5] Paragraph 105 (page 21), Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories, dated 6 March 2012

Under the EMIR text, a transaction between a financial counterparty or non-financial counterparty established in the Union and another counterparty established outside the Union can only be regarded as an intragroup transaction “provided that both counterparties are included in the same consolidation on a full basis and they are subject to appropriate centralised risk evaluation, measurement and control procedures *and [...] the Commission has adopted an implementing act under Article 13(2) in respect of that third country*”.

This means that a prior equivalence ruling is required from the Commission in accordance with Article 13(2) before any transaction between a two members of a consolidated group where one is established outside the Union can be regarded as an intragroup transaction.

This seems to mean that until such time as the European Commission rules on equivalence (even in respect of jurisdictions where such an equivalence ruling may be likely to be forthcoming once the relevant jurisdiction has completed its own regulatory reform agenda) intragroup transactions could be subject to risk mitigation techniques for uncleared trades (including pertaining to exchange and segregation of initial margin) and possibly even mandatory clearing requirements in the same way as transactions with external counterparties.

We understand that margin issues may now well be dealt with at EU level in an ESAs consultation in early 2013 (after conclusions have been reached in the current BCBS-IOSCO deliberations). We urge ESMA and the European Commission to ensure that any potential problems caused by a combination of these timetable issues and the detail of eventual margin rules are prevented to the extent possible, for example through careful phase-in of applicable requirements or transitional provisions in order to allow sufficient time for equivalence assessments.

Contracts that have a direct, substantial and foreseeable effect

The OTC derivatives business is global. It is therefore crucial to establish a workable approach towards third countries and to provide legal certainty about extraterritorial application of rules to contracts (and hence the potential for legal conflicts). If this is not achieved, market participants are likely to be subject to multiple and/or conflicting obligations in different jurisdictions which could lead to higher costs, market distortions and regulatory arbitrage. What are the perimeters of EU regulation? What does it mean for a contract to have a ‘direct, substantial and foreseeable effect’ in the EU? In general, we feel that EU regulators should feel that they can defer regulation to 3rd country regulators where regulation in those countries delivers equivalent regulatory outcomes to those in the EU.

We add that it is important that sufficient emphasis is placed not only on interaction of the European regulatory regime with the United States’ regulatory regime, but also with other regulatory regimes within the G20 group.

IV. CCP Requirements

IV.II Recognition of a CCP (Chapter III)

The Consultation Paper sets out draft RTS at Annex III, Article 1 3C in relation to the information to be provided to ESMA for the recognition of a third country CCP under EMIR Article 25.

The Signatory Associations welcome the opportunity to comment on the draft RTS. In particular, EMIR Article 25 makes it clear that ESMA may only base its recognition decision on the fulfillment of the conditions set out in Article 25(2). While ESMA may wish to require a third country CCP to provide it with certain information (e.g., the rules and procedures of the CCP), the RTS should make it clear that this information will not be used in the process for determining whether or not to grant recognition. Some of the items listed in Article 1 3C are ambiguous and seem to indicate that ESMA may conduct an assessment beyond simply considering whether the conditions in Article 25(2) are met.

Requirement to provide evidence of compliance with applicable rules and information on financial resources: under Article 25 EMIR, ESMA may only recognise a CCP where the Commission has adopted an implementing act determining that CCPs authorized in a third country comply with legally binding requirements which are equivalent to the requirements laid down in Title IV of EMR, that those CCPs are subject to effective supervision and enforcement in that third country and that the legal framework of that third country provides for an effective equivalent system for the recognition of CCPs authorities under third-country legal regimes.

In addition, ESMA shall establish co-operation arrangements with the relevant competent authorities in those third countries, providing at least for prompt notification to ESMA where the third country competent authority deems a CCP it is supervising to be in breach of the conditions of its authorization.

Although it may be appropriate for a CCP seeking recognition to provide ESMA with a copy of its rules and internal procedures and evidence that it is duly authorized in its home jurisdiction, it is not clear why the CCP should be required to demonstrate its compliance with applicable law, when the Commission will have determined that the CCP is subject to effective equivalent supervision, and the third country supervisor of that CCP will be required to notify ESMA of any possible breach by the CCP.

Similarly, if the Commission has determined that the CCP is subject to equivalent supervision in its home jurisdiction, and if the CCP is required to comply with the prudential requirements applicable in that home jurisdiction, it is not clear why the CCP should be required to provide ESMA with evidence of its financial resources. If those financial resources are considered to be sufficient for its home competent authority, ESMA should not need to conduct a further review and assessment.

Similar points apply in relation to the request for details on the margin methodology and calculation of the default fund, list of the eligible collateral, and results of the stress tests and back tests performed during the year preceding the date of application.

Classes of financial instruments cleared: a CCP seeking recognition to clear OTC derivatives should be required to provide the information required to be included in the public register in accordance with Article 1 PR. This would assist ESMA in determining whether the recognised CCP clears any OTC derivative contracts which are already, or which should be, subject to the mandatory clearing obligation.

Requirement to provide the identities of the shareholders or members with qualifying holdings: this information may not be available to the CCP, for example if it is established in a jurisdiction which does not impose change of control notification or approval requirements for CCPs, and which does not have major shareholding reporting obligations. A CCP should only be required to provide this information if it is readily available.

Other information to be provided: ESMA may also wish to request additional information from a CCP requesting recognition, including:

- Full name of the relevant legal entity, together with any identification code used to identify the CCP in the third country where it is established and authorized;
- Name and contact details for an officer of the CCP who will take responsibility for all communication with ESMA (e.g., the chief compliance officer);
- Any other information required to be included in ESMA's public register, or a commitment to provide this information upon recognition.

IV.III Organisational requirements (Chapter IV)

Clear, concise and effective rules specifying CCP governance arrangements are vital if EMIR’s mandatory central clearing requirements are to avoid inducing systemic risk into the post-trade space via the failure of inadequately capitalised or poorly managed CCPs. For this reason, it is in the interest of regulators, CMs, clients and CCPs themselves that the governance standards outlined in the draft RTS are more demanding when compared to that of governance regimes for other non-systemically important firms. It is also important that the governance structure of a CCP require higher or heightened governance or approval processes than those followed in the normal course of business for the alteration of its rules, procedures or contracts. These assertions are grounded not only in the belief that CCPs should be stable low-risk entities, but also from a competitive risk perspective, as the expansion of mandatory clearing may result in a 'race-to-the-bottom' amongst CCPS as they seek to exploit the significant business opportunities provides by EMIR.

Accordingly, we generally welcomes the provisions of the draft RTS which relate to CCP governance as they firmly establish the duties and responsibilities of the board and senior management in regards to risk management, audit and compliance. We support the requirement that a CCP must specify a chief risk officer, a chief compliance officer and establish an internal audit function as a necessary part of that process. We also firmly support the draft RTS clearly placing final responsibility and accountability for managing a CCP's risks with the board.

The ESMA proposal that a CCP should have dedicated human resources with appropriate expertise to ensure a sound, prudent and efficient management for the management of the CCP and who are separate from the wider group is welcome however it should be applied proportionately. The Signatory Associations support policies which ensure that a CCP performs its critical functions independently and free from conflicts of interest, and as such we agree with the view that there should be dedicated Heads of Compliance, Risk and Technology in each jurisdiction. We do believe that applying a blanket human resource exclusion requirement to *all* functions such as HR, Treasury, Finance or Sales, could be disproportionate and uncessary however. For these non-critical functions, CCPs should have the flexibility to resource these roles according to both its needs and the needs of its members.

One area we do believe should be clarified further is the CCP governance process regarding the role/involvement of the Risk Committee for assessing and agreeing whether the CCP model (legal, operational, etc) fits the appropriate standard for clearing a given class of derivatives. Indeed EMIR Article 28(3) provides that the Risk Committee shall advise the board on the clearing of new classes of instruments – guidance from ESMA on how this can be achieved is needed.

In regards to remuneration, we welcome ESMA clearly stating that the remuneration policy for staff engaged in risk management, compliance and internal audit functions must be decoupled from the performance of the CCP. Further, remuneration should be competitive in comparison with the market for risk professionals. This is an essential characteristic of sound risk management and removes a key conflict of interest issue, one that is assisted by the requirement for a remuneration committee to oversee such policies.

In relation to Compliance and the Risk function, the relationship between the two functions is unclear. Accountability for technical compliance obligations in relation to risk management should be placed clearly with Risk. Legal opinions confirming the soundness of CCP rules, procedures and contractual arrangements should be reasoned and made available to CMs. Changes to CCP rules that materially alter the risk profile of the CCP should be approved by the Risk Committee.

Where Article 2 (1) states "…*a CCP shall provide incentives to its clearing members to manage and contain the risks they pose to the CCP"* we ask ESMA to clarify in the recitals what would constitute an incentive, how such incentives must be managed by the CCP to ensure that it does not undermine the risk profile of the CCP, and specifically, to cite inappropriate incentives which may be contrary to the risk management principles of the CCP.

We welcome the disclosure obligations at Annex III, Article 7 ORG but ask that clause 1 is extended so that the CCP investment policy and account structure is made publicly available. This information is key to prospective members and market participants and should not only be made available after they have made their determination to join or trade on the market. Account structure information should be sufficiently detailed to allow market participants to carry out independent due diligence on client asset protection (which will rest upon a combination of actual segregation of assets combined with the terms of the rule book). At clause 1(b) the words "supplementary texts" is fluid. All CCP documentation with legal effect including contract specifications, market notices and guidance should be available. Additionally, key information should be made available regardless of whether a client is "known to the CCP". As regards clause 4, which lists information that should be disclosed to CMs, the text should be explicit that overview information is not sufficient. Information should be adequate to permit CMs to fully test the risk management methodology of the CCP. CMs should be able to rely upon translated information provided by CCPs, as such the words "**and binding**" should be inserted after the words "Information shall be available".

IV.IV Record keeping (Chapter V)

General Comments

We agree that record keeping is an essential element for assessing CCP compliance with the relevant regulations and a useful tool to monitor CMs and, where necessary, clients activities and behaviours. We offer our support for the RTS proposals pertaining to Transaction Records (Article 2 RK) and commend ESMA on accepting that the proposal outlined in the discussion paper requiring position identification to reflect whether a position was 'long' or 'short' was inappropriate (Article 3 - Position Records). We do believe that a pay off description of the relevant derivative products should be added to Article 3

Retention and inspection of records

We welcome the RTS rejecting a requirement that CCP records be maintained within the EU. We do advise where backup data is taken to offsite storage, and would need to be retrieved and restored, ESMA must accept that the response time for regulatory queries could be days rather than hours.

IV. V Business continuity (Chapter VI)

The Signatory Associations support many of the proposed elements of these requirements including the policy framework, requirement for secondary processing sites and business recovery sites, regular testing, communication and awareness. We welcome the steps ESMA has taken to ensure that the RTS are aligned with CPSS-IOSCO Principles for FMIs.

As per our submission in the discussion paper, we continue to assert that it is imperative that a comprehensive plan to address CCP stress is agreed ex ante. Accordingly, we welcome the provisions of Article 1 BC paragraph 3 which specifies that a CCPs BC plan take into account the level of interoperability across CCPs, linked payment systems and credit institutions, as well as critical functions and services which have been outsourced by the CCP. These considerations are vital if non-defaulting portfolios are to be ported relatively seamlessly to another CCP rather than having to unwind large portfolios over the course of a relatively short period.

In our discussion paper submission we cited that while a 2 hour recovery time for a CCP's critical system may be proportionate, this was not the case if the means to achieve this target was via a purely technical solution, particularly as the risks to the primary site where such a high tech solution is based may be at risk of force majeure scenarios. In its explanation, ESMA cited that general opinion is that a 2 hour recovery time is feasible and desirable for systemically important FMIs. While we agree that a 2 hour recovery time is desirable, we continue to believe that if this target is to be achieved via purely technological means, it is not proportionate.

We agree that the secondary site should have a geographical risk profile which is distinct from the primary site. However, it should be made clear that to be "distinct" the CCP back up site should not be in the same regional proximity, as this would not help in the event of a disaster affecting the region.

IV. VI Margins (Chapter VII)

Percentage confidence level - Article 1 MAR

The distinction between "OTC derivatives" and "financial instruments other than OTC derivatives" is not in itself sufficient to justify using different confidence intervals (99.5% and 99% respectively). Instead, the onus should be on the CCP to consider, for each asset class or product individually, all criteria in Article 1 MAR (2) (including complexity, liquidity, volatility etc.), and to determine whether 99% or a higher level is appropriate, subject to regulatory approval. For example, an additional illiquidity premium could be applied at the discretion of the CCP. In other words, asset class / product specific add-ons are the only way to cover risks adequately.

Further, 99% is the standard for uncleared OTC transactions proposed by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) in their July 2012 consultation paper "Margin requirements for non-centrally-cleared derivatives”. If the standard for cleared trades ended up higher than for uncleared trades, it would not seem to encourage the propagation of central clearing (counter to the G20’s policy objective).

In addition, 99% is the standard adopted by the US. If the EU was to diverge on this level and require a higher minimum standard it would potentially disadvantage EU CMs against those who are able to satisfy their clearing obligations through CCPs located in other jurisdictions and make EU CCPs less competitive than the rest of the market applying the 99% percentage confidence level. More broadly, to facilitate international alignment, a level playing field and the recognition of non-EU CCPs, it would be advisable that the confidence level interval in the EU should not be more onerous/stringent than in other jurisdictions.

Importantly, the percentile cannot be considered in isolation – the look-back period and liquidation horizon are also crucial factors.

<u>Look-back Period – Article 2 MAR</u>

The mixing of recent data and data from the most stressed period over 30 years is not a good idea for margining.

Selecting the most stressed period may not provide the best protection for the CCP as the period is arbitrary and not reflective of the sensitivities of the member portfolios. In other words, there is no “special six month” period for any product portfolio. An approach which ignores this fact will cause certain portfolios to have very high margins (supporting a notion of avoiding pro-cyclicality, but increasing liquidity costs) while others, which are just as risky, will not attract prudent margin.

Mandating specific fixed periods (such as six months) of recent data is also not prudent as it will be unlikely to include a sufficient diversity of market conditions under which to derive IM.

Accordingly, we consider these proposals to be overly-prescriptive. Instead, we propose that the minimum required IM of a portfolio should be floored at the 25th percentile of the portfolio’s value where that value is derived from market data for the portfolio over a reasonable historical period.

<u>Liquidation period – Article 3 MAR</u>

ESMA proposes 5 days minimum for OTC and 2 days for all other products. This is different to the CFTC final rule of 1 day minimum for all other products. This is a concern because diverse and inconsistent requirements between different supervisors will increase costs and make it less likely that robust international standards can be developed. Further, in light of the “equivalence” recognition frameworks being developed in the U.S., a unified approach will also facilitate mutual recognition.

We believe that the liquidation periods need to align with the practice of liquidation. Liquidation practices will be different at CCPs, which close-out CMs, from the associated close-out practices of CMs which need to close out clients and potentially indirect clients.

While longer periods will be appropriate for less liquid asset classes other OTC trades are very easy to liquidate, so CCPs and CMs need a broad remit for charging for liquidation and the modelling of close-out periods for portfolios recognising the difficulties of the task and the fact that there is no straightforward solution.

<u>Portfolio margining – Article 4 MAR</u>

On p. 106 (Article 4 MAR), Portfolio margining it states:

- "The level of negative price correlation should be at least minus 70% for each pair of financial instruments or for each pair of baskets of financial instruments where the offsets are allowed." (the “Correlation rule”)
- The amount of margin offsets shall be proportional to the level of correlation evidenced. The maximum offset shall be calculated as 80% of the correlation [...]" (the “Offset rule”).

We are concerned that these formulations seem to have rule-based approaches like SPAN or RBM in mind, for which offsetting is included explicitly for some product pairs. This approach effectively rules out the usage of more risk sensitive methodologies by CCPs, e.g. where multivariate offsetting structure is implicitly covered within scenarios.

As a result of the Correlation rule, portfolio margining for some positions that have a strong theoretical basis would not be permitted, such as for two year vs. ten year interest rate swaps. Likewise, the Offset rule would mean that the IM for two exactly offsetting swaps (or a swap hedging an option) was the same as that for two much less correlated trades.

More generally, if the objective of the portfolio margining RTS is to find the more conservative (margin-wise) correlations for a given portfolio having “N” risk factors, one would have to see if increasing or decreasing the correlation of each pair of risk factors. As there are N (N – 1) / 2 distinct correlations among the risk factors, the number of margin calculations would increase dramatically, by N (N - 1).

For example, for CDS where each single name is a risk factor, and there are around 200 clearable names in each of Europe and North American, this would mean a calculation burden increase of 400 x 399 = 160,000 times the single calculation, making margin calculation infeasible.

Likewise, in rates, where historical VaR (HVaR) is generally used by CCPs, it is impossible to see how this would be done, as HVaR reflects the actual historical rate co-movements. If one were to use a SPAN approach instead, with 14 swap currencies and say 20 tenors (risk factors) in each currency, our preliminary estimate is a need to increase current calculation burdens by a factor of roughly 80,000, again making portfolio margining infeasible.

Accordingly, we urge ESMA to replace this proposal with the approach adopted by the US CFTC which permits a CCP to allow reductions in IM requirements for related positions (spread and portfolio margins), if the price risks with respect to such positions were significantly and reliably correlated. Under the CFTC's regulation, the price risks of different positions would only be considered to be reliably correlated if there were a theoretical basis for the correlation in addition to an exhibited statistical correlation. The regulation include a non-exclusive list of possible theoretical bases, including the following: (A) The products on which the positions are based are complements of, or substitutes for, each other; (B) one product is a significant input into the other product(s); (C) the products share a significant common input; or (D) the prices of the products are influenced by common external factors.

In addition, Article 4(3) states "All financial instruments to which portfolio margining is applied shall be covered by the same default fund." To avoid unintended consequences of a proliferation of default funds, we suggest the drafting of the standard is amended to "***All financial instruments which the CCP default manages separately should be covered by separate default funds.***"

IV.VII Default fund (Chapter VIII)

We broadly welcome the draft RTS herein. However, the Risk Committee should not only discuss the default fund framework, it should be approved by the Risk Committee.

In addition, in the event of default of a CM, it is not clear how the provisions for Portability are to be applied when interpreting the default waterfall. The proposed RTS does not make clear if this includes or is distinguished from the collateral of that CM's clients. In particular we are not clear whether the CCP may seize and monetise all collateral received from a CM, irrespective of whether that collateral has been sourced from a non-CM or from an indirect CM who did not opt for segregation.

Although the governance structures of CCPs, with risk panels formed from client participants, would reduce the possibility of fraud or other serious misappropriation of funds, there must be regular monitoring to ensure that such rules are being adhered to and to ensure robust ring-fencing of default funds.

Where there is commonality, which may be the case with some cleared OTC Swaps between CCPs (i.e. CME CE and ICE), portability arrangements [for CMs] in the event of the failure of the CCP should form an element of testing.

IV.VIII Liquidity risk controls (Chapter IX)

It is important that the ESMA draft RTS herein are consistent with CPSS/IOSCO standards. We would note that the Risk Committee of the CCP should be consulted upon policies pertaining to liquidity risk.

We believe there is potentially some confusion around the issues discussed in the context of liquidity risks for CCPs. Two different aspects should be considered:

- The broader view of liquidity resources that are available to a CCP in order to face its liquidity requirements and in particular the ability by CCPs to control the possible risks of lack of adequate liquid resources at a time of crisis;

- The specific aspect of intraday access to liquidity for the on-going operational requirements for the settlement of all transactions on CCPs' securities and cash accounts (specifically relevant for equity and bond cash settlements).

We note and appreciate that in paragraph 185 of the consultation paper ESMA has decided not to include concentration limits over CCPs' credit facilities received from CMs or other entities in the same group (as per EMIR Article 44.1 and per ESMA RTS Article 3.2 LIQ in Annex III.IX). However, we believe that it is not yet sufficiently clear that, in addition, the requirements of EMIR Article 44 should not be considered applicable to intraday liquidity needs for settlement purposes.

As we noted in our response to the ESMA DP on 20 March 2012, the current modus operandi of bond or equity clearing CCPs is that they typically use a single payment bank for their intraday liquidity needs in each market where they offer clearing services (only one per market). This is a practical, operational requirement based on how the settlement infrastructures work today.

We would welcome an explicit statement in the final RTS to confirm that EMIR Article 44 does not relate to intraday liquidity requirements for CCPs clearing cash securities for the reasons described in the above paragraph. Consequently, we support ESMA's Policy option choice that the RTS does not provide defined standards, but rather states the factors that should be considered in evaluating concentration risk.

We also agree with the preferred option in respect of a criteria based approach which is more flexible, rather than a prescriptive one, when defining appropriate sources of liquidity.

IV. IX Default waterfall (Chapter X)

ESMA proposes that "A CCP shall keep, and indicate separately in its balance sheet, an amount of dedicated own resources for the purpose set out in Article 45(4) of Regulation (EU) No xx/xxxx [EMIR]. This amount shall be at least equal to the 50 per cent of the capital, including retained earnings and reserves, held in accordance with Article 16(2) of Regulation (EU) No xx/xxxx [EMIR]. The CCP shall revise this amount on a yearly basis."

At the outset, we urge ESMA to tighten "A CCP shall keep, and indicate separately in its balance sheet..." in Article 1 DW (1)

We recommend the following alternative text:

*'**A CCP shall keep an amount of dedicated own an amount of dedicated own resources for the purpose set out in Article 45(4) of Regulation (EU) and ensure this amount is:***

a) funded at all times at the CCP legal entity operating company level (rather than any "HoldCo" corporate entity), with explicit inability of CCP to transfer amounts upstream to parent by way of to dividends or other form at any time; and

b) ***held in segregated account (separate from all other CCP deposit accounts including those meant as first tranches for other CCP segments) in name of CCP with explicit purpose of that segment's first loss GF contribution***.

In setting this skin-in-the-game 50% requirement, we note the importance of achieving a balance of the desire for CCPs to have "skin-in-the-game", which is critical to incentivize CCPs to set adequate margins and regulation that does not favour a particular CCP ownership structure with ensuring there are incentives for CMs to bid in an auction of a defaulting CMs portfolio. We are uncertain as to whether the 50% quantum is the correct balance.

We propose that the CCP should hold 50% of its regulatory capital, in a segregated deposit account, as "skin-in-the-game". However, we consider this should be capped at an amount equivalent to a CM at 75th percentile's default fund contribution for the class of cleared product. (This gives the CCP the same thickness of skin as a prominent CM - but the CCP absorbs the loss first.). We also recommend that the CCP's contribution be subject to a minimum floor of USD$50 million, to provide adequate protection and provide increased confidence in the markets while market participants ramp up access to clearing services.

Also, the total skin-in-the-game should be placed into tranches in the default waterfall (Article 42.4 of EMIR requires capital from the CCP ahead of non-defaulting members, but it does not rule out the CCP putting additional capital after them - in practice CCPs/policy-makers would want further CCP capital post default funds to avoid wind-up of the CCP):

a) one tranche before the non-defaulting members' default fund contributions (our proposed calculation is above). The first tranche ahead of the non-defaulting members is what gives the CCP the incentives to calibrate margins properly and manage risk. In order words, making CCP resources subordinate to the rest of the DF incentivizes the CCP to reduce the chance of these assets ever being called upon, i.e. to make sure that each CM has sufficient IM and individual DF contribution. However, we need the right auction incentives for non-defaulting CMs as well so the CCP first tranche must avoid removing these incentives, by being too large. This structure would reinforce those incentives created by other tools such as financial penalties and/or creating a waterfall within the DF which puts non-bidders first.

b) a second tranche following the non-defaulting members default fund contributions (remaining skin) The fact that further CCP resources would be called upon if the DF was completely exhausted incentivises the CCP to make sure that the overall DF is big enough.

Caveat: We strongly advise ESMA, in conjunction with other relevant supervisory bodies such as EBA, to carry out a thorough systemic risk assessment of this proposal. A robust and in-depth impact assessment of micro- and macro-economic effects and incentives of this proposal is essential to ensure that the framework achieves the desired supervisory objectives.

One element of this is the need for a well designed quantitative impact study. A properly designed impact study will provide the essential information required to calibrate the proposals. To enable this, we urge ESMA to collaborate with the industry in the impact study.

IV. X Collateral requirements (Chapter XI, Collateral)

The signatory associations believe that – whatever the ultimate regulatory technical standards applying to defining 'highly liquid collateral' and the conditions for use of different kinds of collateral by CCPs CMs and clients - it is important that CCPs are transparent in relation to their collateral policies and methodologies (e.g. haircuts used for different types of collateral). Such transparency will aid market participants in gauging and managing risk associated with dealing with CCPs. We further believe that it is important that CMs and clients have an opportunity to comment on these policies.

We welcome the provision (Article 1 COL 3 (b) (vii) (1) that financial instruments accepted by a CCP as collateral cannot include instruments issued by the CM providing the collateral, but would add that consideration should be given to whether instruments issued by other members (of that CCP) should be acceptable as collateral from that CM.

We believe that CCPs should be encouraged to accept the following forms of collateral, predominantly:

- Cash, in the currency of denomination of the underlying instrument or that in which the relevant transactions are settled, and U.S. Dollars, Euros, Japanese Yen, and British Pounds.

- Direct obligations of, or obligations guaranteed by the sovereigns of the jurisdiction in which the CCP resides or other highly rated (i.e. 'A' or above) sovereigns, to the extent practicable under current regulation.

There is an argument – in particular from the point of view of financial institutions that would be likely to be clearing members of multiple CCPs (and hence underwriters of the risk managed by these CCPs) - that dependence on other forms of collateral e.g. corporate bonds, equities, gold etc. should be limited, with usage and conditions therein monitored by risk committees and the local regulator. Views expressed by such financial institutions would include that such alternative collateral types should together account for a limited percentage of initial margin at a member level, up to a specified value (across house and client accounts) and across the CCP in aggregate and that CCP rules should explicitly prohibit (and clearing systems should prevent) members' ability to pledge their own (and other members') issuances.

It is also important to acknowledge the significant liquidity reduction in certain non-cash assets if eligible collateral for every CCP was limited strictly to those non-cash assets listed in the second bullet above. Such liquidity strain may be further exacerbated by the competing and similar uses for such collateral pursuant to the impending rules for uncleared swap margin in the United States and European Union and the Basel III reforms (including, notably, the Basel III liquidity ratio).

We recognize that NFCs will be able to use commercial bank guarantees as collateral at CCPs – based on the EMIR text – but note also that regulatory technical standards will set out the conditions for their use. In this regard, we note that the CPSS-IOSCO Principles for financial market infrastructures (April 2012) underline that guarantees are most appropriately used if 'fully backed by collateral' and 'realisable on a same-day basis' or 'subject to an explicit guarantee from the relevant central bank of issue' if supported by a 'legal framework applicable to and the policies of the central bank'. We note, also, that the CPSS-IOSCO principles states that 'when evaluating types of collateral, an FMI should consider potential delays in accessing the collateral'. As such (subject to the clarification suggested below) we welcome a number of the provisions in Chapter X, Article 1 COL 3 (c).It would be worth clarifying whether it is the bank guarantee or the collateral backing the bank guarantee that ESMA intends should be 'realisable on a same day basis', further to the point made above . If the latter, it is not clear which financial instruments – as referred to in Chapter X, Article 1 COL 3 (b) - would be fit for purpose.

Further to our concerns regarding CCP transparency, the signatory associations would welcome more detail in the RTS on how valuations should be performed by CCPs, especially under stressed market conditions or where marking-to-market in real time is not possible. How 'current' does pricing have to be to meet the 'highly liquid' requirement? Would the previous night's closing price – industry standard – suffice?

The CPSS-IOSCO principles recommended independent validation of valuation procedures by CCPs, at least annually – we note that no such requirement is set out in the draft RTS.

We would also welcome more detail on how haircuts are calculated and how concentration limits are set. If such detail is not set out, we repeat that CCP transparency is vital, in order for CMs and clients to be able to gauge relevant risks.

The word 'marketable' is used – seemingly as a synonym for 'liquid' – in Annex III (Draft regulatory technical standards on CCP requirements), recital 45. We believe 'liquid' is a more appropriate word in this context.

Paragraph 1 requires a CCP to 'determine concentration limits at the level of each CM and at the level of all clearing members'. We have reservations about how this can work in practice, and whether it is achievable, given the ongoing administrative monitoring burden imposed. For example, the CCP may be *within* concentration limits having received collateral from Client A, but should Client B then deliver the same line of security, this could lead the CCP to breach the limits at an aggregate level. It is not clear what practical corrective action should be taken, nor whether it would be Client A in breach, Client B, or both. The liquidity implications of being required to offer replacement collateral would also have to be managed. This scenario is further complicated by bringing Non Clearing Members and Indirect clearing members into the equation.

IV. XI Investment policy (Chapter XII)

General comment:

Our response to questions 51-56 (CCP Investment Policy) of ESMA's first EMIR RTS Discussion Paper dated 16 February 2012 proposed solutions and standards for several issues which remain a serious cause for concern. We would draw ESMA's attention in particular to our response to question 55 in which we raised concerns with (i) the rehypothecation by CCPs of clearing members' non-cash initial margin (we believe such rehypothecation or re-use by CCPs should not be permitted other than to access central bank liquidity in the limited circumstances of clearing member default), and (ii) the posting to CCPs of clearing members' non-cash collateral by way of title transfer (we believe that CCPs should be required to receive clearing member non-cash margin only by way of security interest or provide clearing members with a security interest in such non-cash collateral so that it would not form part of the assets of the CCP upon its insolvency). Our proposals are aimed at better insulating clearing member collateral from CCP insolvency risk, thereby also facilitating compliance (by clearing members and their clients) with Basel III/CRD IV. In this regard, we would recommend that ESMA consider requiring CCPs to provide reasoned legal opinions to the effect that margin and guarantee fund contributions would not be included in their insolvent estates. This also would go some way to satisfying the "bankruptcy remoteness" legal opinion requirement which clearing members and some clients will need to obtain for Basel III/CRD IV purposes.

We note ESMA's preference expressed in paragraph 213 for a criteria-based rather than a prescriptive approach to the Investment Policy RTS. However this less objective mechanism would allow each CCP to put its own interpretation on the criteria and apply them in different ways, leading to a subjective and potentially divergent approach. In the absence of prescriptive regulatory checks and balances (as proposed in our response to questions 51-56 of ESMA's first Discussion Paper in this regard dated 16 February 2012), assessment and ongoing monitoring of each CCP's investment policy application and performance will be a key issue.

In order to ensure consistency of approach across CCPs and jurisdictions, this criteria-based approach would entail the policing by national competent authorities and ESMA (for third country CCPs) of the application of the relevant criteria by each CCP and also by each competent authority. Not only would each national competent authority need to ensure that the investment policy of each CCP within its jurisdiction complies at all times with the criteria, but it would also need to calibrate its own regulatory methodology in this regard such that it is consistent with the approach taken by other competent authorities and ESMA.

If the criteria-based approach is to be followed by ESMA, would national competent authorities have the resources not only to monitor the application of the criteria by each CCP for which they are responsible, but also to check that their own approach to regulating CCP application does not diverge from the approach of their peers? Who would be responsible for overseeing consistency at each of the two levels - and how often will this be monitored at each level?

Similarly, if the criteria-based approach is to be followed, if ESMA or a national competent authority decides that the criteria are being applied incorrectly by any CCP (e.g. by one which appears to be taking investment risks in order to make a turn on the collateral posted to it by clearing members), would the CCP be forced by the relevant regulator to revise its policy, or its application of its policy, within a strict timeframe? Would the relevant regulator have the resources to monitor closely that CCP's investments once the policy (or application of it) has been amended, in order to confirm the effectiveness of the changes?

- A "comply or explain" mechanism would not work with a criteria-based approach: the subjectivity of this mechanism and the potential for different CCPs to put their own interpretation on it makes it difficult to envisage CCPs being required by ESMA either to comply with the RTS investment policy criteria or explain their non-compliance.

- ESMA may wish (as it has done in relation to macro hedging) to ensure CCP accountability by requiring CCPs to embed ongoing oversight of their investment policy (and their application of it) by the CCP's Board as advised by its risk committee (such requirement to be set out in the terms of reference of each CCP's risk committee).

- ESMA may also wish to consider embedding more objective criteria into its requirements throughout the INV RTS for CCPs to "demonstrate" their compliance with the RTS, rendering the standards less open to differing interpretations by different CCPs. In this regard, we would draw ESMA's attention to the standards proposed in our response to questions 51-56 of ESMA's first Discussion Paper dated 16 February 2012.

  We would particularly draw ESMA's attention to our response to question 52 relating to the CCP's repo counterparties and the contractual documentation entered into between each CCP and such counterparties which we consider to be of serious concern and do not believe has been addressed in the RTS. Our response proposed as follows: "An ability for CCPs holding cash collateral to repo it out means that ESMA should consider setting parameters to ensure the robustness of such repo arrangements. Repos should be for short term cash management purposes only and preferably limited to placement with eligible Central Banks failing which, eligible credit institutions (with robust documentation). We agree that such repo arrangements should be entered into on a secured basis only; they should also be marked to market daily in order to ensure their robustness, and involve only eligible financial instruments, and, where eligible Central banks are not available for these purposes, eligible repo counterparties in accordance with ESMA's criteria. CCPs should be required to ensure that their contractual arrangements with eligible repo counterparties include suitable protections for the CCP so that CCPs have adequate contractual recourse against such repo counterparties. This overnight repo risk also necessitates the specification by ESMA of criteria covering the creditworthiness of appropriate repo counterparties (even in circumstances where simultaneous exchange of cash for securities is assured via DVP (delivery versus payment) mechanisms). We would suggest that the factors specified by ESMA to cover repo counterparty selection should be linked to the relevant CCP's requirements for eligibility as a clearing member (e.g. appropriate capital, rating etc – though ESMA may consider that

> long-term ratings are not sensitive enough for this purpose), though ESMA may wish to specify a floor for each factor for repo counterparty purposes."

ESMA may also wish to consider dealing with these issues by requiring CCPs to report every quarter to ESMA or to their national competent authority on their compliance with ESMA's criteria, setting out in each report in detail how each standard has been met during the quarter.

ARTICLE 1 INV

Article 1a: ESMA should consider adopting a more prudent and risk-averse approach in order to restrict the jurisdictions covered (e.g. to those not subject to sanctions of any kind, or to those not on a Financial Action Task Force on Money Laundering list) by linking its requirement for issuance or guarantee by a government, central bank or multilateral development bank to the criteria for permitted currencies in both (d)(i) and (d)(ii). This means that the jurisdictions should be limited only to those whose legal currency is one whose risks the CCP can demonstrate with a high level of confidence it is able to manage and one in which it clears transactions.

Article 1b: "demonstrate" – please see under General Comment above.

Article 1c: since (as demonstrated by current markets) some 2 year instruments are fairly illiquid and thus their markets can be volatile, we believe that the average time-to-maturity of the portfolio should not exceed 1 year and that investments should be in overnight instruments.

Article 1d: we would suggest the addition of a new paragraph (iii) which captures the fact that the currency should be freely convertible and transferable and not subject to any restrictions in terms of how and where it is held, along the following lines:

> ***(iii) a currency in respect of which there exists no event or condition that has the effect of it being impossible, illegal or impracticable for, or has the effect of prohibiting, restricting or materially delaying the ability of, any CCP (1) to convert that currency through customary legal channels; or (2) to effect currency transactions on terms as favourable as those available to residents of the jurisdiction of that currency; or (3) to freely and unconditionally transfer or repatriate any funds in that currency from accounts inside the jurisdiction of that currency to accounts outside that jurisdiction or between accounts inside that jurisdiction; or (4) to receive the full value of any cash payment in that currency due to the introduction by any relevant governmental authority of a new currency regime (including the introduction of a dual currency regime) or the imposition of currency exchange limitations.***

Article 1e: ESMA may wish to include tax constraints in this provision as well, such that there is no tax, charge, duty, reserve, special deposit, insurance assessment or any other similar requirement for holding the financial instrument.

Article 1h: ESMA may wish to consider inserting the following additional conditions after this Article or in Article 1e:

- there is no term of or condition relating to a financial instrument that has the effect of prohibiting, restricting or materially delaying the ability of the CCP to purchase, hold, receive, sell or remain the owner of that financial instrument or any amount received in respect thereof; and

- no settlement or custodial conditions are applicable to the relevant financial instrument, such that it can be freely settled with no restrictions.

Article 1.2: ESMA may wish to reconsider whether it is suitable for the concept of "not primarily for profit" to be adduced in the assessment of whether an instrument is liquid and bears minimal credit and market risk. We agree that CCPs should be required not to prioritise profit-making, but we are of the view that this would sit better in a separate Article (and potentially as a purposive Recital as well) as a stand-alone requirement on CCPs, rather than as an interpretative element of the criteria for defining a liquid and low risk asset. Clearly that test is a separate factual test, not based on the profit-making desires of the investor.

As regards the proposal that profit not be the "primary aim", ESMA may consider it more appropriate to turn this around, so that the investment policy criteria are not met unless the primary or overriding aim is the preservation of principal amounts held.

ESMA may further consider requiring that any investments actually made should be made only where to do so would reduce (or at least not increase) the risk profile that the collateral would otherwise have. This would potentially prevent government bonds being flipped into other "riskier" eligible assets to make a better return for the CCP.

ESMA may also wish to consider inserting a general statement in the recitals to the RTS to the effect that CCP investments should be consistent with the primary objective of a CCP's investment policy, which should be to minimise interest rate, investment, forex and credit risks and to safeguard principal.

It would be useful from a risk management perspective for clearing members to have visibility into CCPs' investment practices. To that end, we would recommend that ESMA requires an industry-standard report to be shared monthly by CCPs with their clearing members, showing tenor, security type, etc.

ARTICLE 2 INV

Where these provisions for depositing financial instruments outside a securities settlement system give flexibility for the CCP to use third country institutions, ESMA may wish to consider imposing additional conditions on the use of third country institutions (or at least on the jurisdiction of their home state) so that such institutions are only used where reasonably appropriate in relation to the assets in question. We would note that this criterion is often included in a custody context, so that there is less scope to hold those assets which can be held in multiple jurisdictions in what might be considered to be a more 'risky' jurisdiction.

- As per our comment under Article 1 INV 1a above, ESMA may wish to consider adopting a more prescriptive approach here and restrict the third country jurisdictions covered (e.g. to those not subject to sanctions of any kind, or to those not on a Financial Action Task Force on Money Laundering list) by linking these criteria to its RTS criteria elsewhere for permitted currencies.

- We would also refer ESMA to our response to question 55 of ESMA's first Discussion Paper in this regard dated 16 February 2012, in which we suggested:

  "As between the EU securities settlement systems and the other four systems listed in paragraphs 140(a)-(d), each system should be assessed by the CCP through its risk committee at the relevant time in light of the different depositary models and the legal and other protections available at that time. Where core CSD services are not ring-fenced from ancillary services that are risk-taking, such as the provision of credit (as has been suggested in relation to the recent EU proposed regulation on Central Securities Depositories), CSDs/ICSDs may face typical custodian bank risks. We suggest that ESMA avoid a hierarchy among the five options (SSS, CSD, third country CSD, central bank & credit institution),and instead require CCPs to manage their custody risk for any of those arrangements against those key requirements in the Regulation on a security interest basis."

ESMA may also wish to consider the references in this Article to "ensures the full protection of those instruments" and the fact that the Article does not state for whose benefit this is intended. While the intention here, we assume, is that this provision should benefit the CCP, we would ask ESMA to consider that, where the financial instruments have been transferred by clearing members to the CCP by way of security, then this provision should also be for the full protection of the clearing members who posted them.

The references in this Article to "that enables the CCP prompt access to the financial instruments when required" should, we suggest, be further qualified by adding the words "***in accordance with the CCP rules***".

Article 2.1b: "demonstrate" – please see under General Comment above in relation to the potential for divergent CCP assessment, application and implementation of ESMA's high-level criteria.

Article 2.2: "that prevent any losses to the CCP": ESMA may wish to consider amending this to ***"...CCP and, where applicable, the clearing member who deposited those financial instruments***".

ARTICLE 3 INV

Article 3.1: ESMA may wish to consider further restricting the circumstances in which cash may be deposited outside a central bank by requiring prior approval from the CCP Board after consulting the CCP's risk committee.

Article 3.1a(i): "demonstrate" - please see under General Comment above in relation to the potential for divergent CCP assessment, application and implementation of ESMA's high-level criteria.

Article 3.2: is this provision only intended to cover those circumstances in which cash is deposited outside a central bank? If so, how has the 98% threshold been calculated and what factors were taken into account in its determination? We would query whether it would be more prudent and risk-averse to retain the deposit in cash rather than forcing 98% of the deposits to be invested in/secured by highly liquid financial instruments (which would import the weaknesses highlighted in our comment on Article 1 INV above). It is also not clear what ESMA intends by "collateralisation", or by whom and how this should be achieved. The lack of definition of "collateralisation" could result in cash deposits which are less safe because, for example, they are subject to repos with counterparties for whom criteria are not prescribed (please see our additional comments under General Comment above in relation to repo counterparties). ESMA may wish to consider simply repeating Article 2.2 INV here instead, to the extent that cash should be held under arrangements that prevent any losses to the CCP due to the default or insolvency of the authorised financial institution (to the extent that this is possible with cash).

ARTICLE 4 INV

ESMA may wish to consider a more prescriptive approach to this Article, since it may be easily misinterpreted such as, for example, to enable CCPs to pick up "cheap" bonds, or to widen their range of investments into unsuitable products.

Article 4.1: The requirement for investments to be "sufficiently diversified", in particular, is subject to a wide range of interpretation and ESMA may prefer both this policy and its application to be approved by each CCP's Board after first consulting with the CCP's risk committee.

Article 4.3: we would reiterate our comment under Article 1 INV 1a above: ESMA may wish to consider adopting a more prescriptive approach here and insert an additional paragraph (d) which restricts the jurisdictions covered (e.g. to those not subject to sanctions of any kind, or to those not on a Financial Action Task Force on Money Laundering list) by linking its issuance criteria to its RTS criteria elsewhere for permitted currencies. ESMA may also wish to require the issuer types/currencies of issuance to be subject to prior CCP Board approval, after consultation with the CCP's risk committee.

IV. XII Review of models, stress testing and back testing (Chapter XIII)

Article 1 SBT

Model Validation

A CCP's clearing members, through their margin and default fund contributions, provide the principal sources of the CCP's financial stability. Because their capital is at risk, we believe that it is essential they have a say in matters affecting the kinds of risk to which that capital is exposed. Thus, it is our view that a CCP should treat its risk committee (whose members should include representatives of the CCP's members) as an indispensable participant in the model validation process. Consistent with this view, we believe that Article 1 SBT should require a CCP to accord its risk committee an oversight role with respect to all aspects of the validation process, including the selection of the independent party referred to in this article, definition of the scope of the validation process and review and analysis of test results.

Articles 1(1) SBT and 1(2) SBT: Without limiting the generality of the foregoing comment, we believe these articles should specify that both a CCP's supervisory body and its risk committee should review and approve any material revisions or adjustments to the CCP's models, their methodologies, its liquidity risk management framework and the policies used to test the CCP's margin, default fund and other financial resources methodologies and framework for calculating liquid financial resources.

Article 1(5) SBT: We would recommend that ESMA specify in this article that when a CCP relies upon proxy pricing data, the use of proxy curves must be well-documented by the CCP and fully disclosed to its risk committee.

Article 3 SBT

Back testing

This article does not explicitly require that CCP back testing should be of current positions and not historical positions. Maintaining on-going records of potential losses of historical positions against historical margins is not back testing, and it does not indicate the adequacy of a CCP's current margin methodology for the clearing of its members' current cleared positions.

Additionally, we believe that the definition of "back testing" in Chapter 1, Article 2(1) Definitions, should be modified to insert the words "of each member portfolio" so that it reads in relevant part as follows: "as ex-post comparison of observed outcomes of each member portfolio with expected outcomes derived from the use of margin models."

[Article 3(2) SBT: We would recommend that (1) this article be revised to specify that the range of historical time horizons to be considered by a CCP should include, at minimum, the most recent year or as long as a CCP has been clearing the relevant financial instrument if that is less than a year and (2) Article 14(2) SBT be deleted in its entirety.]

Article 3(3) SBT: We believe it would be helpful for this article to require that the statistical tests referred to in the article include analysis of the frequency of exceptions (versus expected outcomes, given applicable confidence intervals) and the presence and extent of the clustering of exceptions.

Article 5 SBT

Stress testing

Article 5(4) SBT:. Consistent with our view that a CCP's risk committee be treated as an indispensable participant in the CCP's risk management process, we believe that the risk committee should be able to instruct the risk management department of the CCP to consider the inclusion of stress tests discussed by the risk committee. Accordingly, we would suggest that the words "or as instructed or requested by the risk committee" be inserted at the end of this article so that it reads as follows: "A CCP shall have the capacity to adapt its stress tests quickly to incorporate new or emerging risks ***or as instructed or requested by the risk committee.***"

Article 8 SBT

Stress testing – liquid financial resources

Article 8(1): This article should refer to "covered" liquid financial resources and should reference the following CPSS-IOSCO PFMI liquidity risk minimum requirement:

> *An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions.*

Article 11 SBT

Reverse stress tests

Article 11(3) SBT: This article's statement that the results and analysis of reverse stress tests are to be used to help identify extreme but plausible scenarios strikes us somewhat inconsistent with Article 11(1) SBT's direction that in conducting such tests, CCPs are to model extreme market conditions that go beyond what are considered plausible. We also believe that this article should specifically mandate the involvement of a CCP's risk committee in its reverse stress testing process. To address both these points, we would suggest revising this article so that it states that (1) a CCP should use reverse stress testing to help determine whether, in the case of test results that indicate the plausibility of any given modeled scenario, the stress tests themselves should be updated or the CCP should increase its financial resources and (2) the reverse stress testing methodology, results and analysis should be reported to, and subject to the oversight of, the CCP's risk committee.

Article 12 SBT

<u>Testing default procedures</u>

We believe it would be helpful if ESMA distinguishes more clearly in this article between the conducting of full end-to-end simulation exercises with all parties and the testing and reviewing of default procedures. It may be helpful to define both concepts in the definitions article of Chapter I and use the defined terms in this article. Additionally, this article should be revised to require that all default procedures tests and simulation exercises be subject to risk committee oversight, with such oversight extending to the full scope of the test or simulation, the results of and lessons learned from the test or simulation and any changes proposed to be made to the CCP's default procedures (which changes should be subject to risk committee approval prior to implementation).

Article 13 SBT

<u>Frequency</u>

Article 13(12) SBT: The first sentence of this article should be revised to provide that simulation exercises in accordance with Article 12(3) SBT should be performed at least twice, rather than only once, annually.

Article 15 SBT

<u>Information to be publicly disclosed</u>

As ESMA is no doubt aware, CPSS-IOSCO recently published their consultation paper "Disclosure Framework for Financial Market Infrastructures," http://www.bis.org/publ/cpss101c.pdf, in which they addressed public disclosures required to be made by CCPs in order to comply with the principles set out in CPSS-IOSCO's "Principles for Financial Market Infrastructures," http://www.bis.org/publ/cpss101a.pdf. We would recommend that this article be revised to specify that its requirements will be consistent with the final disclosure framework document published by CPSS-IOSCO.

V. Trade Repositories

As stated in our response to the February DP, reporting to Trade Repositories is a complex process with asset class specific components. The formal forum established in the US through the ISDA Data Working Group, where industry participants and CFTC representatives are engaging on a regular basis has proven very beneficial in developing a workable solution within the mandated time frames.

ISDA and industry representatives would welcome engaging with ESMA in a similar way, preferably early in the process to ensure we can meet regulatory objective while leveraging existing market infrastructures, and providing additional clarity about precisely where the reporting obligations rest.

We support the ESMA approach of requiring the reporting of data at a level of granularity that will be appropriate to enable regulators to fulfill their oversight and prudential role in a forward thinking manner. We equally appreciate the concern that requesting data beyond the reporting of the minimum characteristics of contracts and counterparties might lead to increased reporting costs.

We would like to highlight that such data will be of limited value for regulators, while creating significant additional cost for reporting participants, unless certain adjustments are made to the proposed rule. The adjustments, which are further detailed below relate to the following three themes:

- Consistency with other international regulators;
- Reference to, and use of, industry data standards; and
- Principle-based regulatory approach.

Consistency with other regulators

We believe it is essential that ESMA strives for compatibility with high level international principles and with the regulations being implemented in third countries.

However, working with combined data from EU-based TRS and recognized third country TRs in practice will only be possible if this data is expressed in a consistent manner.

The Draft Technical Standards as proposed contain a number of specific provisions that would make the use of data from multiple repositories particularly difficult:

- While there is reference to an ‘Internationally agreed UTI’ (Common Data Table, p. 143), the format is specified as 20 digits (Common Data Table, p. 172), which makes it incompatible with the format that has been adopted by the CFTC as part of its final rules.
  We recommend defining the Trade Identifier as floating (maximum) length of 42 characters. In addition we recommend for ESMA to work with other regulators to ensure consistency in the reporting workflows with as goal to ensure that a given trade, reported to multiple TRs (which we expect to happen because of overlapping regulatory requirements) carries the same unique trade identifier. This will allow regulators to avoid double-counting such trades when sharing information.
- As it relates to the Unique Product Identifier, we support the approach of deferring its usage until a universal solution has been developed. In the interim however, if ESMA is not prepared to envisage appropriate phase-in to allow for such universal solution to be available (which is our preferred solution) rather than making use of an ESMA-defined taxonomy, we recommend the usage of the ISDA-defined taxonomy[6]. The initial taxonomy has been developed with input from a wide variety of market participants and has included a public consultation period. The taxonomy is freely available on the ISDA website and a governance document has been developed to provide transparency with regards to future changes to the taxonomy. We expect this taxonomy to further evolve once reporting has started in different jurisdictions and to be refined over time with regulatory input. Having different starting points in different jurisdictions would indeed make the data usage more difficult, increase the overall cost and jeopardize the efforts of adopting a common UPI at a later point in time. We note that any requirement to comply with an interim solution before a permanent harmonized solution is available will have associated costs and build requirements (even in connection with providing information to third parties to report on their behalf). We urge ESMA to consider this additional cost, particularly for those market participants who are not subject to reporting requirements in any format at present.

- The Draft Technical Standards specify a set of data points which, while comparable, are not the same as those specified by other regulators (and specifically, the CFTC, which has already issued its final trade reporting rule). This will make the sharing of information by regulators very difficult, other than at an aggregated level.

Reference to industry data standards

We applaud that the Draft Technical Standards make reference to data standards in a number of areas throughout the document however, a number of provisions contained in the draft document seem to contradict this policy statement and raise clear concerns in relation to the usability of the data to be collected.

In the following areas existing industry standards are not leveraged:

- ESMA should look to always make use of the ISO currency standard. The field 32 ‘Currency of Collateral Amount’ should be adjusted to this effect.

[6] http://www2.isda.org/identifiers-and-otc-taxonomies/

- The use of free text formats should be avoided where possible. This non structured data is not comparable between trades and the practical value is extremely limited. Examples are the following fields: Other Collateral Type (field 29), Commodity Daily Hourly Quantity (field 59), Commodity Delivery Point, Zone (field 55).
- The financial industry has worked very effectively over the years to define and implement market conventions. As a result, ESMA should not attempt to redefine conventions such as the Delivery Type (field 12), the Payment Frequency (fields 40 and 41), the Reset Frequency (field 42), the Commodity Base (field 52) or the Option Type (field 61). Doing so would result in significant additional costs for reporting participants and result in difficulties when engaging in a dialogue with the marketplace when investigating detailed issues. Additionally, such "proprietary standards" limit the ability for European regulators to share comparable information with other regulators without transformations that at a minimum are costly but could impact the correctness of the information as well. A specification of data formats and how to deal with data that is not applicable (should the field be left blank or not reported?) should be consistent with existing standards and market practices as well. We recommend that (i) ESMA liaise with professional organizations such as ISDA and AFME to understand what has been done in that space, and (ii) refer to such standards as part of its final rule.
- Last but not least, ESMA identifies a precise list of fields which are meant to characterize each product. Aside from issues of consistency with other regulators, this detailed approach raises two sets of concerns: (i) inaccuracy and (ii) inability to evolve.
  i. Will the proposed field allow a proper representation of the main characteristics of the various types of OTC derivatives instruments that are traded, even putting aside the case of non-standardized products? A few examples lead us to question this:
     - The currency (field 4) is positioned at the same level as the taxonomy and product, and specified as being "The currency of the notional amount or the currency to be delivered or, for currency derivatives, the currency to be delivered." A number of derivatives products however have several currencies (e.g. FX products), or have settlement currencies that differ from the notional currency (e.g. non-deliverable products).
     - The Rate / price / spread (field 7) is defined as if the trade will have one or the other. It is however quite common for an interest rate swap to have both a rate and a spread.
     - The meaning of the Floating Rate to Floating Rate, Fixed Rate to Fixed Rate and Fixed Rate to Floating Rate (fields 42-44) is unclear and doesn't correspond to any market convention.
     - As suggested before, representing 50% of the data points required for commodity products through free text fields will lead to a situation where the collected data will be completely unusable.
  ii. How will ESMA handle the dynamic nature of derivatives products if it specifies upfront a static list of trade attributes? This issue has two distinct dimensions:
     - The regulation should provide the ability for participants to report the complex and bespoke derivatives products via an alternative scheme, which accounts for the fact that those products are not yet standardized. We recommend that ESMA leverage the recommendations developed by the Technology

Advisory Committee to the CFTC on this matter (we include this document – "Generic Product Representation" - with our submission in annex).

- The regulation should provide sufficient flexibility for the reporting framework to evolve in such a way that reporting attributes can be adjusted or added in response to changes in either the regulatory requirements or as required by product and marketplace evolutions.

The above issues can be addressed by relying on industry data standards, such as FpML. FpML is widely used across market participants and service providers, has an appropriate product scope, and is meant to evolve over time in order to meet the product and marketplace changes.

As this has been noted as a specific concern as part of the Draft Technical Standard, we would also like to take this opportunity to point out that these data standards provide appropriate underlyer representation, including for the case of basket trades.

Principle-based approach

The CPSS/IOSCO Report on OTC Derivatives Data Reporting and Aggregation Requirements identifies the following functional categories of data elements that are of relevant value for the Trade Repositories:

1. Operational data, i.e. data used by a Trade Repository for internal management purposes such as transaction number, trading and clearing venue, etc.
2. Product information, i.e. information that allows for the classification and/or identification of the instrument.
3. Transaction economics, i.e. the material terms of a transaction, including effective and termination dates, notional amounts, coupon amounts, payment schedules, etc.
4. Valuation data.
5. Counterparty information.
6. Underlyer information, i.e. unique code for identifying underlyers and various attributes of the underlyers.
7. Event data, i.e. information that records the occurrence of an event and includes a time stamp (which indicates precisely when a particular event occurred).

While extremely valid for ESMA to be prescriptive as it relates to the operational data and counterparty information, we recommend for the technical standards to provide general guidance as it relates to the other data points. This could avoid some of the pitfalls pointed out above.

Our specific recommendation is that the technical standards be adjusted to require the reporting of any derivative term that is commonly represented by an industry data standard. This creates a dynamic definition which goes beyond the regulators' expectations as stated in the Draft Technical Standards, while at the same time encouraging broad adoption of those data standards across the marketplace.

Scope and Registration

While many of the requirements in EMIR apply only to OTC derivatives, the requirement to report contracts to a Trade Repository goes beyond the scope of equivalent reporting requirements proposed in other jurisdictions in response to the G20 commitments on transparency, and applies to a much broader range of derivative products including exchange traded futures and options. The proposed technical standards for Trade Repositories do not currently differentiate between OTC and listed derivatives, and we believe this will lead to unintended complexity for market participants and Trade Repositories in meeting the reporting obligation, for reasons we set out in more detail below.

Although extensive preparatory work to develop Trade Repositories has been done by industry participants in global OTC derivatives markets over the past two years, dating from the enactment of Dodd-Frank in the US, comparable work still needs to commence for listed derivatives. The identification of Trade Repository service providers, design of reporting workflows and common data stores, and build-out of technology solutions to deliver reporting will require a significant lead time for industry participants trading listed derivatives to meet the obligation. To that end, we welcome ESMA's decision to enable phased implementation by linking the commencement of the reporting obligation to the registration of Trade Repositories for "that particular derivative type", with a backstop date of 1st July 2015.

However, "derivative type", is currently broadly defined in the Implementing Technical Standards (ITS) by reference to one of five categories of underlying asset classes, and does not include any reference to product types. In the Regulatory Technical Standards (RTS), Trade Repositories are required to specify the "types of derivatives" for which they are registering to provide services, but do not explicitly have to specify the product types. This drafting could have a number of unintended effects:

i. The commencement of reporting for OTC derivatives may be delayed because Trade Repositories would have to complete additional development work to support listed derivatives referencing the same underlying asset classes before registering.

ii. Trade Repositories could potentially register before market participants have had an opportunity to develop the extensive market conventions, workflow and technological changes referenced above for listed derivatives, rendering them unable to comply.

iii. Obliging Trade Repositories to offer services for all products referencing an asset class could limit the number of service providers, in particular for exchange-traded derivatives, where Exchanges and CCPs may be unwilling to want to develop solutions for OTC derivatives not traded or settled across their platforms.

We would recommend that ESMA expand the definition of “derivative type” in Article 6 of the Annex VI ITS to include reference to both the product type *and* the underlying asset class. Additionally, the RTS for the registration of Trade Repositories should be expanded to include a requirement for Trade Repositories to include in their application for registration the specific product type(s) for which they are applying to provide services.

We also believe the information to be provided should be reconsidered, particularly from a listed derivative perspective. It would be valuable to indicate which information needs to be provided for either category of derivatives or for both.

We welcome ESMA’s decision to link the commencement of the reporting obligation to the registration of a relevant Trade Repository (TR). An important consequence of this is that the act of registration will set the deadline for all impacted counterparties to commence reporting simultaneously. To that end, it is vital that at the point of registration, TRs can evidence that they are capable of onboarding a huge volume of counterparties within a relatively short space of time, and supporting all necessary trade reporting. We believe that a period longer than 60 days may be necessary to enable compliance by all market participants. In the proposed rules, once a TR is registered for a “particular derivative type”, the reporting obligation commences after 60 days. To that end, to avoid the risk of counterparties being unable to report in full compliance with EMIR within 60 days of a TR being registered, we would suggest TR registration applications should include the following:

- Detailed reporting user manuals, which should, as a minimum, contain field level guidance of exactly how data is to be reported in all lifecycle scenarios for all the asset classes/products for which the TR is registering to provide services. This should reduce the potential for any “interpretative” issues industry participants may have, including where additional clarification is required up front from regulators, and ensure any technical questions on how to report are addressed *before* the 60 day count down to compliance commences.

- Confirmation of the specific methods by which TRs will allow market participants to submit reports, and that these methods will accommodate the needs of all market participants, including the use of open source and market standard formats. This will ensure open access for all market participants.

- Confirmation that reporting portals and all workflow scenarios have been fully tested, signed off and released into production environments prior to registration.

- An estimate of the anticipated messaging volume and number of counterparties to be supported, and confirmation that the TR has been tested to support these volumes.

- Final TR commercial user agreements, onboarding documentation and any other contractual terms, validated as enforceable in all Legal jurisdictions in which the TR must provide services to enable EMIR compliance by all counterparties with a reporting obligation.

- Documentation of the onboarding and testing process for new counterparties to submit reports, including total onboarding lead times (which necessarily must be significantly less than the 60 day lead time).
- Commitment that sufficient resources will be available to enable all market participants to test and commence reporting simultaneously within the 60 day window.

Finally, further guidance is required with regard to reporting obligations for third country entities entering into a derivative contract with a Financial Counterparty or Non Financial Counterparty established in the EU or whether a non-EU entity may be subject to the reporting obligation in EMIR because it enters into a derivative contract with ‘a substantial and foreseeable effect within the EU’.

Cost considerations

We applaud the attention ESMA is giving to the cost impact of the different reporting requirements and appreciate all efforts to lower the cost of implementation where possible without compromising the quality of the data or impacting the regulatory objectives. Several of the detailed comments further in our response will in fact increase the data quality while lowering the impact and cost of implementing.

In order to provide a cost estimate we surveyed members on the cost impact of the ESMA reporting requirements. Given the short time period for response it was not possible to provide more detailed cost figures. We are certainly willing to further work with ESMA on assessments of cost and impact following the consultation period and provide more detail were required.

The average expected cost of implementation per firm with the ESMA standards very much in line with requirements in other jurisdictions (scenario 1 as explained below) is 21 Full Time Equivalents (FTE). This cost can more than triple to an average 65 FTE per firm if optimization of the current infrastructure is not pursued.

The starting point for the exercise is the cost of the implementation of the CFTC Dodd-Frank reporting requirements which are furthest along in the implementation cycle. We asked firms to give an estimate for the cost of implementing the ESMA reporting requirements under two scenarios. The first scenario would be for the ESMA reporting requirements to be aligned as much as possible with the current infrastructure built for the Dodd-Frank reporting, which is in line with our comments on the reporting requirements expressed in this response. The second scenario would be the opposite; the final requirements limit the reusability of the infrastructure built to date. Both scenarios should be seen within the context of and the boundaries of the current consultation paper.

The cost exercise excludes the work required to build an exposure repository. We also want to point out that the ESMA requirement to report listed derivatives is an important scope difference from the CFTC reporting requirements, which is included in the estimates.

Separately there is a cost estimate in the paper in annex on the proposal for the representation of complex and bespoke products ("Generic Product Representation").

Data on Exposures

We continue to support the idea of reporting collateral/exposures, however believes this should be done via a single "Counterparty Exposure Repository". A purpose-designed Counterparty Exposure Repository would be the optimum solution to provide an aggregated risk view for regulators, which could be created to contain the net mark-to-market exposure for each counterparty portfolio and the corresponding collateral.

EMIR/MIFID

We welcome ESMA's efforts towards the objective of a common reporting mechanism under EMIR and the draft MiFID proposals in relation to reporting to Approved Reporting Mechanisms ("ARM") to avoid duplication and reduce the reporting burden for firms. However, we suggest that the reporting obligation under MiFID should be considered satisfied irrespective of whether the Trade Repository is also an ARM.

Identifiers

We strongly support the LEI process under the auspices of the FSB (though we note that in relation to 'beneficiaries' the LEI may not capture the entity of interest). With reporting potentially starting in July 2013, there is the possibility that an LEI solution will not yet be fully functioning. As a fall back we strongly recommend ESMA to use and leverage the Interim Identifier as specified by the CFTC (CICI). The CICI will only be used for a limited period of time, until the global LEI is ready for usage, and easy transition to the LEI is one of the requirements for the CICI. Given that (i) the interim identifiers will only be used for a limited period of time, (ii) the CICI is furthest along as an alternative and (iii) with a likely start date of CFTC reporting in October 2012, the investments will already have been made by the time the ESMA technical standards will be approved, creating another interim and temporary identifier with different specifications has no added value and will impose unnecessary costs on the industry in terms of investments and attention diverted from other projects.

We would also observe that data privacy issues could arise in relation to the cross-border flow of information concerning beneficiaries.

Other clarifications

Paragraph 252 states: The table is divided in two sub-sets: (i) section 1 – counterparty data (to be reported separately by each counterparty or their appointed reporting entity; and (ii) Section 2 – common data (may be reported by only one counterparty, if reporting also on behalf of the other, or an appointed reporting entity).

We believe that the RTS should provide maximum clarity about where the precise reporting obligation resides. Where the data allows for it, we strongly prefer the ability for one counterparty to be able to report both the counterparty data and common data for a particular trade, which is in line with the reporting flows adopted in other jurisdictions. We recommend changing the language between () for section 1 – counterparty data to "may be reported by only one counterparty, if reporting also on behalf of the other, or an appointed reporting entity"

In addition, there is currently no way to link a record for table 1 data with table 2 common data. As common identifier we suggest the use of the UTI. Further work needs to be done to detail the flows to allow the exchange of this common identifier between the parties to the trade.

If both sides of the trade report, they will need to use the same UTI, which will present challenges in being able to report by the following day, if the UTI cannot be exchanged in advance of the timeframe. This is particularly the case for non electronically confirmed trades where the paper confirmation will be used to share the UTI between trading counterparties, (which is the process for USI sharing between counterparties agreed to meet the CFTC)

Reporting of allocated trades: We seek clarification from ESMA that trades should be reported after the allocation took place; not pre-allocation.

<u>Annex V: draft RTS on Trade Repositories (page 137)</u>

(3) A requirement for data reported to a TR to be agreed between two parties means a confirmation and or matching process needs to take place before trade submission. Is this the intention? While a common UTI will be helpful in reconciling data, the reconciliation will take time, in particular if two parties submit to different trade repositories. A defined hierarchy of who submits, and definition of rules to ensure two parties submit to the same TR when submitting trade data independently, would be welcomed.

In particular guidance on reporting responsibilities, consistent with guidance in other jurisdictions, would be welcomed in the below cases:

- Prime Brokerage give ups (Prime Broker versus Executing Broker versus Client)
- Novations of bi-lateral trades (Remaining Party versus Transferor versus Transferee)
- The reporting role of the Clearing Broker in cleared trades.

It would be helpful for ESMA to clarify the requirement to report new, amends and cancels. We propose that dealers send a single trade update daily on open trades reflecting all amendments on a trade for that date, e.g. if there are 3 partial unwinds on a trade during the day, an end of day position is sent that represents the sum of all the unwinds.

Article 2 – Definitions

We recommend the inclusion of a definition for Hybrid Derivatives.

(1) We note that the dealer's ability to accurately report beneficiaries is reliant on data supplied by the dealer's client. In addition the definition of beneficiary should be considered and expanded for use cases outside of those described in paragraph 260.

(3) "execution timestamp": For non electronically executed trades (voice) it is hard to capture the moment the parties agree to the primary economic terms. Moreover, the value derived by moving the industry to UTC appears minimal when compared to the costs involved.

(4) "confirmation": we suggest removing "any relevant master agreement" from the definition. We also suggest a more prescriptive definition to accommodate negatively affirmed trades. In a negatively affirmed trade a transaction is assumed good unless the counterparty notifies the derivatives provider within a certain timeframe.

Article 3 – Details to be reported

As mentioned earlier, we prefer to allow one party to the trade to submit all the trade details, including counterparty information. In the current proposal there is no link between the counterparty information and the trade information so in practice it will prove difficult to reconcile the counterparty information submitted by party A with the trade information from party A, submitted by party B. We note as well that in case reporting starts without the availability of Universal Identifiers such as UTI, it will be very difficult to reconcile information on the same trade submitted to different TRs.

Life cycle events and modifications are not captured and the reporting requirements for these events should be specified. We note that this could be accomplished either through end of day snapshot or individual event reporting. Firms should be allowed to use either as defined by the TR.

Any lifecycle events to be reported on a trade should be reported to the same TR as the original trade.

The impact of a novation of a trade e.g. in the case of clearing, on the trade identifier should be considered and be made consistent with the impact in other jurisdictions.

Guidance is sought as well when a trade has been modified prior to initial reporting to the trade repository. Are two separate records required or just one with the final iteration of the trade?

Article 4 – reporting by a third entity

While we acknowledge the need to ensure the quality of the data in the repositories, the ultimate responsibility for accurate data submission should stay with the reporting parties and suspension of third parties should happen in coordination with reporting parties in order to allow them to continue to fulfill their reporting obligations.

(1) We believe that a requirement that a third entity be able to "guarantee" protection of data and compliance may be an unrealistic burden to impose on a third party commercial entity.

(2) Where a competent authority deems a third entity to be "unfit" the counterparty using that entity must be given an appropriate amount of time to make alternative arrangements.

(4) ESMA should detail what the timeframes are for replacement if ESMA prohibits further submission by third parties. Parties most impacted by this are smaller counterparties and buy side users with reporting requirements as they are most likely to rely on such third party services.

Article 5 – cleared trades

The article should detail whether porting or transferring a position in a CCP to another member is a new trade or a modification.

Clearing member house positions can be reported by the CCPs or exchanges. We would welcome clarification around client cleared trades given that these are two separate trades.

With respect to carry brokers (and generally indirect clients) it would be helpful if ESMA would confirm that a clearing member should not be obligated to report to the Trade Repository transactions between direct client and its client (indirect clients of clearing member).

Article 6 - reporting of collateral

Please see our earlier comments as to the requirements of EMIR Article 9(1) and the scope of ESMA's mandate. The Technical Standards (Article 6.1) suggest "all collateral exchanged" should be reported. The apparently very broad nature of this obligation has raised a series of questions which we would welcome the opportunity to discuss further with ESMA.

1. Trade reporting is required on inception of the trade, but at the point of reporting the trade the collateral may not have been determined let alone exchanged. Should the trade be reported *without* the collateral information or held back until the collateral information is available? If a trade is reported without collateral details how should the collateral details be communicated, once available?

2. The required collateral will be in two parts: (a) Initial Margin (cash or non cash) and (b) Variation Margin (mainly cash but can be non cash) the value of the Variation Margin will change daily or even more frequent. Should these values be distinguished in the reporting? If so, how should this be done?

3. How should the distinction be made between collateral given and collateral received on the same trade? e.g. A party pays Initial Margin and receives Variation Margin on the same trade?

4. Is it necessary to report each time that the type of collateral changes? (Field #29)

5. Is it necessary to report each time the value of collateral posted changes? (Field #31)

6. Is it necessary to report each time there is a collateral substitution? (Field #29, #32 may change)

7. Is it necessary to report each line of collateral exchanged?

8. If collateral is transferred in a TriParty environment where the pool of collateral changes multiple times a day (over 10 times), do we report at the end of day or after each collateral substitution?

9. Do we have to re-report the original transaction each time there is collateral change to report?

10. What are the reporting responsibilities of a collateral agent if engaged? A collateral agent does not necessarily have the details of the underlying trade.

<u>Article 7 – Reporting log</u>

We fully support the need for an audit trail of all modifications made to the data in the TR (we understand this to be separate from reporting of any lifecycle or continuation events on trades). We believe that this audit function is the responsibility of the TRs and should be left to the different SDRs to specify. By being too prescriptive in this area ESMA risks requiring costly changes to existing infrastructure with no added value.

<u>Article 9 – Entry into force</u>

Sufficient time will need to be given to market participants to comply with these rules and to make appropriate changes to systems. The date of application will need to be much later than the date of entry into force that is envisaged (20 days after publication). 20 days is insufficient for compliance.

<u>Annex VI: Draft ITS on Trade Repositories (page 167)</u>

<u>Article 3 – Identification of counterparties and other entities</u>

The hierarchy proposed by ESMA is the following: (1) use a LEI. (2) If no LEI is available use an interim entity identifier which is compatible with the FSB recommendations. (3) If no LEI and no interim identifier is available, use BIC codes where available.

We note that the final fall back – the use of BIC codes is not possible in all instances as not all entities necessarily have a BIC. We propose to provide the following option under (3): if no LEI and no interim identifier are available, use alternative identifiers such as BIC codes or Trade Repository IDs where available. This allows for maximum flexibility at the fall back level while being consistent with other jurisdictions.

More importantly, we propose to support the development of an interim identifier to bridge the gap with the LEI implementation as necessary, as described in the identifier section above.

<u>Article 6 – reporting start date</u>

Please clarify whether trades entered into on or after the date of entry into force of EMIR which are expired or terminate before the reporting start date should be reported to the TR. We note that certain data fields specified as required in the final technical standards, might not be readily available for the historical trades. Completing trade records with this data at the time of back loading will be operationally onerous and costly and might not be possible in all cases. The value of the additional data should be considered carefully against the cost.

Please clarify whether trades entered into before the date of entry into force of EMIR and outstanding on the date of entry into force of EMIR but expired or terminated before the reporting requirement need to be reported. For these pre EMIR trades certain data required to be reported might not be available in a standardized way. We recommend allowing a minimum set of data fields to be reported for these trades.

Additional comments on fields in the table:

Table 1: Counterparty Data

Table 2: Common Data

- 4 – Currency: Currency derivatives may have more than one currency applicable. We recommend allowing for both notional currency and deliverable currency.
- 3 – Underlying: It could potentially be challenging for Trade Repositories to identify the composition of basket underlyings. To facilitate this identification process, further

prescription is requested for this field and we support the use of the underlying structures as defined in FpML for these purposes.

- 9 – Price Multiplier / 10 – Quantity

  This should not apply to OTC derivatives, only to futures & options.

- 15 and 16 – "Directly linked to commercial activity or treasury financing" and "clearing threshold"

  We question the utility and practicality of requiring this information to be submitted in respect of each individual trade. We would refer to the section of our response on Non-Financial Counterparties (Chapter VII) for a further discussion on this point. If ESMA does require reporting of this data field, this information would need to be provided by the Non Financial Counterparty. As a practical matter a Non-Financial Counterparty may not know this when it submits information on a particular trade (especially as currently drafted exceeding a clearing threshold in one class of OTC derivatives on a consolidated basis means they are subject to the clearing obligation across all classes of OTC derivatives) and it is not clear whether this would be regarded as reportable as being over the clearing threshold on day 1 of breaching a threshold, or whether a Non-Financial Counterparty would need to have been over the threshold for 30 days for this to apply. Not only would this data field represent stale and unreliable data, it would impose a practically unworkable administrative and monitoring burden on Non-Financial Counterparties. As mentioned in the section of our response on Non-Financial Counterparties (Chapter VII), counterparties are not necessarily well placed to measure the accuracy of the information provided. The regulators, in retrospect, will be the only parties that have access to the full information to determine the accuracy of this information.

- 17 - Settlement date

  Please specify whether For Credit and Interest Rate OTC derivatives, this requires reporting the settlement date of the upfront fee.

- 18 - Master Agreement type and 19 - Master Agreement Date

  We question the value of requiring Master Agreement Type and Date. Requiring this data adds cost to the reporting requirements with no clear benefits.

- 24 - Clearing timestamp

  The CCP is the primary record for this field. Therefore, reporting of this field should be done by the CCP.

- 32/33 - Currency of collateral amount - Other currency of collateral amount

  We strongly recommend using ISO currency codes and allowing all currencies in the same field.

- 34 – Mark to market value of contract

  We request further guidance on the information that needs to accompany the Mark to Market value on an ongoing basis through the life of the trade.

- 43-45 Floating rate to floating rate/Fixed rate to fixed rate/Fixed rate to floating rate

We believe that this should be a text and not just a numerical field, e.g. EURIBOR vs. LIBOR would be the usual reference rather than numerical value. We welcome further guidance from ESMA regarding the content expected in these fields.

- 63 -64 Action type and Details of action type
  We suggest for ESMA to engage with the industry to further define the information required and the processes to follow for modifications.

V.I Reporting obligation (Annex VI)

Reporting of collateral (Article 6)

The Signatory Associations continue to support the idea of a single "Counterparty Exposure Repository" to provide an aggregated risk view for regulators, which could be created to contain the net mark-to-market exposure for each counterparty portfolio and the corresponding collateral. The text in the CP acknowledges that there may be a requirement to report on a portfolio basis, however does not carry reference to a Counterparty Exposure Repository but instead states that this data would be captured into a trade repository. All trade repositories to date are structured to receive data not on a portfolio basis but at a trade level. There are also portfolio level effects such as Thresholds, Minimum Transfer Amounts, Rounding and Initial Margin that cannot be translated to a trade level view. Reporting portfolio level data such as collateral held on a trade level would be impossible to accomplish in practice and if attempted would produce results that are meaningless from a risk and commercial perspective. The key aim of a Counterparty Exposure Repository should be to gauge the impact of relationship level risk and risk mitigation measures on systemic risk. We strongly recommend that population of trade level data into a trade repository be limited to field 27 of the collateral data attributes outlined in Section 2e of Table 2 on page 144 of the CP, with all other fields being populated in a Counterparty Exposure Repository.

At the request of ESMA, we submitted a high level indicative roadmap for compliance with ESMA's proposal around the reporting of collateral on 18th July 2012.

The following caveats should be considered when reviewing the roadmap:

- The below is based upon a favourable understanding by the industry around the attributes listed in Section 2e of Table 2, on page 144 of the CP. Should the final rule not correspond, further consideration will be required and the roadmap revised accordingly.
- The industry will require a period of at least 6 months following the publication of the final rules detailing the required attributes to be reported.
- As previously noted, we support the creation of a "Counterparty Exposure Repository" which would contain the net mark-to-market exposure for each counterparty portfolio and the corresponding collateral. We strongly believe that this is essential to the success of this reporting, because collateralization is performed at the counterparty portfolio level and not at the trade level. There are portfolio level effects such as Thresholds, Minimum Transfer Amounts, Rounding and Initial Margin that cannot be translated to a trade level view. Therefore we believe that reporting counterparty exposure information to a Global Trade Repository on a transaction or swap level will be impossible to accomplish in practice and if attempted would produce results that are meaningless from a risk and commercial perspective.
- Given the short timeframe, the roadmap has not yet been discussed with all parties. Further discussion with solution providers, buy side firms and other market participants may require revisions to the roadmap.

	Trade & Positions	Collateral with "Phase "1 Financial Counterparties (FC) (*)	Collateral with FCs not included in phase 1 & Non-Financial Counterparties (NFCs)
"Phase 1" Financial Counterparties (FC)	July 2013	December 2013	From Q4 2014 & Phased
FCs not included in phase 1 & Non-Financial Counterparties (NFCs)	Phased to Q4 2014	Phased to Q4 2014	Phased to Q2/Q3 2015

(*) "Phase 1" Financial Counterparties (FC): Not all FCs should comply with the earlier milestones. The definition of appropriate criteria, applicable internationally, to determine which Financial Counterparties should comply with the earlier milestones needs further discussion within the industry and with regulators.

Our view is that the Counterparty Exposure Repository should be a purpose-designed counterparty portfolio level, data repository. The operation of which is distinct from the operation of the global trade repository currently in production. It is essential that there is only one single global counterparty exposure repository, as counterparty risk is only meaningful if it captures all exposures under a specific relationship. Fragmentation would make the concept unworkable and the data useless in practice. We draw attention to the FSB repo work that is currently being undertaken under the chairmanship of the UK FSA, and while recognising that a global repository for repo, securities lending and collateral upgrades may be better placed to provide an overview of the exchange of collateral between parties we would need to investigate further to ensure suitability.

Proposed amendments to **Article 6**

~~***2. In the event***~~***Where*** counterparties exchange collateral on a portfolio basis and it is not possible to report collateral exchanged for an individual contract, counterparties may report to a ~~***trade***~~ ***counterparty exposure*** repository collateral exchanged on a portfolio basis, in which case the ***data required under Table 2, Section 2e – Exposure – Portfolio Level, of the Annex*** ~~***following information***~~ shall be reported. ~~***for all the collateral exchanged:***~~

~~***a. collateral type;***~~

~~***b. collateral amount;***~~

c. ~~***currency of collateral amount.***~~

3. The counterparties shall report to the ***counterparty exposure*** ~~***trade***~~ repository the specific contracts over which collateral has been exchanged.

Table 2 – Common Data

Section 2e – Exposure – *Trade Level*

27	Collateralisation	Whether exchange of collateral occurred to cover the contract in accordance with Article 11 of Regulation No (EU) No xx/2012 [EMIR].
~~***28***~~	~~***Collateral basis***~~	~~***Whether the exchange of collateral occurred on a portfolio basis.***~~

Section 2e – Exposure – *Portfolio Level*

29	Collateral type	Type of collateral that is posted to/by a counterparty.
30	Other collateral type	Any other type of collateral that is posted by a counterparty
31	Collateral amount	Amount of collateral that is posted by a counterparty
32	Currency of collateral	Currency of the amount of collateral that is posted by a counterparty
33	Other currency of Collateral amount	Other currency of the amount of collateral that is posted by a counterparty
34	Mark to market value of contract	Revaluation of the contract, specifying the difference between the closing price on the previous day against the current market price.
35	Mark to market	Date of the last mark to market valuation.

	date of contract	
36	Master netting agreement	Type of master agreement in place covering netting arrangements, if different from the master agreement identified in field 18

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