ISDA Safe, Efficient Markets

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ISDA (International Swaps and Derivatives Association) Comments on Hungarian Presidency compromise text of 5 January 2011 on EMIR

18 January 2011

We note the retention of the broadening of the **subject matter and scope in Article 1**, so that the Regulation applies to all derivatives. We also note that both in Art 1 and in many other articles and recitals the text has been reworded to reflect the extended scope. Our understanding is that this amendment has been introduced to ensure that MTFs – on which OTC derivatives are transacted - that become regulated markets at a later date would have to apply mandatory clearing (at present there is no mandatory clearing requirement for MTFs in MIFID).

We make the general remark that we assume that there has been a complete analysis of the effects of this amendment on other parts of the text – to ensure there is no unintended consequence resulting from it.

In relation to **scope and definitions (Articles 1 and 2)** we continue to believe that there is a strong case for exempting some types of financial institution from clearing requirements including

- Pension fund managers and insurance companies managing pension funds with liability driven investments (LDIs) for whom the frequent margin calls associated with central clearing may represent an inappropriate liquidity strain and (resultant) disproportionate cost. A previous exemption for IORPs is not apparent in the 5 January text;

- Captive finance companies of non-financial corporations. These are excluded under Dodd-Frank. If a similar exclusion is not reflected in EMIR, this could (a) put European companies at a disadvantage vs. US competitors or (b) encourage regulatory arbitrage by compelling European companies to establish captive financing operations in the US which they would use to fund and hedge their activities on a global basis.

Furthermore, we believe that consideration should be given as to whether there is a case for **scoping out intra-group transactions**. In this regard, it should be considered whether the extra operational risk created by requiring clearing of these transactions is justified by the extent to which counterparty risk is reduced by clearing them. ISDA has prepared a briefing on this issue which it has circulated with this text.

We welcome the introduction of the new recital 12b acknowledging the special characteristics of FX business. We believe that – at a minimum - this recital should be retained. There is a strong case for exempting some of the FX business from EMIR at level 1 on the basis that (a) large parts of this business represent limited counterparty risk (short maturities) (b) central settlement is already in place, addressing the key risk in FX business (and effort should be concentrated in getting more counterparties signed up to CLS and (c) it is quite possible that the US Treasury may exempt large parts of this business from Dodd-Frank – including relevant clearing and margining requirements (a decision is pending). If FX business was to be exempt for clearing solely, under EMIR, it would still be subject to reporting requirements, as well as new collateral and capital requirements.

The reference to the '**objectives' of trade repositories** (in the 7 Dec Belgian Presidency text) previously included in the definition of trade repository in Art 2 is now moved to Art 67 on trade repositories' transparency obligations. We do believe that relevant regulators should have access to information from the industry that they need to fulfil mandates such as systemic risk and market integrity monitoring but some coherent thinking still needs to be done as to whether or not it is really appropriate to impose responsibility for responding to all such needs on trade repositories. For example, transaction reports may be a more appropriate market integrity monitoring tool. We are concerned at the prospect of regulatory overlap and duplication.

Regarding Art 2 (6), we believe **the definition of financial counterparty** should be reworded, to avoid **extraterritorial implications** and clarify the scope as compared with the relevant sectorial EU directives. **Definitions of 'established' and 'branch'** should be added, as well as some specific provisions on (non)application of Title II to **EU branches of non-EU entities and non-EU branches of EU entities** ought to be included in Art 2. Equally the application of EMIR rules where an **EU firm acts as an agent** needs to be addressed. For details and wording propositions, please refer to the attached briefing on Territorial Scope Issues. Legal uncertainties arising herein should be addressed – in particular as this is a Regulation.

Art.3 (Clearing obligation): The text in square brackets indicates that **'backloading'** onto CCPs of contracts that exist before the date of effect of the clearing obligation will no longer be required. We have strong reservations about requiring backloading for existing contracts, for a number of reasons:

- This change would bring Europe (approximately) into line with the US legislation, which does not require backloading of existing contracts, if they are reported to trade repositories (to be precise, a mandatory clearing requirement in Dodd-Frank applies to contracts either (i) 360 days after date of enactment of Dodd-Frank (which was 21 July 2010) or (ii) not less than 60 days after publication of final relevant rules – the later of these two. Contracts entered into before that date do not have to be cleared.

- This change would mean that Europe and European market participants (in particular buyside firms, which are more likely to have more 'one way' risk then dealers, for

example) would not face a much more extreme 'liquidity crunch' impact than would be experienced in the US (because Dodd-Frank carves out existing contracts);

- A requirement to clear existing contracts is logistically extremely challenging – it would require dealers to persuade tens of thousands of clients to agree to have their contracts centrally cleared;
- Apart from the logistical challenges, the clearing requirement would create major legal challenges. Existing bilaterally risk-managed contracts have been negotiated based on price assumptions which are inextricably linked with the credit risk conditions, exposures and risk mitigation tools addressed in those bilateral contracts. Counterparties may feel that a forced clearing requirement could represent a threat to their property rights, unless they are absolutely satisfied with the terms associated with new arrangements.

We believe that the compliance resources available to firms involved in the derivatives business would be more efficiently used (in terms of reducing operational risk) by focusing on other operational enhancements which will reduce risk, including trade compression (an operational process through which dealers' positions facing other dealers are maintained, but the number of contracts involved are reduced enormously - creating huge reductions in the gross notional volume of derivatives business), legal standardisation work (facilitating central clearing), further 'electronification' of derivatives post-trade processes (moving towards a straight-through-processing environment in OTC derivatives business), and further work to get more trade repositories and clearing houses up and running.

In the 5 January 2011 text, the words 'concluded on' are now replaced with 'entered into'. Thus the wording currently is: *'The clearing obligation shall apply to all derivative contracts which are entered into on and after the date from which the clearing obligation takes effect…'* We welcome this important change, as this clarifies that contracts that have been negotiated and signed by counterparties but which have not yet matured should not be cleared.

Article 3(1) of the proposed compromise text still indicates that when a financial counterparty in the EU (or a non-financial counterparty in the EU that is subject to the clearing obligation) deals with third country entities, the clearing obligation only applies if the third country entity would be subject to the clearing obligation if it were established in the EU. However, it will be necessary to clarify that EU counterparties should not be liable for a breach of the Regulation if they take reasonable steps to establish whether or not an EU or non-EU counterparty is an **entity of a kind triggering the clearing obligation**. For further details and wording proposals, please refer to the attached briefing on Territorial Scope Issues.

Article 3(2) proposes that in order to comply with the clearing requirement, counterparties should become clearing members or clients of clearing members. As drafted a 'client' has to be a direct client of the clearing member. However this language may be inadequate, as it does not recognise **instances where a client accesses clearing 'indirectly' through a**

broker chain (e.g. via an 'affiliate' of a clearing member). This wording may benefit from clarification.

Recital 12, Art 4.2b, Art 4.4 (Eligibility for the clearing obligation): The text indicates that clearing could be 'phased-in' for example in terms of percentage levels of eligible contracts to be cleared by certain dates, or different dates of application for different categories of market participants. We continue to support the '**phasing-in'** suggestion, as explained previously, because it would

(a) allow regulators and CCPs to focus on the getting the most systemically important market participants onto CCPs first i.e. dealers and more systemically important buyside firms;

(b) allow time for other buyside participants – who would probably feel the impact of clearing (in relative terms) most keenly – to ready themselves and their finances for these demands.

Other key points **on Article 4** are still valid, where the text has not changed since the 7 Dec version:

- ..*'The impact on the level of counterparty credit risk in the market, within the relevant class of derivatives and between classes of derivatives, as result of applying an obligation to the relevant class of derivative contracts'* should be considered if a contract is to be deemed eligible. We believe there are some situations where a requirement to clear 100% of all eligible contracts could actually increase risk in the financial system. For example, where two dealers have a balanced position facing each other, comprising a collection of eligible and non-eligible contracts alike, taking the eligible contracts out of this relationship and putting them onto a CCP could create a large bilateral exposure between the dealers in relation to the ineligible contracts (where no exposure had previously existed). If Art 3aa is retained, we would welcome this, in this context.

- The ability of a CCP to handle the volume of relevant contracts should be a pertinent consideration for the purposes of eligibility determination and we therefore oppose the 7 December text's deletion of this criterion reinsertion of this criterion in the 5 January text.

- We still believe there may be a case for making international convergence a clearing eligibility consideration;

- We continue to believe that the list of criteria for consideration in relation to eligibility should not necessarily be exhaustive. ESMA should be able to consider any factor brought to its attention if this factor is pertinent in systemic risk terms.

- A positive change is introduced into recital 12a. It has been aligned with Art 4, i.e. the suggestions to (a) incentivise CCPs to offer clearing services in certain classes of derivatives and to (b) limit or restrict trading in derivatives that are eligible for

clearing but for which no CCP has now been altered (in particular the suggestion that trading of derivatives be restricted, if ESMA decides so, has been removed. We believe that neither the recital nor the article should refer to such a power/measure, as it could have unhelpful consequences in terms of basis risk and liquidity.

In **Article 5 (Access to a CCP)**, we welcome the deletion of the requirement that venues obtaining access should complying with 'operational and technical requirements' set out by the CCP. If retained this could be deployed as a means for CCPs vertically integrated with trading venues to block access. We support the revised article.

On **Article 6 (Reporting Obligation),** we are still concerned that the intent behind the article could be better addressed by referring to "*Counterparties or CCPs*" (rather than "*counterparties and CCPs*"), but are not convinced that even this change will resolve the issue of duplication. Perhaps the text should clarify that the obligation to report applies to one counterparty only (i.e. the obligation is satisfied by one counterparty reporting)? We also note that Article 6(2) still does not contemplate reporting of positions to home regulators, but rather to ESMA. This is likely to have practical implication and we would query the basis on which home regulators have been excluded from this process, even though a new sentence may provide some improvement in this area. In addition, this new sentence raises the same question as Art 67 regarding lack of clarity as to the roles of trade repositories in terms of systemic risk, market integrity and transaction reporting (please see the above comment on Art 2 and 67).

Under **Article 7 (Non-financial counterparties)** we

- Welcome the retention of the proposal that 'open' contracts entered into by non-financial counterparties would not have to be cleared (no backloading) – where non-financials exceed the clearing threshold - and that the words 'concluded on' are replaced by 'entered into'. We strongly support keeping this provision for the reasons explained above (please see the comments on Art 3).

- We continue to support the suggestion that "clearing thresholds shall be determined taking into account the systemic relevance of the sum of net positions and exposures by counterparty per class of derivatives over *a specified time period"* – in other words, a non-financial would not be required to clear all contracts by virtue of it *momentarily* exceeding this threshold.

- Again, we welcome the suggestion that a non-financial counterparty would have 6 months to comply with its clearing requirements if exceeding the threshold.

In **Article 8 (Risk mitigation techniques for contracts not cleared by a CCP)** paragraph 1a, clarification that only **initial margin** (in cases where title transfer is not deployed) would have to be segregated is re-inserted – we strongly support this.

However, corporates may be very concerned about some other changes introduced in Art 8. A deletion of reference to Art 7 (2) and a reference to all 'non-financial counterparties' widens the scope of Art 8 to **non-financial companies that are under the clearing threshold** and thus are excluded from the clearing obligation. This deletion imposes on them collateral or risk capital requirements. These 'small' and 'non-systemically risky' non-financial counterparties were formerly (intended to be) excluded from the scope of Art 8 and we strongly believe that this exclusion should be restored and made explicit in order to ensure risk proportionality of the EMIR proposal regarding non-financial corporates. This would be in line with recently proposed provisions in Dodd-Frank rulemaking allowing exempted corporate end users to rely on available financial resources to mitigate counterparty risk (rather than furnishing collateral).

As such, we would welcome reinstatement of the wording used in the Belgian Presidency compromise document of 7 December 2010 i.e.

"Financial counterparties or the non-financial counterparties referred to in Article 7(2), that enter into an OTC derivative contract not cleared by a CCP, shall ensure that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational and credit risk, including at least: …"

In **Article 23 (third countries) and 63 (equivalence and recognition)**, the text retains ESMA's period of up to 180 days to rule on the recognition or otherwise of third country CCPs and trade repositories. Certainly, in the case of trade repositories, this seems an excessive amount of time for such a decision. Furthermore – also in relation to Article 23 and 63 – while we understand the political reasons for the demand for arrangements to be in place for onsite inspections of third country CCPs and trade repositories, we continue to believe that such arrangements are best made through dialogue with regulators in other jurisdictions and not in regulation.

Article 23(2)b introduces an additional requirement that third country CCPs should comply with prudential requirements 'applicable in that third country'. This seems a reasonable requirement.

In addition, **Art 23 (1)** should be clarified in relation to **branches**. Please see the attached briefing on territorial scope issues for details and a suggestion for wording.

We welcome the retention of the previously introduced **Art 32a (Communication procedures with clearing members and market infrastructure)**, as it references to the need for CCPs to use 'relevant international communication procedures and standards for messaging and reference data'.

Under **Art. 35 (Participation requirements),** we welcome the suggestion that CCPs must seek the advice of the Risk Committee in establishing categories of clearing members and admission criteria. We continue to support the provision of more clarity as to what is meant by '*necessary additional financial resources*' in paragraph 3, for the purpose of clearing members who wish to clear on behalf of clients and, in particular, what '*additional*

obligations' ('proportional to the risk brought' by clearing members) could/should be imposed on clearing members in a default situation. The concern in this regard is that an undue burden could fall on these clearing members – if holding a high proportion of position in such a situation – thus jeopardising their position and that of the CCP.

Article 37 (Segregation): The 7 Dec version of the text stipulated that CCPs 'should' offer the option of full segregation. In the 5 Jan text, the word 'should' is replaced by 'may', suggesting that CCPs are not required to offer full segregation. We assume this is to reflect that provision of 'full segregation' is not intended to be mandatory and that it does not necessarily need to be one of the risk mitigation options provided by a CCP. We make the following observations on optionality:

- without optionality, some customers could be forced to accept either a more expensive regime, or a less secure regime (depending on the nature of the offer) than they would have chosen freely; and
- if optionality is required, care should be taken in implementation to ensure that customers that don't opt for the more expensive option do not end up bearing costs indirectly (for example by being forced to risk mutualise within the diminished default resources available to the CCP). Customers should be fully aware of any costs they bear directly or indirectly in different options available.

The wording regarding clearing members' obligations remains unchanged as compared to previous text i.e. '*Clearing members shall offer full segregation to their clients.'* While some customers may be of the view that optionality would be beneficial in this context, the Hungarian Presidency should consider whether the wording here should be adjusted to be consistent with the foregoing CCP requirement.

Art. 37a (Provision of margins and default fund contributions) still allows CCPs to use margins or default fund contributions collected via a security financial collateral arrangement, where agreed with a member. We strongly oppose CCPs being able to use margins or default fund contributions in this way and believe the text should be amended in this regard.

In **Article 41 (other available financial resources)** there is still no mention of any cap on non-defaulting members' liability towards the CCP. Some general commentary – at least – would be welcome on this point, even if it cannot be addressed in detail at level 1.

In addition, the following deletions are now introduced to Art 41 (1):

Such resources may include any other funds provided by clearing members or other parties, loss sharing arrangements, ~~(the own funds of a CCP)~~ parental guarantees or similar provisions. Such financial resources shall be freely available to the CCP (~~and shall not be used to meet the capital required under Article 12~~.).

We welcome the improvement in **Art. 42 (Default waterfall)** in relation to ensuring increased CCPs' use of their 'own funds' before depleting the default fund ('skin-in-the game') by the introduction of more detail in this regard (rather than just referring to '*a reasonable part'* of their own funds) as well as the proposition on technical standards and requirement for a CCP to use 'its own funds up to the amount proportionate to the total default fund contributions'. This is reflected in the new Art 42 (4a-4b) and amended art 42 (3a) and 12.

Art. 43 (Collateral requirements) continues to indicate that CCPs may be able to accept highly liquid collateral other than cash as collateral, with the EC to draft standards defining what types of collateral can be considered highly liquid. We believe that a distinction should be made herein between initial margin and variation margin, however. We also believe strongly that extensive public consultation should take place as to what constitutes '*highly liquid*'.

In **Art.44 (Investment policy),** we would make the observation that the language added to the 7 Dec version in paragraphs 2 and 2a that appears to be designed to reassure clearing members as to the security of their default fund contributions and that seems to contradict the aim of the last paragraph of Art. 37a regarding reuse of such contributions by CCPs is still included.

A new article 44 (1a) is added. It stipulates that:

1a. The amount of capital, together with retained earnings and reserves of a CCP, which are not invested according to paragraph 1, shall not be considered for the purposes of Article 12(2).

Article 45 (4d) has been removed and we believe it should be reinserted and further clarified in order to provide for legal certainty and enforceability of EMIR provisions:

4d. The requirements set out in paragraph 5 shall prevail over any conflicting laws including insolvency legislation, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them.

In Article 46 (Review of models, stress testing and back testing), we would again suggest that regulators adopt a risk based approach to determine the likelihood that a clearing member will be able to meet its unfunded obligations across all clearing houses.