

15/07/15

ISDA/FIA Europe/IA Joint Response to the ESMA Clearing Obligation no.4 (IRS for EEA currencies)

INTRODUCTION

The International Swaps and Derivatives Association ("**ISDA**"), FIA Europe and the Investment Association ("**IA**") welcome this opportunity to respond to the consultation paper on the draft regulatory technical standards ("**RTS**") establishing a clearing obligation on certain interest rate OTC derivative classes denominated in certain non-G4 European currencies ("**EEA currencies**").

We strongly support the overarching goal of reducing systemic risk in the OTC derivatives market by introducing an obligation to clear certain classes of OTC derivatives in central counterparties ("**CCPs**") that have been authorised or recognised in accordance with the requirements of Regulation (EU) No 648/2012 ("**EMIR**"). However, we believe that it is inappropriate, at the current time, to impose an obligation for the classes of derivatives proposed in the RTS.

We hope that our comments in this response and follow-up discussions will assist ESMA with the preparation of the form of RTS which will be submitted to the European Commission (the "**Commission**"). This response is intended to continue the constructive ongoing dialogue between ESMA and derivatives market participants and to focus on the practical concerns and risks surrounding the implementation of the clearing obligation. In particular, we would like to highlight the following critical issues:

A. Suitability of the EEA Rates classes for clearing

1. We believe the EEA Rates classes proposed for mandatory clearing do not appropriately address systemic risk, and should not be subject to a mandatory clearing obligation. We consider that there is insufficient liquidity in the EEA Rates classes, and as such a clearing member default in one of the EEA currencies could significantly impact liquidity and financial stability.
2. If, contrary to the above, ESMA determines that a clearing obligation should be imposed for the EEA Rates classes, we would encourage ESMA ensures that the obligation be extended to include fixed-to-float swaps out to 10 years in maturity and forward rate agreements out to two years in maturity. The maturity thresholds as currently stated are arbitrary and could lead to fragmented liquidity and dislocations in the rates curve.

B. Counterparty categorisation

3. The determination of Category 1 counterparties for the purposes of the EMIR clearing obligation should be undertaken on an asset class basis, and not on a per RTS basis as currently suggested by ESMA for the introduction of the EEA Rates Clearing Obligation.
4. We support ESMA's proposal that counterparties that have determined they belong to Category 2 or 3 in respect of the regulatory technical standards governing OTC interest rate derivatives classes denominated in the G4 currencies should also belong to the same respective categories for the purposes of the EEA Rates RTS.

15/07/15

C. Identification of contracts subject to the clearing obligation

5. To prevent decisions of CCPs to cease clearing a particular contract from dictating whether that contract is tradable, the application of the clearing obligation to a particular contract should be conditional not only on the contract being of a type that would have been accepted for clearing by a CCP at the time of its authorisation, but also on the contract being of a type which will be accepted for clearing by an authorised or recognised CCP as at the later of (i) the date of trading and (ii) the date on which the contract is required to be cleared under EMIR.

D. Phase-in periods

6. We believe that ESMA's proposal to lengthen the phase-in periods by three months in the event that the EEA Rates RTS is published in the EU Official Journal less than three months after the G4 Rates RTS is published, will create an additional layer of complexity operationally, and in terms of communication between market participants including end user clients. We would accordingly recommend that the proposal to grant an extra three month period should be removed from the EEA Rates RTS.

E. Frontloading

7. We have significant concerns around OTC derivatives traded during the frontloading window (FL) and cleared at CCPs that have not yet been authorised or recognised by the time the clearing obligation enters into effect. If the relevant ESMA recognition decisions for non-EU CCPs (in particular US derivatives clearing organisations) where classes proposed in the EEA Rates RTS are cleared are not in place before the start of the relevant FL period, this will increase costs for end users and fragment the European derivatives markets.

QUESTION 1: DO YOU HAVE ANY COMMENT ON THE CLEARING OBLIGATION PROCEDURE DESCRIBED IN THIS SECTION?

A. Counterparty categorisation should be assessed on an asset class basis - categorisation for the EEA Rates classes should be harmonised with the G4 Rates classes

We fully support ESMA's proposal that counterparties that have determined they belong to Category 2 or 3 in respect of the regulatory technical standards governing derivatives classes denominated in the G4 currencies (the "**G4 Rates RTS**") should also belong to the same respective categories for the purposes of the EEA Rates RTS. We believe such an approach should be harmonised across all RTSs including the draft Credit Derivatives RTS and all future RTSs.

However, we also believe that Category 1 counterparties should be assessed on an asset class basis and not on a per RTS basis as currently suggested by ESMA for the introduction of the EEA Rates Clearing Obligation. A per asset class classification means that a counterparty could be a Category 1 counterparty for one asset class but a Category 2, 3 or 4 counterparty for another class. However, if a counterparty is deemed Category 1 for a given asset class, it should retain that designation for all future RTSs for that given asset class. Therefore, we assert that counterparties that have determined they belong to Category 1 in respect of the G4 Rates RTS, should also be classed as Category 1 for the purposes of the EEA Rates RTS. While we understand that some G4 Rates clearing members may not have clearing arrangements in place for EEA currencies, establishing such clearing arrangements

15/07/15

as a clearing member, or as a client of clearing member, for such classes is less onerous than establishing arrangements for a different asset entirely. Allowing Category 1 members to fluctuate between categories within a given asset class adds an additional layer of complexity and operational burden for market participants who will be required to validate counterparty classifications multiple times.

We believe there are two main alternatives to achieving such an outcome:

1. **Option 1:** The EEA Rates RTS is adopted as a standalone RTS.
2. **Option 2:** The EEA Rates RTS is adopted as an RTS amending the G4 Rates RTS by:
 - a. Amending Annex I to include the EEA Rates classes; or
 - b. Adding a separate annex (Annex II), specific to the EEA Rates classes

The undersigned associations support ESMA's proposed approach to follow Option 1.

Option 1: The EEA Rates RTS would be adopted as a standalone RTS and the currently proposed draft RTS would need to be amended in the following way:

- Article 2(1) of the RTS should be amended so that the classification test of a Category 1 counterparty in respect of EEA Rates classes would be whether the counterparty is a clearing member on the date of entry into force of the EEA Rates RTS for at least one of the types of OTC derivatives listed in Annex I, of at least one of the CCPs authorised before that date to clear at least one of the types of OTC derivatives listed in Annex I, and/or was a clearing member on the date of entry into force of the G4 Rates RTS for at least one of the types of OTC derivatives listed in the G4 Rates RTS Annex I, of at least one of the CCPs authorised before that date to clear at least one of the types of OTC derivatives listed in the G4 Rates RTS Annex I.

While we feel this is the most effective way to adopt this definition of Category 1 given the various states of the other clearing obligation proposals underway, we ask that ESMA minimise to the greatest extent possible any variations between each RTS with respect to common components of the clearing obligation implementation such as Counterparty Category definitions and recital clarifications in order to provide market participants with the required legal certainty and implementation consistency.

Option 2a: The EEA Rates Clearing Obligation could be introduced through amendments made to the G4 Rates RTS and its existing annex. This could be achieved in the following ways:

- Split Annex I into parts A and B, so that part A encompasses the G4 Rates classes, and part B comprises the EEA Rates classes.
- The test of classification of a Category 1 counterparty in respect of a specific EEA Rates asset class would be whether a counterparty is a clearing member on the date the G4 Rates RTS enters into force for at least one of the types of OTC derivatives listed in part A of Annex I, of at least one of the CCPs authorised before that date to clear at least one of the types of OTC derivatives listed in part A of Annex I, or a clearing member on the date the EEA Rates RTS enters into force for at least one of the types of OTC derivatives listed in part B of Annex I, of

15/07/15

at least one of the CCPs authorised before that date to clear at least one of the types of OTC derivatives listed in part B of Annex I.

- The phase-in periods listed in Article 3 of the G4 Rates RTS should be separately stated for part A and part B of the Annex and by reference to the date part A and part B of the Annex come into force.
- The minimum remaining maturity periods listed in Article 4 of the G4 Rates RTS should be separately stated for part A and part B of the Annex and by reference to the date part A and part B of the Annex come into force.

The benefit of the approach described above is that it facilitates an amendment process whilst at the same time creates certainty as to how future clearing obligations will be brought into effect for Rates derivatives (particularly in respect of counterparty classification, phase-in periods and the application of the frontloading requirement). It also ensures that derivatives within an asset class are treated consistently (i.e. a clearing member for basis swaps will be treated as a Category 1 counterparty for all interest rate products subject to the clearing obligation) whilst allowing for differentiation of counterparties between asset classes (i.e. it does not treat a counterparty as a Category 1 counterparty for all asset classes just because it is a clearing member for one asset class).

We would also note that by drafting the first RTS in a way that envisages subsequent amendments, ESMA is not precluded from developing standalone RTS in the future if it determines that this is necessary for a particular asset class.

Option 2b: Similarly to Option 2a, ESMA can introduce the EEA Rates Clearing Obligation through amendments made to the G4 Rates RTS and the addition of multiple annexes. This could be achieved in the following ways:

- The in-scope EEA Rates classes would be listed in a separate Annex.
- The test of classification of a Category 1 counterparty in respect of a specific EEA Rates asset class would be whether a counterparty is a clearing member on the date the relevant Annex comes into force for at least one of the types of OTC derivatives listed in the relevant Annex, of at least one of the CCPs authorised before that date to clear at least one of the types of OTC derivatives listed in the relevant Annex, or was a clearing member on the date an existing Annex comprising classes of derivatives in the same asset class as the relevant Annex came into force for at least one of the types of OTC derivatives listed in the existing Annex, of at least one of the CCPs authorised before that date to clear at least one of the types of OTC derivatives listed in the existing Annex.
- The phase-in periods listed in Article 3 of the RTS should be separately stated for each Annex and by reference to the date each Annex comes into force.
- The minimum remaining maturity periods listed in Article 4 of the RTS should be separately stated for each Annex and by reference to the date each Annex comes into force.

B. ESMA should continue its work in developing a register of clearing members to assist market participants with their determination of which clients and counterparties are Category 1 counterparties for a particular asset class

We encourage ESMA to continue its work toward establishing a register of clearing members (which includes their LEIs and date on which they became clearing members for a given class) for all authorised and recognised CCPs, which would assist market participants when establishing whether a particular counterparty is a Category 1 counterparty for a given asset class. However,

15/07/15

we believe that ESMA's approach to allowing counterparties be classed as Category 1 counterparties by RTS rather than by asset class will make the maintenance of such a register more onerous, as ESMA will have to maintain multiple registers per asset class, instead of a single register per asset class.

QUESTION 2: DO YOU HAVE ANY COMMENT ON THE STRUCTURE OF THE INTEREST RATE DERIVATIVE CLASSES DESCRIBED IN THIS SECTION?

Mitigation of situations in which parties may be prevented from trading

The structure of the interest rate derivative classes described echoes the approach from previous technical standards on Interest Rate Derivatives, and we continue to support this structure in principle, in the spirit of consistency across asset classes. However, we have significant concerns that the proposed structure could create situations where certain derivatives are rendered untradeable on both a cleared and uncleared basis, solely on the decision of authorised CCPs to cease clearing the products (otherwise referred to as 'deadzone risk').

Under the proposed structure, a situation in which a CCP may choose to stop clearing certain contracts following its authorisation – which does not in itself remove the clearing obligation even if no other CCP clears those contracts – is not contemplated. Firms would then be left with a situation where a contract contains the specified characteristics and was clearable at the time of authorisation but where no authorised or recognised CCP is willing to clear that contract. Article 5(6) of EMIR does not cover this situation – it only works to remove the clearing obligation where no CCPs are authorised or recognised to clear a particular class of contracts. It does not apply where a CCP continues to be authorised to clear the class of contracts but, in practice, ceases to do so.

We note that this issue is complicated further if a CCP removes a clearing service during the frontloading period, and it is unclear how the firm and the client would be able to remediate this situation while remaining in compliance with the RTS, other than by terminating the contract. We would be surprised if this was ESMA's intention – as again it would amount to a retrospective ban on the trading of a particular contract (again contrary to ESMA's intention, as set out in paragraph 26 of the G4 Rates Final Report).

In order to prevent decisions of CCPs to cease clearing a particular contract from dictating whether that contract is tradable, the application of the clearing obligation to a particular contract should be conditional not only on the contract being of a type that would have been accepted for clearing by a CCP at the time of its authorisation, but also on the contract being of a type which will be accepted for clearing by an authorised or recognised CCP as at the later of (i) the date of trading and (ii) the date on which the contract is required to be cleared under EMIR. We again reiterate that this RTS modification would not result in a change in the outcome of what the policy has suggested should be subject to the clearing obligation, rather it provides a necessary clarification to the legal certainty of that policy.

QUESTION 3: DO YOU AGREE WITH THE PRINCIPLE THAT, IN THE CONTEXT OF THE CLEARING OBLIGATION, SYSTEMIC RISK SHOULD BE CONSIDERED NOT ONLY AT THE AGGREGATED EU LEVEL, BUT ALSO AT COUNTRY OR EVEN INSTITUTION LEVEL?

15/07/15

Systemic risk can be defined as "a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy". The undersigned associations agree with this definition, and while in principle, we also agree that systemic risks should be considered not only at an aggregated EU level, but also at country and institution level, we believe that systemic risk resulting from an institution level should be addressed by measures imposed directly at the institution level, for example, through greater supervisory scrutiny, enhanced prudential requirements and effective recovery and resolution planning. The imposition of a clearing obligation is too blunt a tool to use to target systemic risk at an institution level (where large institutions already clear on a voluntarily basis) as it also ensnares much smaller, non-systemically risky counterparties.

We also firmly believe that systemic risk at an aggregate level is of higher importance and should take higher priority. It is also important to note that while the clearing obligation is designed to reduce systemic risk, in many cases trying to solve for a reduction at risk at a country or institution level by imposing a clearing obligation may increase systemic risk at an aggregate level. Systemic risk is propagated through either (i) the interconnectedness of balance sheets among market participants, or (ii) direct common exposures among market participants. Imposing a clearing obligation on a set of classes concentrated in a member state and traded amongst a small set of counterparties, which are not suitable for clearing, would immediately lead to an increase in direct common exposure for all counterparties clearing at the CCP. It is therefore crucial that the process for ensuring that the clearing obligation reduce systemic risk take into account the fact that not all CCP-cleared OTC derivative contracts can be considered suitable for mandatory CCP clearing, as per Recital 15 of EMIR.

QUESTION 4: IN VIEW OF THE CRITERIA SET IN ARTICLE 5(4) OF EMIR, DO YOU CONSIDER THAT THIS SET OF CLASSES ADDRESSES APPROPRIATELY THE SYSTEMIC RISK ASSOCIATED TO INTEREST RATE OTC DERIVATIVES? PLEASE INCLUDE RELEVANT DATA OR INFORMATION WHERE APPLICABLE.

No. While the undersigned associations strongly support the overarching goal of reducing systemic risk in the OTC derivatives market by introducing an obligation to clear certain classes of OTC derivatives, we believe the classes of interest rate derivatives proposed for mandatory clearing in the EEA Rates RTS do not appropriately address systemic risk, and we believe the classes should not be subject to a mandatory clearing obligation. We believe that there is insufficient liquidity in the EEA Rates classes, and as such a clearing member default in one of the EEA currencies could significantly impact liquidity and financial stability. If ESMA, however, decides to proceed with a mandatory obligation for the classes identified, we believe that the obligation should be extended to include fixed-to-float swaps out to 10 years in maturity and forward rate agreements out to two years in maturity. The maturity thresholds as currently stated are arbitrary and could lead to fragmented liquidity and dislocations in the rates curve. We believe that, within each EEA currency, liquidity is comparable, albeit at a low level, across all maturities up to 10 years, and then declines significantly for maturities longer than 10 years, an assessment that is largely supported by the analysis underlying the MiFIR draft RTS described below.

We believe the EEA Rates classes as proposed should not be subject to mandatory clearing for the following reasons:

Liquidity – many of the proposed classes have been identified as illiquid by ESMA in the draft MiFIR RTS 9

15/07/15

We believe that a good proxy definition of liquidity for the purposes of the clearing obligation resides in MiFIR. A liquid market, as per Article 2(17)(a) of MiFIR for a financial instrument or class of financial instruments, is defined as a market where there are ready and willing buyers and sellers on a continuous basis, and where the market is assessed in accordance with the following criteria, taking into consideration the specific market structures of the particular financial instrument or of the particular class of financial instruments:

- the average frequency and size of transactions over a range of market conditions, having regard to the nature and life cycle of products within the class of financial instrument;
- the number and type of market participants, including the ratio of market participants to traded financial instruments in a particular product;
- the average size of spreads, where available;

This definition of liquidity overlaps with the considerations ESMA is required to incorporate in its analysis of the volume and liquidity of classes of OTC derivatives contracts, namely market size and depth and the number and value of transactions. Using the draft MiFIR RTS 9 analysis, and making assumptions around the minimum numbers of trades per day and notional volume per day to qualify a class as liquid, ESMA identified (in the draft MiFIR RTS 9) that the following classes of swap (which have been proposed to be subject to a clearing obligation in the EEA Rates RTS) are illiquid¹:

Forward Rate Agreements

- NOK up to 1Y
- PLN up to 1Y

Fixed to Float Swaps

- CZK up to 10Y
- DKK – 1.5M to 6M
- HUF – up to 10Y
- NOK – 1.5M to 6M
- PLN – 1.5M to 6M
- SEK – 1.5M to 3M & 12Y to 15Y

Although the liquidity thresholds (minimum numbers of trades per day and notional volume per day) that ESMA have utilised in the MiFIR liquidity analysis have been challenged by the industry, we nevertheless believe the comparison of the liquidity analysis undertaken under MiFIR to calibrate the trade transparency requirements to be helpful in understanding the suitability of the EEA currencies for being subject to the EMIR clearing obligation. However for the avoidance of doubt, we maintain that the ultimate liquidity analysis with respect to the MiFIR transparency requirements or derivatives trading obligation should be kept separate and distinct given the range of other considerations necessary for the imposition of trade transparency or a venue trading mandate.

Market dispersion

When determining the volume and liquidity of the relevant classes of OTC derivatives, ESMA is required to take into consideration the likelihood that market dispersion would remain sufficient in the event of the default of a clearing member. We believe that it would be difficult to assert with any

¹ <http://www.esma.europa.eu/content/Consultation-paper-MiFID-II-MiFIR-part-1>

15/07/15

confidence, from the analysis presented, that market dispersion would remain sufficient in the event of a clearing member default.

According to Paragraph 68 of the consultation paper, ESMA states that clearing membership is not specified per currency or product type within the interest rate derivatives classes, and that one approach to estimate market dispersion would be to estimate the number of clearing members per class of OTC derivatives by assuming that a clearing member of a given CCP can be active in all classes cleared by the CCP. We believe such an assumption to be a blunt approach, and in practice a less than meaningful measure of dispersion, as not all clearing members will clear all classes of derivatives, and some classes of swaps may only be cleared by a small number of clearing members. While we noted in our comments with respect to the definition of Category 1 implementation that it would be less onerous for a clearing member to begin clearing other currencies within an asset class, and as such we support a classification of Category 1 counterparties on a per asset class approach rather than on a per RTS based approach, we draw a distinction here in that it would still take some time to set up those additional clearing arrangements and expecting a clearing member to be able to clear an additional currency or currencies within the period of time necessary to cater to market dispersion would not be practical.

While ESMA recognises this limitation by stating that the approach should be a combined analysis of market concentration in the actual trading of the classes in scope by calculating Herfindahl indexes using data reported by clearing members to European trade repositories during March, April and May, 2014, we have a number of concerns with the analysis:

- The data sets used to assess liquidity are too short – three months of data is insufficient and does not take into account changes in trading patterns due to seasonality. Also, using trade repository data from the period shortly after the EMIR reporting requirement came into effect raises concerns about the quality of the dataset given the widely publicised challenges that this reporting requirement presented to the industry.
- The analysis is based on number of transactions, and is not risk-based. Therefore, it is possible that although the market may appear to demonstrate significant dispersion on a trade count basis (which, in some cases, can be useful proxy for risk), risk could be concentrated among a small number of market participants, and it is therefore not possible to assert that dispersion would be sufficient to absorb the risk should one or more of those participants default.
- We agree with ESMA that for both DKK and NOK, given the level of concentration (where one bank has a market share well above that of the other market participants) assessment of whether market dispersion would remain sufficient in the event of a default of that particular bank, which is a clearing member of three European CCPs, deserves some more analysis.
- But we disagree with ESMA's assertion that because there are 33 and 44 other clearing members that reported transactions in DKK and NOK, respectively, that there should be a reasonable number of counterparties able to participate in the auction process in the event of a default. The bank is described as a member of three CCPs, however, the bulk of its positions may be cleared at a single CCP, and thus it is possible only a fraction of those clearing members would be able to participate in the auction process. Consideration must also be given to how many clients such bank is clearing for. Given the bank trades DKK and NOK with around 170 counterparties (out of a total of 243 that trade DKK, and 203 that trade NOK), such bank could clear for a large amount of counterparties, and if it were to default, not only will its house positions need to be auctioned, but other clearing members need to have the capacity to take on its clients seeking to port.

15/07/15

We believe that further investigation and analysis into the dispersion of the market is warranted before it can be stated with any certainty that dispersion is sufficient to deal with the default of a clearing member. We also believe that in the interest of systemic risk, such analysis should ensure that the dispersion be sufficient to absorb the risk resulting from the default of not just one clearing member, but a minimum of two large clearing members.

Market size and depth

ESMA states in Paragraphs 47-9 of the consultation paper that the G4 currencies comprise around 90% of volumes globally. It is assumed that because 10% of IRDs are non-G4 currencies that this segment of the market still represents around 8% of the entire derivatives market (IRD = 81.5% of entire derivatives market) which is similar to the size of the FX derivatives market, or all other classes combined. But the biggest components of the non-G4 currencies in terms of turnover for interest rate swaps in 2013 were CAD and AUD. And in Paragraph 51, ESMA states that the EEA currencies represent around 16% of flow of non-G4 currencies, and 50% of non-G4 FRAs. Therefore EEA currencies represent roughly 1.5% of the total global volume in interest rate swaps in 2013 (according to Table 2), and 4.6% of total global volumes in FRAs.

In total the EEA currencies represent a fraction of global volumes and individually even much smaller portions. Thus, we believe that these markets are not systemic in nature.

Lack of parallel futures and bond markets make hedging more difficult

Some of the classes proposed ESMA, for example SEK and NOK, have either no or very illiquid exchange traded derivatives or bond markets, which means recycling the risk associated with such swaps is more difficult and can take much longer than that of the G4 Rates classes.

Voluntary Clearing

Given many large financial institutions are already voluntarily clearing such exposures, the imposition of a clearing mandate would largely affect smaller counterparties, which do not pose systemic risks, and who in many cases will find it difficult to obtain clearing arrangements, and thus may consider abandoning the use of derivatives as hedging instruments. We would ask ESMA to consider balancing the overall reduction of counterparty credit risk to be achieved from mandating smaller participants to move their bilateral exposures to a centrally cleared environment for EEA Rates classes and the associated reduction in overall systemic risk versus the risk of forcing smaller participants to stop using derivatives as hedging instruments.

QUESTION 5: DO YOU CONSIDER THAT THE PROPOSALS RELATED TO THE DEFINITION OF THE CATEGORIES OF COUNTERPARTIES ARE APPROPRIATE IN LIGHT OF THE CRITERIA SET OUT IN EMIR?

As indicated in our response to question 1, we believe that Category 1 should be assessed on an asset class basis. This would mean that only those entities which are clearing members for the G4 Rates classes should be included in Category 1 for the purposes of the EEA Rates clearing obligation.

In terms of the proposed definitions of Categories 2 to 4, we agree that conceptually the definitions should be consistent across the asset classes. We agree with ESMA's determination that to avoid unnecessary compliance costs the same three month quantitative threshold period (as used in the G4

15/07/15

Rates RTS) be used for the classification determination of Category 2 and 3 counterparties under the EEA Rates RTS. This would create more certainty and would reduce the operational burden and client outreach exercise for the determination of a counterparty's classification.

If ESMA allows Category 1 counterparties to fluctuate between categories within a given asset class, an additional layer of complexity and operational burden will be placed on market participants who will be required to validate counterparty classifications multiple times. Moreover, it is not clear which counterparty determination will supersede which in the event a Category 2 firm for the purposes of the G4 Rates RTS, and thus Category 2 for the purposes of EEA Rates RTS (according to paragraph 158 of the consultation), also qualifies as a Category 1 counterparty for the EEA rates RTS.

A. Counterparty categorisation on an asset-class basis

Please see our response to question 1 above. In summary, we recommend that:

- a) Category 1 categorisation should be undertaken on an asset-class basis; and
- b) ESMA should continue to develop a register of clearing members to assist market participants with their determination of which clients and counterparties are Category 1 counterparties for a particular asset class.

B. The threshold test for Category 2 / 3

We support the approach of using the same three months data to provide a determination on categorization of counterparties of Category 2 or 3. In addition, we support ESMA's view that an entity should not have separate categorization for two sub-asset classes within the same asset class i.e. Category 2 for G4 currencies and Category 3 for EEA currencies.

a) Responsibilities of counterparties

The obligation will fall upon market participants to establish their own position within the four categories. However, other market participants dealing with Category 2 / 3 counterparties will need to know such counterparties' categorisation in order to establish whether the relationship may then attract frontloading and also to understand respective phase-in periods.

ESMA should provide very clear guidance to market participants as to the responsibilities of each counterparty in this context, in ESMA Q&A Guidance published as a matter of urgency. We believe this guidance should address issues similar to those contemplated in ESMA OTC Q&A Question 4², in particular:

- **ability of an entity to rely on its counterparty's representation or other confirmation of categorisation for these purposes:** a party will not be able to assess its counterparty's positions on a group basis.
- **presumption in the absence of counterparty confirmation:** it cannot be taken as given that all counterparties (particularly those that are third country entities) will be able to run the threshold calculation in the proposed timeframe so there may be a number of

² <http://www.esma.europa.eu/system/files/2014-815.pdf>

15/07/15

counterparties who are unable to provide a representation or other confirmation promptly. From a perspective of legal certainty, Category 1 / 2 entities need clear guidance as to how they should classify non-representing Category 2 / 3 counterparties (in the same way that ESMA has previously given guidance to FCs in relation to non-representing non-financial counterparties). Should the guidance amount to a presumption of Category 2 classification for non-representing firms, the potentially adverse impact of such a presumption on non-representing firms (in effect resulting in frontloading for non-representing Category 3 firms in exactly the way ESMA is trying to avoid with the threshold) can only serve to re-emphasise the need to ensure legal certainty and operational feasibility for those firms in relation to the threshold test.

- **confirmation that financial entities (including NFC+ AIFs) that are set up after the three-month threshold calculation period are categorised at Category 3 for the purposes of the RTS.**

C. Treatment of pension scheme contracts

Please refer to our answers to question 7 in the ISDA/FIA Europe IRS Response and question 5 in the ISDA/FIA Europe CDS Response.

D. Categorisation of third country entities

Please refer to our answers to question 7 in the ISDA/FIA Europe IRS Response and question 5 in the ISDA/FIA Europe CDS Response.

QUESTION 6: DO YOU CONSIDER THAT THE PROPOSED DATES OF APPLICATION FOR THE DIFFERENT CATEGORIES OF COUNTERPARTIES ENSURE A SMOOTH IMPLEMENTATION OF THE CLEARING OBLIGATION? PLEASE EXPLAIN WHY AND POSSIBLE ALTERNATIVES.

We believe that ESMA's proposal to lengthen the phase-in periods by three months in the event that the EEA Rates RTS is published in the official journal less than three months after the G4 Rates RTS is published, will create an additional layer of complexity operationally, and in terms of communication between market participants and end user clients, which far outweigh the benefits summed in the cost-benefit analysis in Annex II. Having such a two-stage phase-in for each client (stage 1 being G4 and stage 2 being EEA), clients and dealers (who trade currencies in both product sets) will face additional complexity the further apart those stages are. The adoption of each stage in quicker succession would allow firms to consolidate resourcing efforts, internal system controls, client outreach and staff training as opposed to managing that over a longer period of time. Therefore, we believe that the proposal to grant an extra three month period should be removed from the RTS.

QUESTION 7: DO YOU HAVE ANY COMMENT ON THE APPROACH ENVISAGED FOR FRONTLOADING?

We have significant concerns around OTC derivatives traded during the frontloading window (FL) and cleared at CCPs that have not yet been authorised or recognised by the time the clearing obligation enters into effect. If the relevant ESMA recognition decisions for CCPs (in particular US derivatives clearing organisations (DCOs)) – are not in place before the start of the relevant FL

15/07/15

period, this will increase costs for end users and fragment the European derivatives markets. While this is significantly more acute for the G4 Rates classes, the EEA Rates classes are also cleared by US DCOs.

If firms clear OTC derivatives traded during the FL window at CCPs that have not yet been recognised by the time the clearing obligation enters into effect, those firms will have to extinguish their positions and re-open them on EMIR authorised/recognised CCPs, which will cause significant market disruption (especially as some firms may not have clearing arrangements in place with other CCPs). In some cases it may not even be possible to extinguish the exact position and thus trades will be in regulatory breach. Firms will be required to flatten their positions by booking a new exactly offsetting swap and compressing the position (by recognising offsetting cashflows). But if a firm had a range of positions with equivalent cashflows in a non recognised CCP, some subject to FL and some not, and booked a new offsetting swap intended to offset and then compress those cashflows subject to FL, there would be no way to ensure the CCP would use the offsetting swap to offset and compress the cashflows subject to rather than those predating FL. In which case post-FL cashflows could remain intact and in regulatory breach.

Given that an EU-US equivalence agreement remains outstanding, market participants remain concerned that ESMA will not be in a position to recognise US CCPs before the relevant FL start date, and therefore the following practical consequences will result:

- European end user firms (Category 2 firms) will be required to set up costly alternative clearing arrangements with another EMIR authorised or recognised CCP prior to the start of the FL window, and be forced to maintain two separate pools of derivative exposures, thus splitting netting sets, and forcing such firms to post extra margin (an additional funding cost). The establishment of new clearing arrangements is not a straightforward process and can take up to three months, and may be further complicated if a swathe of participants are required to set up arrangements for the same class of derivatives at the same time.
- European firms will be unable to trade with US persons who choose to or are required to clear on US DCOs and in relation to firms that have to comply with the EMIR clearing obligation, thus fragmenting markets. This will likely result in increased trading costs as a result of liquidity fragmentation and loss of market efficiencies.
- Firms intending to clear their trades at US DCOs, will price the trade according to the CCP in which it will be cleared. If firms are eventually forced to then clear the trade at another CCP at the end of the FL period, the trade will have been mispriced given the pricing differences which currently exist in relation to certain trades executed on different CCPs.

Therefore, we believe it is crucial that the European Commission and ESMA aim to achieve full recognition of US DCOs before the start of the Category 1 FL period (or – at the very least – before the start of the Category 1 clearing date (note, the completion of the recognition process by ESMA is not always straightforward as it has notably to establish cooperation agreements with the relevant third-country CCP supervisor). The latter option would, however, place market participants in a situation with major uncertainty as to whether the relevant US DCO will be recognised by the clearing start date and with major difficulties associated with pricing in-scope trades entered into during the FL period.

15/07/15

However, should an equivalence decision not be forthcoming and ESMA be consequently not able to recognise US DCOs before the start of the FL period, we would urge the following possible remedies and solutions be considered:

- If US DCO recognition cannot be guaranteed by the start of the FL period but only by the start of the clearing obligation, we believe ESMA could amend the EEA Rates RTS so as to further delay the start of the FL periods.
- If US DCO recognition cannot be guaranteed by the start of the clearing obligation, the ESMA and/or the Commission could provide formal guidance or adopt a transitional measure clarifying that a trade (executed during but not after the FL period) cleared at a US DCO qualifies as cleared pursuant to the requirements of EMIR as long as the CCP has previously applied for ESMA recognition, regardless of whether or not the CCP ultimately achieves ESMA recognition.

QUESTION 8: DO YOU HAVE ANY COMMENT ON THE COST-BENEFIT ANALYSIS?

Section 8.2.2.3 of the cost benefit analysis provides analysis on the dates on which the clearing obligation starts to apply. We do not feel that option 2 results in a more beneficial one off compliance cost and would instead prefer option 1 with no additional three month phase in window, per the reasons provided in our response to question 6.

QUESTION 9: DO YOU HAVE ANY COMMENTS ON THE DRAFT RTS NOT ALREADY COVERED IN THE PREVIOUS QUESTIONS?

Please refer to our answers to question 12 in the ISDA/FIA Europe IRS Response and question 8 ISDA/FIA Europe CDS Response relating to:

- Treatment of trades that result from systemically risk-reducing processes;
- SPVs;
- Exemption for group restructuring; and the
- Treatment of life-cycle events

Liquidation of contracts at a CCP that has lost its authorisation

The proposed structure of the clearing obligation, for all the RTSs so far proposed by ESMA, currently gives no ability for firms to liquidate the risk that sits at a CCP that had been clearing mandatorily clearable contracts but then subsequently had its authorisation revoked and where the clearing obligation still remains because another CCP clears those contracts. In such cases, any requirement for firms to move outstanding contracts to another CCP may be impractical and in some cases may negatively impact financial stability.

In our view, ESMA should ensure that:

- a) to the extent a clearing obligation is still in force, a firm may either liquidate its positions on the de-authorised or de-recognised CCP or, where the CCP (notwithstanding the de-authorisation or de-recognition) continues to provide clearing services in respect of the relevant contracts, retain its outstanding positions at the relevant CCP.

15/07/15

- b) if a CCP is de-authorised and therefore ceases to provide clearing services, members should be provided with sufficient time, in order to mitigate the impact on the markets, to transfer and/or liquidate their positions and should not be required to do so immediately. In particular, ESMA should consult with clearing members and take into account (i) the relative size and importance of the de-authorised or de-recognised CCP in the market, (ii) the availability of capacity at alternative CCPs and (iii) the proportion of clearing members who already have arrangements in place with such alternative CCPs, before setting a time-line for transfer/liquidation.

In our view, this approach would be consistent with EU policy objectives as set out in other EU legislation - in particular the Capital Requirements Regulation 575/2013, which provides for a three-month period of time in which clearing members may continue to calculate their exposure with beneficial qualifying-CCP capital treatment even following revocation of CCP status.