ISDA Safe, Efficient Markets

January 29th, 2016

European Commission Call for Evidence
EU Regulatory framework for financial services
ISDA response

Introduction

We welcome the developing Capital Markets Union project

ISDA welcomes the opportunity to respond to the call for evidence published by the European Commission as a part of the Capital Markets Union (CMU) plan.

The Capital Market Union aims to reflect a shift towards a market based economy in the European Union, in the face of the capital constraints applying to the credit based economic model that so far has been dominant in the EU.

This consultation comes at a critical moment. Derivatives markets participants (dealers as well as end-users, i.e. non-financial customers and financial end-users such as pension funds, insurance companies, asset managers and building societies) face many challenges in the implementation of the Pittsburgh G20 commitments.

These challenges include the lack of international consistency in the areas of CCP recognition, trading venue recognition, margining, capital rules, data and reporting.

In the European Union, derivatives markets participants also have to anticipate the upcoming implementation of transparency rules under MiFID as well as the overhaul of the market risk framework for capital requirements (FRTB - Fundamental Review of the Trading Book) which may affect the liquidity of derivatives markets.

ISDA members fully support the CMU objective to spur economic growth in Europe by rebalancing Europe's funding mix to ensure that savings are deployed towards business growth and job creation.

There are two aspects regarding support of capital markets to foster economic growth:

- Firstly, the mobilisation of new pools of financing by stimulating institutional and retail investment flows into capital markets instruments, and ensuring that businesses, notably SMEs, are given greater access to funding. The CMU project rightly encourages the emergence of diversified funding sources such as Simple, Transparent and Standardised Securitisation (STS), Venture Capital or Covered Bonds, and proposes changes to the capital requirements for infrastructure investment in Solvency II.

- Secondly, the capacity for providers and users of capital markets instruments to manage, recycle or transform risk. This is where derivatives markets play a critical role.

… But the CMU plan does not enough reflect the key role played by OTC derivatives as a foundation for investment and economic growth.

Derivatives play a crucial role in fostering economic growth and in a market-based economy. This is why ISDA believes that the EU legislative framework should be assessed with regard to the proper functioning of derivatives markets.

The benefits of derivatives to end-users are widely recognized. These benefits include: a) facilitating risk transfer; b) serving as means for price discovery; c) promoting the efficient allocation of resources to their most high value uses over time; d) enhancing opportunities for investors to access alternative asset classes; e) mitigating "underinvestment problems" by creating opportunities for asset-based financing[1]. In addition, another benefit is the "*enhancement of liquidity… By and large, spot markets with derivatives have more liquidity and thus lower transaction costs than markets without derivatives*[2]."

Innovations in the OTC derivatives markets have helped improving management practices of non-financial firms. With regard to interest rate, currency and commodity derivatives instruments, and resulting risk management applications, OTC derivatives have enabled non-financial end-users to face and mitigate the affect of market volatilities.

The European Association of Corporate Treasurers has also stated that "t*he use of derivatives to hedge risks benefits the global economy by allowing a range of businesses to improve their planning and forecasting and offer more stable prices to consumers and a more stable contribution to economic growth.*"[3]

Academic research has shown, based on real-life examples of OTC derivatives used by non-financial firms, that "*derivatives help lower the cost of capital of non-financial firms, both for debt and equity, and this in turn increases the enterprise value. Overall, the success of non-financial firms in managing risks benefits the macro economy and can help reduce systemic risk*"[4].

To illustrate, an ISDA-led a research study based on BIS (Bank of International Settlements) data that shows that 65% of OTC interest rate derivatives (by far the largest segment of derivatives markets) market turnover involves an end-user on one side and reporting dealer on the other. The end-users, comprising non-dealer financial institutions and non-financial customers, use derivatives primarily to hedge risks and reduce volatility on their balance sheets. The remaining 35% turnover relates to dealer market making and the hedging of customer transactions[5].

ISDA also led a survey on the use of OTC derivatives which shows that end-users strongly support OTC derivatives instruments as part of their risk management strategies. Almost 86% of a community of more

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[1] See "*The social functions of derivatives*", Pr. C. L. Culp in "Financial derivatives – pricing and risk management", Kolb series in Finance, Oct. 2009.

[2] See "*Restoring Financial Stability: How to Repair a Failed System*", V. Acharya, M. Richardson, New York University Stern School of Business, 2009. http://pages.stern.nyu.edu/~mbrenner/research/derivatives.pdf.

[3] See letter from European Association of Corporate Treasurers to FSB Chairman M. Carney and IOSCO Chairman G. Medcraft, 11 July 2013: EACT-US-Coalition-Cross-Border-Derivatives-Regulation-July2013.

[4] See "*The value of OTC derivatives : case study analyses of hedges by publicly traded non-financial firms*", Pr. I. Popova and Dr B. Simkins, April 2014. http://www2.isda.org/functional-areas/research/studies/.

[5] See ISDA research paper : http://www2.isda.org/search?headerSearch=1&keyword=end+user.

about 250 respondents estimate that OTC derivatives are very important or important to their risk management strategies[6].

End-users employ derivatives for a variety of key risk management purposes. According to the ISDA survey, 65% believe that derivatives are important for managing exposures so their firms can maintain and improve pricing, operating expenses and returns. Reducing financing costs and managing the cost of capital (47%) and hedging exposures in international markets to maintain and enhance competitiveness (45%) are also rated highly.

The Capital Markets Union project aims to create new funding opportunities for Corporates/ issuers and new investment opportunities to investors. OTC derivatives will help corporates/ issuers and investors to secure their investment and economic strategies7.

While the CMU plan will help to reduce the barriers to single market investment, barriers resulting from national differences will remain: Europe will still have different currencies, different inflation rates, different growth rates and even different longevity rates. This will result in smaller liquidity pools. For example, pension funds looking to source sterling inflation will still face a UK-sized market rather than an EU-sized market. But derivatives can help bridge that gap and complement the CMU by allowing investors to source assets beyond their own borders and currencies by expanding the risk-hedging pool and fund synthetically.

We consider that greater recognition is needed of the key role that derivatives play in investment decisions, and that this should be reflected in the EU financial regulatory framework and in policy aiming to promote European Capital Markets Union.

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[6] ISDA insight: "A Survey of Issues and Trends for the Derivatives End-User community", 8 April 2014: http://www2.isda.org/search?headerSearch=1&keyword=end+user.

[7] See http://www.bis.org/publ/cgfs55.pdf. In this report on Fixed income market liquidity, the Bank of International settlements (BIS) points out the importance of market makers and states that "*a comprehensive assessment of* [market liquidity drivers] *would ideally take account of the multifaceted interlinkages between these markets (eg between the ash, derivatives and repo markets; or given the market making activities of major banks in multiple markets at the same time"*).

Executive Summary

In this section we briefly set out the key issues identified with respect to the regulatory framework for derivatives in the EU according to the template provided by the EC. That template grouped major topics into four areas:

- Rules affecting the ability of the economy to finance itself and grow
- Unnecessary regulatory burdens
- Interactions, inconsistencies and gaps
- Rules giving rise to unintended consequences

In the following section, we address each of these points in greater detail.

⇨ Rules affecting the ability of the economy to finance itself and grow

Issue 1 – Unneccesary regulatory constraints on financing

The objective of the Basel III framework is to improve the safety and soundness of the financial system. However, the resulting capital rules do not, in all cases, align with the objectives of the CMU and sometimes will increase issuance costs and constrict end-users' ability to access capital markets. The consequence of this misalignment will be a reduction in market liquidity. In particular, the European Commission should pay attention to the following measures (some of which have yet to be implemented):

- the **Fundamental Review of the Trading Book** (FRTB);
- the **Leverage Ratio** (LR);
- the **Net Stable Funding Ratio** (NSFR); and
- the **Credit Valuation Adjustment** (CVA) charge.

Issue 2 – Market liquidity

Liquidity in derivatives markets is structurally different from the liquidity in securities markets. Market participants are particularly concerned by the following existing (but not yet implemented) or envisaged rules:

- the **MiFID transparency** framework as long as: a) the calibration of the liquidity thresholds by ESMA in its final RTS and of the definition of the Size Specific To an Instrument (SSTI) are inappropriate; b) there is no waiver in place from pre-trade transparency for package transactions;
- the **European Financial Transaction Tax** which by nature will dramatically affect FTT zone member states and other EU members States if the basis for collection is extra-territorial.

⇨ Unnecessary regulatory burdens

Issue 5 – Excessive compliance costs and complexity and

Issue 6 – Reporting and disclosure obligations

EMIR implementation has proved challenging in many respects. In the context of the **EMIR review**, the following provisions should be amended to make the framework more effective and legally clear:

- Improving derivatives transparency with **rationalised reporting obligations**;
- **Indirect clearing** would be a solution to clearing access;
- **Removal of the frontloading obligation (also relevant under Issue 14/Risk)** would help to reduce systemic risk and improve market efficiency. Frontloading raises issues regarding pricing and phase-in preriods, regarding documentation and regarding non-recognised CCPs;
- **Giving regulators the power to terminate or suspend the clearing obligation** would help to improve CCP resilience and regulators' ability to actively combat systemic risk fallout **(also relevant under Issue 13/Gaps and 14/Risk)**;
- **Effective equivalence determinations (also relevant under Issue 2/Market liquidity and 9/Barriers to entry)**;
- **Product suitability** assessments for central clearing should be more granular and take into account risk characteristics **(also relevant under Issue 4/Proportionality)**;
- **Treatment of trades that result from systemically risk-reducing processes** should be exempted from the clearing mandate and rules governing the margining of non-cleared derivatives **(also relevant under Issue 4/Proportionality).**

⇨ Interactions, inconsistencies and gaps

Issue 10 – Links between individual rules and overall cumulative impact

The industry has identified the following individual rules that inadvertently affect the functioning of markets:

- The absence of a **list of non-EU equivalent regulated markets under MiFID I** forces non-financial counterparties under EMIR to count the transactions done on non-EU exchanges towards the clearing threshold. The list is critically needed in the very short term;
- The **bilateral margining requirement for OTC derivatives traded by securitisation vehicles** will reduce access to this new resource and increase cost of financing.
- The **obligation to post initial or variation margin** applied to the smallest market participants who use only short dated foreign exchange swaps and forwards should be calibrated to avoid that they face disporportionate operational and documentation requirements.

Issue 11 – Definitions

The implementation of the **Short Selling Regulation** ban on uncovered CDS has led to a significant decrease of liquidity to the detriment of hedging strategies of market participants (particularly buy-side firms). The SSR review gives an opportunity to mitigate the adverse effects of this provision by: a) giving more flexibility to the definition of the market making exemption and; b) giving more economic relevance to the definition of correlation whose purpose is to determine if a sovereign CDS is recognised as covered and therefore can be used for hedging investment risk.

Issue 12 – Overlaps, duplications and inconsistencies and

Issue 13 – Gaps

ISDA supports efforts to ensure consistency in the following areas while recognising that this is an international consistency effort rather than a purely 'European legislation fix' even though these issues arise from the implementation of EMIR or MiFID II (for trading venues):

- **Data and reporting**: different reporting rules regarding content and format of data leads to inability to aggregate data between trade repositories;
- The absence of **effective recognition of CCPs** (due to inconsistent margin methodologies) is leading to fragmentation of markets and higher costs for end-users;
- The absence of **recognition of trading venues** is leading to fragmentation;
- Divergences in **national-level rules on margining** leads to fragmentation and higher costs of implementation.

⇨ Rules giving rise to unintended consequences

Issue 14 – Risk

In addition to the EU Financial Transaction Tax which is already addressed under Issue 2 (market liquidity), the following rules, whereas aiming at improving the functioning of markets, would have detrimental effects:

- Implementation of the **EU Financial Transaction Tax**;
- Inappropriate **regulatory distinctions between cleared and non-cleared derivatives** (notably in the Banking Structural Reform if adopted under the form proposed by the European Parliament) which would lead to unavailability of non-cleared derivatives;
- Inappropriate calibration of **Commodity derivatives position limits** under MiFID II if netting rules and aggregation rules are overly restrictive and non-spot months limits are based on deliverable supply;
- Inappropriate definitions and calibratioin of the **Market Abuse regulation** level 2 provisions on investment recommendations, on suspicious transaction and orders reporting, on buybacks programmes and on indicators of market manipulation.
- Inappropriet scope of the **Packaged Retail and Insurance-based Investment Products (PRIIPs)** regulation if it covers hedging products (i.e. derivatives used for hedging purposes) rather than investment products only.

Rules affecting the ability of the economy to finance itself and grow

Regarding the rules affecting the ability of the economy to finance itself and grow, the European Commission has listed four sub-items:

Issue 1 – Unneccesary regulatory constraints on financing that is devoted to the assessment of the capital requirements regulation;

Issue 2 – Market liquidity;

Issue 3 – Investor and consumer protection;

Issue 4 – Proportionality/ preserving diversity in the EU financial sector.

Issue 1 – Unnecessary regulatory constraints on financing that is devoted to the assessment of the capital requirements regulation

- **Capital rules**

Regulatory capital standards have undergone a fundamental overhaul since the financial crisis, when it became clear that banks were insufficiently capitalised to withstand a major stress event. While the bulk of these post-crisis reforms, collectively known as Basel III, has gone a long way towards improving the safety and soundness of the financial system, there are certain aspects of the new rules that have yet to be implemented fully that risk undermining the efficacy of the entire reform effort. It is clear that some capital requirements are set at inappropriate levels, which means certain businesses could become uneconomic thus severely impacting the ability of banks to provide risk management tools that are vital to supporting healthy European capital markets. A proliferation in the use of non-risk-based backstops could impair sound risk management practices, and lead to increased systemic risk. And the piecemeal approach of regulatory reform means each of the rules may make sense in isolation, but the cumulative impact of the capital requirements is unknown and is likely to be punitively high.

Ultimately, certain rules, or combination of different rulesets, are likely to increase issuance costs and constrict end-users ability to access capital markets, and may also negatively impact secondary market liquidity that is already subdued due to the impact of other regulatory initiatives. This will result in dampened investor participation thereby negatively impacting on the depth and efficiency of European capital markets.

We therefore believe that it is crucial that the EC's cumulative impact assessment is forward-looking and takes into account initiatives being finalised at an international level as well as those measures that have not yet been fully transposed. We set out below four key regulatory initiatives, which we believe in their current iterations will significantly negatively impact the aim of fostering a robust capital markets framework:

- the **Fundamental Review of the Trading Book** (FRTB);
- the **Leverage Ratio** (LR);
- the **Net Stable Funding Ratio** (NSFR); and
- the **Credit Valuation Adjustment** (CVA) charge.

Example 1 – Fundamental review of the tradin book (FRTB)

⇨ Fundamental Review of the Trading Book

The **Fundamental Review of the Trading Book** is a Basel Committee on Banking Supervision (BCBS) initiative to overhaul trading book capital rules, with the aim of replacing the current measures under Basel 2.5 with a more coherent and consistent framework. Some of the key components of the proposed framework include a revised standardized approach based on price sensitivities, the introduction of liquidity horizons in the framework to reflect the period of time required to sell or hedge apposition during a period of stress, back testing requirements at trading desk level and enhance public disclosures on market risk capital charges using both standardised and internal models approaches.

There are significant concerns, however, that the additional capital requiments resulting from FRTB implementation will hamper the ability of the market makers to efficiently operate and provide liquidity in financial markets, in particular capital markets. An industry study, based on submissions by 28 banks to the Basel Committee on banking Supervision, indicates that without changes to certain aspects of the framework, banks will likely be required to hold significantly more capital against their trading inventories, which may result in severe and disproportionate impacts on the cost of market-making in certain products and markets.

Industry FRTB QIS
Analysis Executive Su

While the overall capital impact of the FRTB is not yet clear, the Industry QIS analysis suggests that the FRTB framework will result in punitive capital increases for certain business lines. Some of the most affected products are those with the greatest significance for the wider economy, such as sovereign bond markets, SME credit, securitisations, equities, and commodities and foreign exchange hedges.

Based on this study we document a potential increase of 4.2 times in the capital requirements based on standard rules calculations which all banks will have to calculate and disclose post FRTB implementation compared to the current market risk capital charge.

The cumulative impact of the ruleset will likely result in the following impacts on end-user segments:

- **Impacts on corporate end-users:**
  The cost of funding for issuers will likely increase, with costs on funding new market entrants, lower-rated credits and medium-sized companies will be disproportionately impacted.

- **Impacts on sovereign debt management offices (DMOs):**

  The increased capital required to be held against sovereign bonds will potentially impact the ability of sovereign issuers to fund themselves in a cost effective manner.

- **Impacts on asset managers:**

  Liquidity in bond markets, equities and securitisations may deteriorate as a result of increased capital requirements. Less liquid markets are more prone to volatility. The unwinding of QE programmes, in combination with low inventories and sparse liquidity has the potential to intensify volatility, and could make it more difficult and expensive to risk manage portfolios of assets.

While the BCBS is currently embarking on calibration of the FRTB framework, it is crucial that European policymakers are aware of the potential negative consequences of such increases in capital requirements, which may result in certain business lines being hit disproportionately causing banks to scale back from those activities. The FRTB has the potential to create perverse incentives in instances where the risk of positions and their hedges are not adequately recognised. The material loss of risk sensitivity and resulting substantial increase in capital requirements could result in significant changes in market intermediation and in particular banks' ability to provide primary and secondary market liquidity specifically in sovereign, equity, and securitised products. We believe that any residual issues that have the potential to harm European capital markets should be addressed in the BCBS calibration period, and we encourage European policymakers to pursue the resolvement of these issues at the BCBS level.

Example 2 – Leverage ratio

⇨ Leverage Ratio – A Barrier to End-User Clearing Access

Given the enormity of the task of overhauling bank capital standards, a number of elements within the capital framework have been developed in isolation. But this means while each of the rules may make sense in a vacuum, the cumulative impact of capital requirements is unknown, and may duplicate or even contradict the intentions of other rules, either those developed by the Basel Committee or other regulations governing over-the-counter derivatives markets.

The BCBS proposed in 2013 the **Leverage Ratio** as a supplementary and backstop measure to the risk based capital requirements. In parallel, market regulators have endeavoured to address systemic risk concerns in the over the counter (OTC) derivatives market by ensuring that standardised OTC derivatives are cleared through central counterparties. In Europe, this commitment is in enshrined in EMIR. However, the impact of the LR on Clearing Members (CMs) runs counter to the G20 commitments on OTC central clearing and acts as a disincentive to market particpants to provide clearing services. This will act as a severe constraint on the ability of end users to gain access to central clearing and may force some to abandon the use of derivatives, which will significantly impact their ability to participate in capital markets activity.

Under the current BCBS Leverage Ratio rules, for the purposes of calculating derivatives exposures in the denominator of the ratio, segregated margin received from clients is not allowed to offset the potential future exposure (PFE) associated with such off-balance sheet

exposures – the policy rationale being that such margin can increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself. However, we believe that margin that is segregated may not be leveraged by a bank to fund its operations, and that such segregated margin solely functions as a risk mitigant in reducing exposures with respect to a bank's cleared derivatives exposures.

We are currently conducting an analsyis of the results that banks submitted as a part of the BCBS Monitoring Workbook's (BMW) exercise. The objective of this initiative is to investigate the aggregate impact of the SA-CCR and its proposed modifications in the context of the LR Framework, as well as to provide data-driven feedback to policymakers for further consideration. We will be happy to share this analysis with the EC once it is completed.

Failure to recognise the exposure-reducing effect of such margin acts as a significant disincentive to central clearing, as margin will substantially increase a clearing firm's total leverage exposure, leading to an increase in the amount of capital required to support client clearing activities, which will:

- Lead to more clearing firms exiting the business thus concentrating risk among a smaller set of providers;
- Negatively impact the liquidity of cleared swaps, as higher clearing costs will force participants to limit their use of derivatives;
- Result in a reduction of clearing member capacity to clear for end-users thus forcing some participants to abandon use of derivatives; and
- Increase counterparty risk for clearing members as many will be disincentivised from collecting excess margin.

Therefore, we believe that leverage ratio should be amended to recognise the exposure-reducing effect of segregated margin.

We also note with concern that the leverage ratio only allows cash variation margin and not securities variation margin, to offset mark-to-market exposures of OTC derivatives positions. This means that counterparties who tend to post securities collateral may be adversely impacted by this requirement. This will particularly impact pension funds, who do not hold a large proportion of their assets in cash (a fact recognised in the clearing exemption granted to pension funds in EMIR), and rely on their ability to post securities (usualy high quality liquid assets) as collateral.

Example 3 – Net Stable Funding Ratio (NSFR)

⇨ Net Stable Funding Ratio

Another area of concern in relation to upcoming capital regulations and the impact on the derivatives market relate to the **Net Stable Funding Ratio** (NSFR) that Basel Committee finalized in 2014 and is expected to become fully effective as of 2019.

We believe that the treatment of derivatives under the NSFR needs to be reconsidered, otherwise under current rules, the aggregate increase in funding requirements for banks will

result in an additional annual requirements that could have a significant negative impact on the cost of trading derivatives and thus the wider economy.

We believe that two components of the NSFR derivatives methodology should be further considered before being transposed into regulation: the recognition of margin received by banks (including rehypothecable initial margin) and the 20% required stable funding (RSF) factor for derivatives liabilities. Without modification, these two components, according to the industry study will result in:

- An estimated additional funding requirement of €767 billion for the entire industry (extrapolated from a €345 billion requirement across 12 banks) – this is approximately 10 times larger than the total amount of actual funding required;
- This translates into an additional annual cost (based on a long term funding cost of between 150-200bps) of between €12-€15 billion.

NSFR QIS Summary v10.pdf

These additional costs run counter to the development of capital markets in Europe – which aim to develop and diversify the supply of funding, particularly for companies which rely solely on credit extension by banks, and are heavily dependent on deep, liquid and accessible derivatives markets.

We propose that a small number of technical refinements be made to the NSFR to better capture derivatives funding sources without deviating from the overall intention of the Basel Framework:

- **Recognition of margin received by banks:**

    - Under the BCBS framework derivatives assets and liabilities are calculated after counterparty netting and deduction of variation margin. However, the rules introduce an asymmetry between posted and received collateral. This creates RSF volatility, ignores the funding value of high quality liquid assets (HQLAs), and can potentially have a negative impact for asset liquidity. **We believe that all rehypothecable cash and HQLAs (where such collateral meets regulatory margin standards) be recognised**. Without recognition of HQLAs, counterparties who tend to post securities collateral may be adversely impacted by this requirement. This will particularly impact pension funds, who do not hold a large proportion of their assets in cash (a fact recognised in the clearing exemption granted to pension funds in EMIR), and rely on their ability to post securities (usualy high quality liquid assets) as collateral.

- **20% RSF for derivatives liabilities:**
    - The framework requires that a 20% RSF be applied on total payable (post netting) gross of variation margin posted. This requirement does not incentivise managing derivatives volatility and does not appropriately capture funding risk. What is more, the requirement was not included in any NSFR consultative document, and the industry is uncertain as to how the methodology was developed and whether its

impact is understood. **We believe that the 20% factor should only be applied as a floor.**

- **Initial margin (IM) recognition:**
    - Under the BCBS framework, IM posted receives an 85% RSF, however, no recognition is afforded rehypothecable IM received. But rehypothecable IM received can be used to meet IM posting requirements. **We believe that rehypothecable IM received should be allowed to offset IM posted before the 85% RSF factor is applied.**

Example 4 – Credit Valuation Adjustment (CVA) charge

⇨ Credit Valuation Adjustment

The review of the CVA risk framework by the BCBS is currently taking place with the goal to improve the current framework, which has been acknowledged by regulators and the industry as being one of the most problematic components of the general Basel III framework. The main issues identified are the regional implementation, flawed calculations and a lack of alignment with industry best practices and accounting standards. While in its July 2015 review of CVA risk the BCBS proposed an improved treatment of market risk hedges, it suggested that internal models may be excluded from the final standards, reflecting a move away from internal models by regulators. This is very concerning to most industry participants, particularly given recent industry-led CVA QIS results which have emphasized that using the proposed standard approach SA-CVA would result in a significantly higher amount of capital than when using the internal model approach IMA-CVA. Excluding IMA-CVA would increase the cost of derivatives and disincentivize hedging, leading to increased systemic risk. Furthermore, the EBA recently proposed to partially capture exempted excessive CVA risk under Pillar II in Europe, putting larger banks at a competitive disadvantage and creating a new unlevel playing field within the EU, while diverging even more from the Basel framework and other regional implementation, aggravating the inconsistent global implementation of the Basel standards.

We therefore call for **alignment of capital rules with CMU objectives:** at a global level, the Basel Committee on Banking Supervision plans to finalise an overhaul of the capital framework for market risk, which governs capital levels for banks' trading activities, by the end of 2015.

However, if the framework is finalised as per the current timeframe, key areas of the framework will not have been adequately considered. Addressing these areas is critical because the potential increase in capital could impact both sovereign and corporate derivatives and debt markets, making financing more expensive, and in particular, hampering SMEs looking to graduate from traditional bank loan funding to the public market.

The end-2015 deadline should be extended so that key components of the framework can be assessed via another quantitative impact study. This would not impact the overall implementation timeline.

Issue 2 – Market liquidity

ISDA members consider that the combination of several existing or upcoming texts may have a detrimental effect on **market liquidity**, e.g. MiFID II transparency regime for derivatives, EU Financial Transaction Tax.

Example 1 – MiFID Transparency

⇨ **The MIFID II/ MIFIR transparency regime should be calibrated appropriately**. We are in favour of greater transparency in derivatives, but the thresholds for determining whether derivatives should be traded on trading venue and subject to pre- and post-trade transparency under MIFID/MIFIR should be appropriately calibrated. The calibration of the liquidity thresholds by ESMA in its final RTS published and the definition of Size Specific To an Instrument (SSTI) may have detrimental effect on the functioning of derivatives markets. See our position paper.

On the **SSTI threshold**, ESMA has not demonstrated that its proposals reflect the point where liquidity providers are exposed to 'undue risk'. In this respect ISDA members think that ESMA should be asked to re-calibrate SSTI.

On **liquidity thresholds**, For some asset sub-classes ESMA has not set the threshold at which a sub-class is deemed liquid (in terms of trades per day and notional size) at a level suggesting presence of 'ready and willing buyers and sellers on a continuous basis'. There also remain important concerns about the quality of ESMA data and mechanical issues that incorrectly categorise transactions. The proposed thresholds to define liquid markets designate a number of instruments liquid, when they are in fact illiquid. This will subject illiquid product classes to liquid instrument transparency requirements, which will potentially damage overall liquidity in those products. The end result will be higher costs for end users.

Another critical point related to transparency rules is the treatment of **Package transactions**. Investment firms often conduct, on own account or on behalf of clients, transactions in derivatives and other financial instruments or assets that are composed of a number of interlinked, contingent trades. Packages are entered into by investment firms for two main reasons:

- *<u>Management and minimisation of execution costs and risks</u>*: the price quoted on the package is typically less than the aggregate price of the components when priced individually and executed separately due to the different risks associated with a package of trades. Simultaneous contingent execution ensures that the end user is not left with the risks arising from unexecuted components.

- *<u>Diversification</u>:* in some cases, end users may be seeking to diversify their portfolio into investments in several distinct instruments rather than concentrating their holdings in a single instrument. Others may identify that holding several instruments may provide a superior hedge for exposures compared to holding a single instrument.

Package transactions can take various forms, including, for example,

- *Simple asset swaps:* These are frequently sought by asset managers and pension funds seeking to manage their interest rate exposure. Typically, in an asset swap, they might buy a government bond (and receive a fixed coupon) and then enter into a swap (paying the equivalent fixed rate.
- *Multiple swaps traded collectively to manage pension liabilities:* In this case***,*** a pension fund will manage its interest rate risk by comparing the interest rate sensitivity of its fixed-income investments with that of its pension liabilities. If the pension fund has exposure to interest rate falls, it may seek to enter into a package of swaps where it receives fixed rates for a package of interest rate swaps across several maturities where the term of each swap in the

package aligns to the maturity profile of its liabilities. This will typically provide a superior hedge than transacting a single larger representative swap with a single maturity.

ISDA is concerned that MIFID 2/MIFIR might apply a trade transparency regime to Packages which would make it difficult for investors to access Packages on the current optimised basis.

If Packages containing illiquid or large components cannot qualify for waivers in a manner consistent with those provided when trading those components on a standalone basis, liquidity providers will be deterred from providing liquidity in packages. As a consequence, end users will be prevented from executing the package and will be forced to transact the components of the package separately. This will expose end investors to increased risks and costs of execution as investors will have to approach different market makers for each component and will be unable to synchronise execution across all components. Ultimately, package users will pay more to hedge their risks.

Also, it is possible that the identification of one component of a package could lead to the disclosure of the other component, which if the latter had been traded in isolation, would qualify for a waiver. For example, an asset swap where the interest rate swap has a bespoke maturity date to match the underlying bond may have a notional below the interest rate swap SSTI, but above the bond SSTI. By informing the market of a bespoke date interest rate swap taking place, the market will assume the bond has traded too, especially around the time of bond issuance. Pre-trade transparency would then be msleading.

While we welcome ESMA's adoption of a deferred publication treatment (in relation to post-trade transparency) for packages as well as a treatment allowing packages to be scoped out of the trading obligation under certain conditions, ESMA did not feel empowered under MIFID 2/MIFIR Level 1 to allow a (conditional) waiver from pre-trade transparency requirements for packages

It is therefore important that the European Commission propose an amendment to MIFIR Level 1 to facilitate such a treatment (ESMA itself has expressed support for the creation of an appropriate waiver regime for Packages in relation to pre-trade transparency).

Example 2 – EU Financial Transaction Tax (EU FTT°

- ⇨ The **European Financial Transaction Tax** (EU FTT) is also a major concern and should, from ISDA members' perspective, be abandoned: The imposition of EU FTT would produce harmful effects to both the financial sector and the real economy. The initiative runs counter to the CMU because it will both increase fragmentation and inefficiency. It would first and foremost increase the cost of hedging for end-users, thus acting as a disincentive to manage risk. These increased costs would act as an obstacle to accessing financial markets, restricting liquidity, and ultimately hamper economic growth. It is crucial that cost-benefit analyses be conducted (and taken into account) before proposing new regulations that may have harmful effects on the liquidity of the market.

If adopted, the proposal to impose a broad-based EU FTT will deprive Investors and Corporates of valuable hedging tools, and undermine underlying financial markets (notably equity markets and debt markets) in FTT zone Member States.

It will also have negative economic impact on FTT zone Members States, businesses and investors because it would: a) force investors not to hedge or to sell their assets in more volatile markets; b) reduce liquidity, making it more costly for firms to hedge risks; c) create higher costs for participating countries and private Corporates based in these countries.

Finally, it will create a disadvantage for Issuers (both Sovereigns and Corporates) and Investors who are subject to the tax.

And obviously a very large part of market liquidity will be driven away from the FTT zone.

We therefore urge EU policy markets and the members of the FTT coalition to abandon this project.

Issue 3 – Investor and consumer protection

Derivatives markets are less affected by investor protection regimes since derivatives are wholesale markets. We however note that the inappropriate regulatory distinctions between cleared and non-cleared derivatives may indirectly affect retail investors and retail financial services users regarding investment in Money Market Funds and regarding mortgage credits. Please see below our response to the “Rules giving rise to unintended consequences” item

Example 1 – PRIIPs Regulation

- ISDA members strongly support the Packaged Retail and Insurance-based Investment Products Regulation and notably agree the integration of the EU retail product market will produce "choice, transparency and competition in retail financial services to the benefit of European consumers". The implementationof the Key Information Document (KID) is an important step towards the development of this market, and we wish to see this initiative succeed.
- The scope of the regulation needs to be refined. The question of which products the regime applies to is critical. PRIIPS is expressed to apply to "investments", but this is not a term with an established EU law meaning. Our view is that the primary meaning of the term "investments" is products which an investor purchases to obtain a return on the amount invested – that is, a term investment product in which investment is made at the beginning of an investment period, a return is paid at the end of that period, and a return is calculated by reference to a formula. It is also clear that the definition is intended to be based on functional rather than legal characteristics. This interpretation is supported by Recital 1 and the definition of PRIIP in Art 4(1) of the Regulation.
- The PRIIPS regulation applies to sales of products to a wide variety of commercial entities - municipalities, local authorities and many commercial companies. These entities have a positive requirement for risk management or hedging products, as well as for foreign exchange forwards and derivatives. The production of KIDs for such products is not only extremely challenging; it is uninformative since these products are not purchased as investments, but as risk management tools. Consequently we believe that the imposition of a KID requirement on such products would significantly impede access by these entities to useful financial management tools.
- In our view, there are two ways in which this problem might be addressed. One would be to confirm that products which do not have an investment purpose are not "investments" and therefore do not require a KID to be prepared. Another might be to provide that, where a product

is sold for risk management rather than investment purposes, a pro-forma KID making that fact clear would be required. Such a KID would omit the risk information required for a normal KID, and would simply state that the product concerned should not be regarded as an investment in the normal sense. It is also possible that there may be other available policy options. However, if something is not done to address this issue, the consequence may be to prevent the financial services system from providing essential risk management products to those who require them.

Issue 4 – Proportionality/ preserving diversity in the EU financial sector

Example 1 – Rules on bank structures

On proportionality and preserving diversity in the EU financial sector, the calibration of upcoming frameworks on bank structure is a major concern for market participants. See our response to the Issue 14 - "Rules giving rise to unintended consequences" item.

Example 2 – EMIR margin rules for non-cleared derivatives – sovereign concentration rules

We wish to point the joint committee of the European Supervisory Authorities' proposal of margining of non-cleared trades as part of EMIR Level 2 rules. In particular we highlight the second consultation paper dated 10 June 2015 and titled "Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012" in its articles 7 LEC 2 to Article 7 LEC 4.

The proposed rules for the EMIR level 2 margining of non-cleared trades have a sovereign concentration rule which requires that, for large users of derivatives, the amount of collateral supporting non-cleared OTC derivatives (for both variation and initial margin) cannot exceed 50% where the issues are from the same country.

We believe that the proposed issuer concentration limit, when applied to sovereign bonds issued by EU governments outside the Eurozone, would have significant adverse implications specific to users of non-Euro denominated OTC derivatives. This would include, for example, derivatives denominated in British sterling, the Polish zloty, the Hungarian forint and the Swedish krona.

We believe that it is inappropriate to apply the proposed issuer concentration limit on collateral to bonds issued by such sovereign issuers when used to collateralise derivatives denominated in the same non-euro currency.

To provide a practical example, a UK pension fund with British sterling-denominated liabilities would hold British sterling-denominated bonds, issued by the UK, and use British sterling-denominated derivatives to manage its financial solvency risk. Current market practice would allow the pension fund to collateralise the British sterling derivative contracts using UK government bonds. However, the sovereign concentration rule would prevent that, and would require the pension fund to collateralise at least 50% in non-UK bonds, such as Euro-denominated bonds, for example. This would introduce currency risk (both for the derivatives contract, and for the pension fund if it was incentivised to hold bonds in currencies other than its liabilities).

This rule would therefore increase, and not reduce, risk for countries outside the eurozone. We note that the BCBS/IOSCO international standards, and the US rules, do not have any concentration rules as part of the margining rules for non-cleared contracts.

Unnecessary regulatory burdens

The European Commission asks here for an analysis from the industry of the costs and benefits of regulatory burdens:

Issue 5 - Excessive compliance costs and complexity

Issue 6 – Reporting and disclosure obligations;

Issue 7 - Contractual documentation (e.g. unnecessary and disproportionate changes)

Issue 8 – Rules outdated due to technological change;

Issue 9 – Barriers to entry.

From ISDA members' perspective, the full implementation of the EMIR clearing obligation remains a source of questions which need appropriate answers. ISDA will make concrete proposals in the context of the EMIR review to enhance the framework applicable to clearing of derivatives.

ISDA's top priorites in relation to the view of the EMIR review are:

- Improving derivatives transparency with **rationalised reporting obligations**;
- **Indirect clearing** would be a solution to clearing access;
- **Removal of the frontloading obligation (also relevant under Issue 14/Risk)** would help reducing systemic risk and improving market efficiency. Frontloading raises issues regarding pricing and phase-in preriods, regarding documentation and regarding non-recognised CCPs;
- **Giving regulators the power to terminate or suspend the clearing obligation** would help improving CCP resilience and regulators' ability to actively combat systemic risk fallout **(also relevant under Issue 13/Gaps and 14/Risk)**;
- **Effective equivalence determinations (also relevant under Issue 2/Market liquidity and 9/Barriers to entry)**;
- **Product suitability** assessments for central clearing should be more granular and take into account risk characteristics **(also relevant under Issue 4/Proportionality)**;
- **Treatment of trades that result from systemically risk-reducing processes** should be exempted from the clearing mandate and rules governing the margining of non-cleared derivatives **(also relevant under Issue 4/Proportionality).**

These priorities are relevant to both Issues 5 and Issue 6.

Issue 5 - Excessive compliance costs and complexity and Issue 6 – Reporting and disclosure obligations;

EMIR REVIEW RESPONSE FINAL [19

Example 1 – Improving Derivatives Transparency: Rationalized Reporting Obligations

The primary objective of European reporting requirements is to provide regulators with increased transparency in derivatives markets in order to better enable the monitoring and assessment of risks that pose a threat to the stability of the financial system. However, since the start of dual-sided reporting requirements, experience has shown that the requirement has fallen well short of providing regulators with a clear and unambiguous set of data that allows effective monitoring of systemic risk, thus undermining a key part of the G20 objectives for the reform of derivatives markets. As a result of the operational complexity of the current regime, the on-going complications with implementation and the burden placed on non-dealer counterparties, significant trade data gaps exist today, thus undermining the ability of regulators to effectively assess systemic risk.

ISDA believes that these problems can in large part be addressed by rationalising the reporting regimes to only oblige the more sophisticated party to report, which we believe will significantly simplify the operational complexity associated with the current reporting requirements, lower costs, and in almost all cases remove the reporting burden for non-dealer derivatives users. We believe the simplification of the operational complexities associated with the reporting process combined with initiatives by regulators to improve the clarity and specificity of their requirements will lead to an improvement in the availability of quality data for regulators as resources can be deployed in a more focused way to improve data quality.

⇨ **Dual-sided reporting has so far not produced sufficient data quality and is operationally complex for all market participants (especially end-users):**
  - Overall current pairing rates at trade repositories is around 60%, whereas current confirmation rates for most asset classes are at or above 90%.
  - Efforts to address discrepancies in transaction reporting have revealed that differences in data reported by each party for the same transaction do not mean the parties don't agree on the terms of the transaction. In almost all cases, the discrepancy can be attributed to either: (i) fields that are required for reporting but are not material terms of the transaction or its confirmation (eg the Unique Transaction Identifier (UTI) or a party's legal entity identifier); or (ii) a difference in the way the data for the field is reported (eg, notional currency in ISO 4217 value (CAD) versus use of a non-ISO value (CND).

⇨ **An alternative rationalised EMIR reporting regime would establish a reporting model that can be exported across to reporting regimes in other regulations**
  - There is already movement in other regulations to explore the efficacy of having the reporting obligation fall on only one party. For example, in the Securities Financing Transactions Regulation (SFTR), ESMA is required to present an annual report to the European Parliament, the Council and the Commission on the efficiency of the reporting model.

To help achieve a more rationalised reporting requirement we have designed an initial blueprint, including suggested Level 1 changes, for a European OTC derivatives reporting framework for consideration by the Commission (uploaded blueprint). The blueprint is the result of a collaborative industry effort comprising both sell- and buy-side trade associations and their members (Alternative Investment Management Association (AIMA), British Banking Association (BBA), FIA Europe, Global Financial Markets Association (GFMA), Investment Association (IA), Managed Funds Association (MFA)).

In short, we believe that the reporting requirements should be re-designed as per below:

i. Non-financial counterparties (NFCs) that do not meet the conditions referred to in EMIR Article 10(1)(b) – ie NFC minuses – should be exempted from the reporting obligation (NFC minuses are already exempt from reporting collateral and valuation data).
ii. The reporting obligation should not apply to intragroup transactions for all non-financial counterparties, including those NFCs that do meet the conditions referred to in EMIR Article 10(1)(b).
iii. Exchange traded derivatives – derivatives which are not defined as OTC derivative as per EMIR Article 2(7) – should be exempted from the reporting obligation or be subject to single-sided reporting, which should be done on a position rather than trade-by-trade basis (ISDA supports and endorses the response of FIA Europe with regards to the issue of ETD reporting).
iv. The reporting obligation for cleared trades between a central counterparty (CCP) and clearing member (CM) should reside with the CCP, and with the CM for trades between a CM and counterparties for which it is providing access to a CCP (CMs or clients may be required to outsource the reporting or report trades themselves when clearing at third-country CCPs or clearing with third-country CMs).
v. The reporting party for non-cleared transactions should be determined via the use of a hierarchy (entity decision logic), which should be laid out in regulatory technical standards.

It is important to iterate that the blueprint seeks to establish a reporting hierarchy to support single-sided reporting (SSR) but does not otherwise suggest wholesale change to existing transaction reporting requirements as set out in the current RTS/ITS. While some changes to accountabilities and reportable data attributes would be necessary to enable SSR, key features such as reporting timeframes and transaction data should otherwise be left unchanged. This is important to preserve existing reporting solutions established by members and to minimise costs associated with implementing a rationalised reporting regime.

Example 2 – Solutions to Clearing Access: Indirect clearing:

The indirect clearing rules, as set out in Regulation 149/2013, are problematic from a clearing member perspective, and undermine the efficacy and objectives of the approach. ISDA is keenly aware of concerns that smaller derivatives users in Europe may be unable to access CCPs due to potential capacity constraints of clearing members, and that regulators view indirect clearing as a mechanism to help solve the access problem. The industry would agree with the benefits of indirect clearing in principle but the restrictions now placed on "compliant" indirect clearing arrangements are excessive and introduce novel legal and risk concerns. Redesigning the current ruleset will allow CMs to offer indirect clearing arrangements without being exposed to difficult-to-manage risks. However, we also firmly believe that clearing members should not be forced to offer such arrangements.

Porting under the indirect clearing rules might give rise to insolvency-based challenges against CMs. Protections afforded CCPs are not available to clearing members when acting to port assets and positions in the event of a failure of their immediate client, the indirect clearer. We do not believe that Regulation 149/2013 has the effect of overriding national EU member state insolvency regimes in this regard (and one must, in any event, cater for circumstances where an intermediary is not based in an EU member state, since non-EU entities may well also find themselves subject to the clearing obligation, directly or indirectly, or be providing intermediate clearing services).

Meanwhile, under the rules, clearing members are required to provide "a credible mechanism for transferring the positions and assets to an alternative client or clearing member, subject to the agreement of the indirect clients affected." Upon an indirect clearer's default however, the clearing member immediately has uncovered market risk for the open positions it holds at the CCP of entities whom it has not taken on as clients, has no direct recourse against and who may also be in default themselves at such point. Any arrangement which anticipates that clearing members take on indirect client risk for any period of time, in order to facilitate porting, fundamentally undermines the clearing member's ability to protect itself (and its other clients). These are novel and material risks.

Therefore, we believe that it is essential that revisions to the EMIR regime give appropriate recognition to the differences in scope of the EMIR clearing obligation which require specific consideration. In particular we believe that:

- It is ensured that indirect clients are able to choose to use recognised CCPs (and not just authorised CCPs) in order to satisfy EMIR clearing obligation. One cannot rely on practices at the CCP level to facilitate CM compliance since recognised CCPs will not be subject to detailed EMIR requirements.

- Indirect clearing requirements take account of complexities introduced by non-EEA regimes which may become relevant because of the location of the clearing member, indirect clearer or indirect client.

- Appropriate acknowledgement is given to the heightened risk profile of OTC derivatives, as to default profile and liquidity, when considering the risks assumed by clearing member and/or indirect clearer under an indirect clearing arrangement. In particular, limitations upon the obligation to make leapfrog payments for the prompt/direct return of assets to indirect clients should be explicitly acknowledged.

- Article 4 of EMIR should be amended to state that requirements detailed in the relevant RTSs shall prevail over any conflicting insolvency and other laws, regulations and administrative provisions of a Member State.

- The requirement to facilitate the porting of positions of assets of indirect clients should be removed.

- Clearing members should not be obligated to offer net omnibus segregated accounts (NOSA).

Example 3 – Reducing systemic risk and improving market efficiency: Removal of the frontloading obligation

ISDA believes that the frontloading requirement creates significant pricing and market risk management challenges, particularly where bilateral collateral terms differ from CCP collateral terms, which can impact financial stability. It also creates significant challenges for EU counterparties pricing trades in the absence of counterparty classification information especially when trading with non-European counterparties. Thus we believe that the obligation should be removed for all future classes of derivatives declared subject to the clearing obligation.

Pricing issues, systemic risk and undermining phase-in periods

Even though counterparties (classed as Category 1 and 2 under current proposals from ESMA) entering into or novating OTC derivatives during the frontloading window will know the classes of derivatives that will be subject to the clearing obligation, the CCPs currently authorised or recognised to clear those derivatives, the date on which that obligation begins to apply and the minimum remaining maturity at that date above which the clearing obligation applies, market participants will be unable to accurately price trades that will be cleared at a future date – which will likely lead to a divergence in pricing and overall market disruption, and necessitate the introduction of documentation solutions requiring negotiation and agreement between counterparties.

- Contracts traded bilaterally are typically priced as a function of the credit support annex (CSA) associated with the contract. In cash-collateralised trades, the rate at which interest is paid on received collateral is the rate used to discount the future cash-flows of the derivative – this is generally accepted to be the relevant OIS rate. For example, the cash flows of a US dollar-denominated fixed-to-floating interest rate swap collateralised with US dollars will be discounted using the Fed Funds rate. Whereas, if the contract was collateralised with Euros, the discount rate would have to take into account the term basis swap between the currency of exposure (dollars) and that of the collateral (euros).

- Clearing houses typically require that the currency of the derivative determine the currency of the mark-to-market collateral posted daily (variation margin) – for example, a US dollar-denominated derivative has to be collateralised with US dollars, and is therefore valued using the Fed Funds rate. However, derivatives concluded in the bilateral space are subject to a plethora of different collateral agreements – ranging from single currency CSAs to multi-currency, multi-instrument CSAs (many of which allow the posting of non-cash assets such as corporate bonds). Many trades are also uncollateralised, and are typically discounted at a given dealer's own costs of funds.

- As a result, many OTC derivatives traded bilaterally in the frontloading window will be subject to a re-pricing adjustment at the point they are frontloaded into a CCP. If this future revaluation is not reflected at trade inception, one of the parties will suffer a loss when the trade is cleared. But pricing a trade, which will be valued differently at a point in the future, can be very complicated. Dealers may therefore have to adopt a hybrid pricing approach that incorporates the assumption of one discount rate for the period until the contract is cleared, and another for the remaining life of the contract, or price a transaction as if it were to be cleared immediately after execution

- Both the hybrid pricing approach and the price to clear approach are likely to result in less efficient pricing. This issue is likely to be compounded where a bilateral trade can be cleared at more than

one CCP, since the pricing for clearing at each eligible CCP may differ. The parties to a frontloadable trade may therefore need to pre-agree the CCP where they intend to clear the trade, even though the counterparty does not have clearing arrangements in place with the CCP at the point of execution.

- While the hybrid pricing approach is typically employed by dealers when valuating OTC derivatives backed by multi-currency CSAs (the discount rate for a given period of time is determined by the currency of collateral posted, which is usually the collateral cheapest to deliver during that period), there are a variety of different pricing approaches employed, each of varying complexity. And because there is no agreement among market participants as to how to price trades backed by multi-currency CSAs, valuation disputes are frequent and have caused substantial market disruption.

- Frontloading de facto imposes exactly the same pricing difficulties, even on plain vanilla OTC derivatives collateralised with a single currency.

- However, while dealers are able to estimate the point at which the discount rate will change in a multi-currency CSA – the point at which a currency becomes the cheapest to deliver as implied from forward discount curves – a dealer will not know the exact date on which the trade will be frontloaded, allowing it to identify the change in discount rate. Because clients can decide to frontload trades at any date from the start of the frontloading period up until the end of the phase-in period, dealers will be forced to make an assumption as to when the discount rates will change, or otherwise price the trade as a cleared trade from inception.

- The pricing is further complicated by the fact that a counterparty may not have a clearing arrangement in place at the time the clearing obligation takes effect. Because clearing members are likely to be unwilling to pre-commit to clear the contract when the clearing obligation becomes effective, dealers cannot be sure that the trade will be cleared at all, and will be forced to assign into the pricing a probability that the trade will clear (by widening the bid-offer). If the client has been unable to put the requisite clearing arrangements in place at the pre-agreed CCP, the trade may end up having to be terminated (see below).

- A consequence of being unable to price OTC derivatives accurately means that trades which have not been priced as if they are being cleared from execution, will need to undergo pricing adjustments when frontloaded into CCPs, forcing market participants to make rebalancing payments. If many participants were to backload their trades on the date that the clearing obligation takes effect (at the end of the 12-month phase-in period for trades with Category 2 counterparties) market participants would have to calculate, negotiate and execute large numbers of balancing payments. Individual firms may simply not have the bandwidth to negotiate potentially hundreds of portfolios on a single day.

- Concurrently, the risk that some counterparties may have been unable to put clearing arrangements in place (at the agreed CCP) by the end of the frontloading period, in combination with pricing and valuation uncertainty, could force very large numbers of contracts to be terminated or assigned. This requirement would arise simultaneously at the clearing obligation application date for all trades remaining uncleared, causing major disruption and having a detrimental effect on the stability of financial markets. Parties who wish to rely on frontloading will need to have negotiated bilateral amendments to their ISDA agreements with all their trading counterparties, to incorporate the necessary termination rights. The legal and operational process

surrounding a mass termination exercise would also be considerable, with dealers being requested to provide potentially thousands of independent valuations, and would be exacerbated by the feedback loop from pricing uncertainty which would introduce an element of contention into the calculation of close-out amounts.

- For the reasons summarised above, the frontloading obligation has presented the market with significant implementation challenges. To the extent it is expected that allowing a frontloading period will reduce disruption in the market upon the introduction of the clearing mandate, we note that the market suffered little, if any, disruption in the US where mandatory clearing obligations were implemented without frontloading.

- Moreover, if the only practical response to the frontloading requirement for these contracts is for counterparties to submit them for clearing immediately following execution, this could also undermine the other objectives of the phase-in period.

Documentation burden

Frontloading applies only to Category 1 and Category 2 counterparties. However, because Category 2 counterparties comprise financial counterparties (and alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU that are non-financial counterparties) not belonging to Category 1 which belong to a group whose aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives is above EUR 8 billion, this adds an additional layer of counterparty classification not referenced in EMIR Level 1, and means dealer firms need to document which counterparties belong to such category. However, while the industry has made significant strides towards facilitating an industry-wide categorisation solution in the form of ISDA Amend, it is conceivable that some counterparties will not make use of the solution and firms will be required to engineer a large bilateral communication exercise with their counterparties which will be disproportionately expensive, and potentially confusing and time-consuming for smaller counterparties.

If dealers are unable to ascertain from their counterparty in which Category the counterparty resides, many dealers might feel bound to take a conservative default approach when dealing with uncategorised FC counterparties and having to deem many counterparties to be Category 2, incorrectly forcing the practical challenges of frontloading upon many entities that should have been excluded by use of the thresholds test. These problems are magnified with Third Country Entity (TCE) counterparties, since none of them will be aware of the requirements, nor willing or able to address those requirements.

It is also important to note that the requirement that FCs not falling within Category 1, undertake the threshold calculation at group level, will not be a simple process. As FCs, such counterparties will never have had to make such an assessment for clearing threshold purposes. The assessment will therefore be one which requires all FCs (other than Category 1) to: (i) identify what is their "group" for these purposes, (ii) establish arrangements with all such group companies to be able to access and collate information on OTC derivatives positions. This in itself is a material legal and operational project. It cannot be assumed that such data will be readily accessible. Experience of "group" assessments in the NFC context suggests that this is not a straightforward task.

Frontloading and non-recognised CCPs

Another major concern arises if firms clear OTC derivatives traded during the frontloading window at CCPs that have not yet been authorised or recognised by the time the clearing obligation enters into effect. If firms clear OTC derivatives traded during the FL window at CCPs that have not yet been authorised/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.

If equivalence agreements remain outstanding for certain jurisdictions – using the US as an example – and ESMA is not in a position to recognise non-EU CCPs before the relevant FL start date, the following practical problems and detrimental consequences will result:

Category 1 firms

- **Loss of risk management flexibility** – any artificial disincentive to clearing on US CCPs would compromise the ability of Category 1 firms to both manage their risk and margin requirements on their historical positions by putting on or taking off positions. This includes being able to participate in multi-lateral compression exercises. Managing trade life-cycle events, such as being able to clear swaps resulting from the exercise of physically-settled swaptions that have been contractually agreed to be cleared at a given CCP, will also be impeded.

- **Liquidity provision to end-users could be impeded** – while Category 1 firms would be able to clear derivatives traded with non-Category 1 firms (except Category 2 firms subject to the frontloading requirement from May 21) during the frontloading window at US CCPs (without the possibility of those trades having to be extinguished and reopened in the event of non-recognition of the given CCP), the Category 1 firm would be disincentivised to clear its hedge transaction (which would most likely be traded with another Category 1 firm) at the same CCP because the position would be subject to the relocation pre-conditions outlined above. Instead, firms would be incentivised to clear the hedge transaction at an authorised or recognised CCP – which would split the firm's netting set, increase its risk position and margin requirements, thus impacting the depth and efficiency of liquidity provision and thereby potentially impeding the access clearing member firms provide to clients (including clients that are not Category 1) to clearing on US CCPs.

- **Pricing risks and exacerbation of inter-CCP bases** – In the event firms do clear trades at US CCPs, they will price the trade according to the US 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 frontloading period, the trade will have been mispriced given the pricing differences which currently exist in relation to certain trades

executed on different CCPs. What is more, if a significant number of counterparties seek to extinguish and reopen positions at the same time, the pricing basis that exists between CCPs could be severely exacerbated causing unwanted volatility and stress in the market.

- **Scalability of EMIR authorised/recognised CCPs** – CCPs that are also registered derivatives clearing organisations (DCOs) will be the only CCPs able to facilitate clearing of G4 IRS products in satisfaction of both the CFTC and EMIR clearing obligations without the need for any equivalence determination. It remains to be seen whether those CCPs have scalability to clear substantial volume of additional trades that would normally be cleared in US CCPs, which are not also recognised under EMIR.

Category 2 Firms

Unlike Category 1 firms, Category 2 firms by definition do not necessarily have the ability to clear at least one of the classes of rates derivatives subject to the clearing obligation at an authorised or recognised CCP – in that it is possible that some Category 2 firms (both US and European firms) only have clearing arrangements in place at US CCPs, therefore, in addition to the practical consequences outlined above, the following may also result:

- Category 2 firms will be required to set up costly alternative clearing arrangements with an additional EMIR authorised or recognised CCP prior to the start of the frontloading 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 in excess of three months, particularly because clearing documentation differs between US and European standard templates, 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 clear on US CCPs in products subject to the EMIR clearing obligation, thus fragmenting markets. This will likely result in increased trading costs for end-users as a result of liquidity fragmentation and loss of market efficiencies.

Example 4 – Improving CCP Resilience and regulators ability to actively combat systemic risk fallout - Giving regulators the power to terminate or suspend the clearing obligation

ISDA believes that it is of great concern that ESMA does not have the ability to terminate or suspend as a matter of urgency (i.e. within a few days) the clearing obligation in respect of a specific class (or contracts within a class). Specifically, we believe it is critical that ESMA have the tools to dis-apply the clearing obligation in the event that (i) a CCP notifies ESMA that the liquidity of a class (or contracts within a class) as defined under Article 7(2) of Commission Delegated Regulation (EU) No 149/2013 has deteriorated to an extent that it may become difficult for the CCP to risk manage such derivative class and/or (ii) the liquidity of the class (or contracts within a class) becomes materially less than that on the basis of which ESMA originally determined to make the relevant class subject to mandatory clearing.

Specifically, in such cases and in the absence of a termination or suspension of the clearing obligation, CCPs may find themselves clearing more risk in a contract or product than there would be market capacity to manage upon a member default, or the default of another CCP. A CCP may therefore have no option but to encourage participants to reduce these cleared positions by increasing margin requirements to levels at which it is uneconomic to hold the positions, and thus force the risk to be closed out. Participants would not then be able to replace the closed out cleared contracts with uncleared contracts, as the clearing obligation would still apply in respect of those contracts, leaving hedgers exposed and potentially forcing them to contract their businesses. In contrast, if the clearing obligation were terminated, firms would be afforded the option to de-clear the product and maintain their positions on an uncleared basis.

We also believe that if a CCP which clears a specific class of instruments is de-authorised or de-recognised, this may undermine the basis on which ESMA originally determined to make the relevant class subject to mandatory clearing. Therefore, upon de-authorisation/de-recognition, we believe it would be necessary for ESMA to review the classes of instruments which have been made subject to the clearing obligation to assess whether, in light of such de-authorisation or de-recognition, it is still appropriate for certain classes of instruments to continue to be subject to mandatory clearing.

It is also worth noting that the European Systemic Risk Board (ESRB), in its EMIR Review response[8], has similarly recommended that the EMIR provisions should include the possibility of, and the conditions to be fulfilled, for a swift removal or suspension of the clearing obligation for certain classes of derivatives if the relevant market situation so requires. According to the ESRB, from a macro-prudential standpoint, the mandatory use of CCPs for contracts that no longer have the characteristics qualifying for compulsory central clearing can lead to unintended consequences in terms of CCP exposures on potentially illiquid financial instruments and significant changes in margin requirements, possibly leading to procyclical implications.

Example 5 – Equivalence determinations

Article 13 Equivalence – Mechanism to avoid duplicative or conflicting rules

Positive equivalence determinations under Article 13 are crucial for the purposes of avoiding duplicative or conflicting requirements for clearing (EMIR Article 4), reporting (EMIR Article 9), the treatment of non-financial counterparties (NFCs) (EMIR Article 10), and risk mitigation techniques for non-cleared trades, including, in due course, margin requirements (EMIR Article 11). The absence of equivalence decisions, particularly for the purposes of clearing and margin requirements, could put the international operations of many firms at a competitive disadvantage by requiring, for example, that margin be posted and collected multiple times. Such an outcome would harm not only banks but their clients too, many of which are major European corporates that make significant contributions to outbound and inbound trade and investment flows from Europe to non-EU markets. This would act contrary to the objectives of the Capital Markets Union, which designed to spur economic growth in Europe by rebalancing Europe's funding mix to ensure savings are deployed towards business growth and job creation.

From ISDA's perspective, it is therefore essential that the Commission works closely with other regulators in third countries to develop plans for equivalence and further clarify the practical application mechanics of equivalence. Given EU firms and some of their EU or non-EU counterparties are active in most major markets across Africa, the Asia-Pacific region, the Middle East, Latin America, Switzerland and the US, we

8 https://www.esrb.europa.eu/pub/pdf/other/150729_report_other_issues.en.pdf?d4d412dca869f6c678a4be5d7dc58984

are particularly concerned that the absence of such equivalence decisions could have significant negative impacts on the provision of financial services in, and effective functioning of, those markets to local players, EU firms, their EU and non-EU counterparties, and also to European clients looking to access overseas markets.

Practical application of Article 13 equivalence

ISDA-FIA Europe-MFA-IA-AIMA

We understand that an EC equivalence decision under Article 13 would effectively mean that counterparties entering into a transaction subject to EMIR will be deemed to have fulfilled the obligations contained in EMIR Articles 4, 9, 10 and 11 where at least one of the counterparties is established in a third country declared equivalent. However, it is not fully clear how this principle would apply in practice to trades with counterparties established in, and/or subject to the rules of, an equivalent jurisdiction (particularly an equivalent jurisdiction in which neither counterparties is established).

We believe that when EU counterparties trade with counterparties established in, or subject to the rules of, an EMIR Article 13(2) equivalent jurisdiction, the parties should be permitted to mutually agree which set of equivalent rules would apply to a particular trade between them, based on considerations such as the jurisdictional nexus of the trade and any other rulesets to which the counterparties are subject. This flexible, pragmatic approach would allow for situations where EU firms entered into transactions with counterparties that are obliged to comply with another ruleset – for example, where an EU-counterparty trades with a non-US entity that is majority-owned by US investors (including an investment fund), which is treated by the CFTC as a US Person regardless of where it is established, the parties would need the ability to defer to US rules.

We believe, in order to facilitate such outcome Article 13(3) should be amended so that the implementing act referred to in Article 13(2) shall imply that counterparties entering into a transaction subject to EMIR shall be deemed to have fulfilled the obligations contained in Articles 4, 9, 10 and 11 where at least one of the counterparties is established in, or subject to the rules of, a third country, whose legal, supervisory and enforcement arrangements are deemed equivalent under Article 13(2).

We also believe that EMIR Article 13(3) should each allow for separate equivalence acts to be adopted regarding the obligations contained in EMIR Articles 4, 9, 10 and 11, instead of a single all-encompassing equivalence act, and that any assessment of equivalence for the purpose of EMIR Article 13 should follow an outcomes-based approach.

We also believe that unlike with EMIR Article 25, where the equivalence process was triggered by the submission of an application by a CCP, EMIR Article 13 does not provide any guidance with regards to the process or timeline for the delivery of equivalence decisions. As a result, we believe that while the EC should seek to engage with third country regulators, it should not be a requirement for third countries to have to apply for an EC equivalence determination.

Lastly, to the extent that EMIR Article 13 is ambiguous as to the potential for the EC to adopt transitional provisions pending equivalence decisions, clarification should be given to allow the Commission to adopt temporary equivalence determinations. This is particularly important in the context of requirements governing the margining of non-cleared derivatives.

Current draft rules require EU parties to post collateral to non-EU parties, which creates a potential conflict with rules of other countries that require the collection of margin. It is therefore critical that equivalency determinations be made as soon as possible after the relevant margin rules are adopted, and before the compliance date of the draft rules. If the EC is unable to grant permanent equivalence decisions before the compliance date, we believe it should grant temporary equivalence decisions for those jurisdictions that have issued, or are in the process of issuing, margin rules based on the global BCBS-IOSCO framework.

Regulators from multiple jurisdictions have developed a framework for consistent margin rules, as set out in the BCBS-IOSCO Framework, through an extensive consultative process. The US and Japanese regulators have proposed margin requirements based on the BCBS-IOSCO Framework. Other jurisdictions may issue similar rules in the near future. Because these rules have already been considered and debated during the lengthy BCBS-IOSCO process, an equivalency determination should be significantly easier than for rules developed independently by different regulators. Given the volume of OTC derivatives between market participants in the EU, US and Japan, it is critical that such an equivalency determination be made as soon possible so that parties can make appropriate arrangements before the compliance dates.

A temporary exemption would also be required for jurisdictions without margin requirements (for a period of two years), where EU rules will be very difficult to implement. Parties in such jurisdictions will not have familiarity with the rules and do not have the same regulatory incentives to take the needed operational and documentation measures. Market participants in the EU can educate counterparties but such education and the subsequent implementation will take time. Without a phase-in, many counterparties in jurisdictions without margin rules will not be able to post or collect margin by the compliance dates and will therefore be unable to trade with counterparties in the EU.

Article 25 Equivalence – Recognition of third country CCPs

The Commission's current efforts regarding the equivalence assessment of the legal and supervisory framework of third-country CCPs, which is a prerequisite for recognition of such CCPs by the ESMA, is of vital importance for market participants. The combination of a lack of third-country CCP recognition and the expiry of the transitional provisions related to own funds for exposures to CCPs in the Capital Requirements Regulation (CRR), could severely impact European firms acting on a cross-border basis as EU banks and investment firms would not be able to continue to apply qualifying CCP (QCCP) capital treatment to CCPs not recognised by ESMA. Such concerns are problematic not only for EU firms' continued access to third-country CCPs that have applied for recognition under EMIR, but also for EU firms' access to CCPs established in other third-country jurisdictions.

To this end, we welcome the recent extension of the CRR transitional period. We also welcome the first sets of 'equivalence decisions' for the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore. With the CRR transitional period extended by a further six months we would encourage the EC to continue its work with other jurisdictions, like the US, to ensure that positive equivalence assessments are complete as soon as possible so that ESMA is able to recognise CCPs latest by 15 December 2015 for all jurisdictions where CCPs have applied to ESMA for recognition.

In addition to the jurisdictions where CCPs have applied for recognition, we would also like to stress the importance of EU leadership when it comes to equivalence decisions for jurisdictions whose CCPs may not yet have applied for recognition but are adhering to the Committee on Payments and Market Infrastructures (CPMI) and International Organization of Securities Commissions' (IOSCO) Principles for Financial Market Infrastructures (PFMIs). CCPs from these jurisdictions would have a strong incentive to apply for recognition where equivalence decisions are already in effect. Such jurisdictions, including China, Russia and Turkey represent important emerging markets and European financial firms should be given the opportunity to participate in such markets without experiencing burdensome capital requirements which could place severe limitations on the amount of business transacted by EU firms in these jurisdictions, and in the worst case could force some firms to pull out altogether.

We would like to reiterate the importance of continued regulatory dialogue with foreign regulators on achieving cross-border recognition of third country CCP regimes:

- From a capital perspective: EU firms will incur onerous capital requirements if they (or their consolidated EU and non-EU subsidiaries) continue to access third-country CCPs that have not yet been recognised, or have simply failed to apply for recognition; and

- From a clearing perspective:
  - For clearing of derivatives subject to the EMIR Clearing Obligation, EU counterparties may be unable to clear OTC derivatives contracts through non-EU CCPs that have not been recognised under EMIR by the time the Clearing Obligation comes into effect in mid-2016, even if clearing via a local clearing member (see frontloading concerns under Question 2.2).
  - For clearing of derivatives cleared on a voluntary basis (not subject to the clearing obligation), Article 25 EMIR only allows non-EU CCPs (which have failed to apply for recognition with ESMA by 15 September 2013) to provide clearing services to EU clearing members if the non-EU CCP applies for and receives recognition under EMIR (although the non-EU CCP can provide clearing services, in this instance, via a local unaffiliated clearing member or local subsidiary).

We also believe that some of the issues raised above can be alleviated by:

- Decoupling the link between CCP recognition under EMIR and QCCP treatment under the Capital Requirements Regulation, so that third-country CCPs that do not apply for EMIR recognition can still qualify as QCCPs, which would allow non-EU affiliates or subsidiaries of EU firms to continue clearing at such third-country without incurring punitive capital requirements on their exposures.

- Permitting EU firms to be clearing members of unrecognised CCPs provided that the CCP complies with the CPMI-IOSCO's PFMIs (with the caveat that such clearing member will not be allowed to clear house business subject to the EMIR clearing obligation through such an unrecognised CCP).

- Clarifying that not all OTC derivatives cleared by non-EU recognised CCPs will potentially become subject to the mandatory clearing obligation. Rather than require ESMA to consider all OTC derivatives cleared by a non-EU recognised CCP, there should be an initial threshold applied to give market participants more certainty about which contracts may potentially become subject to mandatory clearing, and to reduce the burden on ESMA.

- Allowing a third-country regime to be considered equivalent in respect of all CCPs established in that third country or just a particular class of CCP (or CCP service).

- Adopting a pragmatic approach with regards to EMIR Article 25(2)(d) requirement, which is too inflexible. Some of the jurisdictions from which third country CCPs have applied for recognition are not included in the list (i.e. out of 16 jurisdictions the following are not considered equivalent for AML purposes: Dubai, Israel, Malaysia and New Zealand).

Example 6 – CCP Resilience – (i) Product suitability assessments for central clearing should be more granular and take into account risk characteristics; (ii) Limited recourse clearing services; (iii) CCP Skin-in-the-game; (iv) CCP Governance

Product suitability

A clearing mandate for a certain class of OTC derivatives should only be imposed if the class is sufficiently liquid and standardised, if CCPs have a proven track record of clearing and risk-managing the product, and there is sufficient price reliability and liquidity in the given class. A requirement to clear products that do not meet this criterion will not only increase systemic risk, but also drain liquidity in the product making it more difficult for market participants to effectively manage risk. In particular, for products for which there is *limited market capacity in a time of stress* to absorb a defaulting member's or members' cleared risk, a clearing mandate would be most inappropriate.

ESMA is required to take into consideration, when specifying which classes of derivatives should be subject to a mandatory obligation, the degree of standardisation of the contractual terms and operational processes of the relevant class of OTC derivatives; the volume and liquidity of the relevant class of OTC derivatives (including the proportionality of margins, the stability of market size and depth, market dispersion, and the number and value of transactions); and the availability of fair, reliable and generally accepted pricing information in the relevant class of OTC derivatives.

However, we believe that when analysing the liquidity of a class of instrument for central clearing, in particular non-linear products, the risk characteristics (or factors) of a given product need to be taken into account. For example, if ESMA was required to consider whether EUR or US dollar swaptions were appropriate for central clearing, the liquidity analysis should extend to determining the ability of the market to absorb a given amount of vega and gamma in a stressed market. Therefore, we believe that the rules governing the suitability assessment of product sets for central clearing should be more granular and take into account conservatively the market capacity to absorb the product's risk factors in times of stress. We recommend that as part of the EMIR Review, the Commission should mandate ESMA to consult on the development of more detailed product suitability assessments by class, inclusive of the aforementioned granular risk characteristics (or factors).

Limited recourse clearing services

ISDA believes that CCPs should offer legally separate, segmented and limited recourse clearing services for each asset class or other class of instruments or liquidation group to reduce contagion risk.

If the default fund of a particular clearing service is exhausted post the default of a CM, a limited recourse service prevents contagion by barring the CCP from drawing on the default resources belonging to other clearing services. Without limited recourse, the resolution process would become more complex as a default in one clearing service could bring down all of a CCP's clearing services, which would lead to less resilient CCPs and possible contagion across the financial system.

Therefore, CCPs that offer multiple clearing services should establish separate default funds for each service, with no recourse to the default funds of the other limited recourse clearing services. CCPs should also be prevented from being able to borrow from or use the non-depleted pre-funded resources available in other limited resource services under resolution.

CCP Skin-in-the-game (SITG)

ISDA believes that current rules for determining the minimum dedicated resources CCPs should contribute to the default waterfall are inadequate. We recommend CCP skin-in-the-game (SITG) should be risk-based and scale with the level of activity being cleared.

According to Article 35(2) of 153/2013, a CCP shall calculate the minimum amount it shall keep of dedicated own resources in the default waterfall, by multiplying the minimum capital, including retained earnings and reserves, held in accordance with EMIR Article 16 and EC Delegated Regulation 152/2013 by 25%. However, such sizing of CCP own resources to be used in the default waterfall is not adequate given that current regulatory capital is not designed to cover credit and market risk from cleared portfolios given the capital calculation nets all financial resources from cleared exposures.

CCP SITG should be risk-based and scale with the level of activity. We believe further work is needed in determining appropriate CCP SITG, and urge the EC to explore alternative measures such as a percentage of DF, percentage of stressed losses or CCP profits etc.

CCP Governance

ISDA believes that EMIR is not sufficient with respect to the role of CCP Risk Committees (RCs). We believe that more needs to be done to ensure that RCs are effective in directing the CCP executive. In particular we believe that:

- CCP rules should require that the RC is consulted and that its views are considered by the CCP on all material matters (for example the development of margin models, anti-procyclical measures, default management process etc) that impact membership risk/exposure at the CCP.

- CCPs should prescribe explicit requirements in terms of background (risk/trading/ operational), and seniority/years of experience of member/client/independent reps on the RC to ensure that they have a well rounded mix of skill sets and benefit from a diversity of perspectives and expertise.

- The role of an RC representative should be that of an expert that provides an independent opinion on a CCP's risk management strategy (including any proposed changes) and its impact on CCP stability, market integrity, as well as impact on users. RC representatives should be encouraged to

provide their own views as experts, and these views may differ from membership views expressed by others at their respective employing entity.

- Confidentiality agreements should be reasonable and should allow RC representatives to seek out additional expertise from within their firms, when needed, in order to effectively perform in their RC role.

- CCPs should be required to implement mandatory "Member Consultation" processes, with a full audit trail required on certain risk-related decision items, alongside RC review. Such a forum would provide members with the opportunity to represent their own interests

- RCs should review and opine on stress scenarios, assumptions and stress testing results on a periodic basis (at least quarterly). In addition stress scenarios and procedure should be subject to a rigorous validation process by an independent party as initial margin models should be.

- Notwithstanding RC approval, CCPs should necessarily be required to consult with member risk groups on the adequacy and appropriateness of stress scenarios and other assumptions before major changes are implemented.

- A CCP's default fund framework should be approved by the RC.

Example 7 – Treatment of trades that result from systemically risk-reducing processes should be exempted from the clearing mandate and rules governing the margining non-cleared derivatives

New and amended trades that result from systemically risk-reducing processes such as multilateral portfolio compression cycles which result from original trades prior to the implementation of the rules governing the clearing obligation or the margining of non-cleared derivatives should be exempt from the clearing mandate and bilateral margining rules. If these post-trade risk reduction trades are not exempted this would:

(i) cause a divergence between the application of the mandatory clearing regimes of the CFTC (which specifically exempts amended transactions from the clearing obligation where the nature of the modification is a partial reduction in notional principal and all other terms of the trade remain unchanged (i.e. risk-reducing compression trades)) and EMIR (http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-01.pdf);

(ii) act as a significant disincentive for firms to participate in both multilateral and bilateral compression exercises, thus frustrating the key EMIR objective of reducing counterparty credit risk; and

(iii) introduce new pricing risks for market participants.

Typically, there are two types of compression mechanisms: the replacement swap method and the amended swap method. Under the former, a compression cycle will result in the termination of existing derivatives which will be replaced with new derivatives, with the effect of reducing notional exposure between counterparties. Under the amended swap method, the notional value between counterparties is

reduced by amending the original derivatives. In both cases, if the new or amended derivatives were to become subject to the clearing obligation, market participants would be presented with significant pricing risks.

- This is because while compression cycles are not designed to change risk or the overall mark-to-market of positions, the requirement to then backload the resultant trades into CCPs will do just that.

- Derivatives traded bilaterally will have been priced taking into account their associated underlying collateral agreements. Contracts traded bilaterally are typically priced as a function of the CSA associated with the contract. In cash-collateralised trades, the rate at which interest is paid on received collateral is the rate used to discount the future cash-flows of the derivative – this is generally accepted to be the relevant OIS rate. However, because derivatives concluded in the bilateral space are subject to a plethora of different collateral agreements – ranging from single currency CSAs to multi-currency, multi-instrument CSAs – backloading the trades into a CCP, where it is required that the currency of the derivative determine the currency of the collateral (variation margin), can result in significant pricing adjustments.

- As there is no industry consensus on how to agree a price to backload trades into clearing – given the differences in discount curves applied and the divergence in approaches when it comes to valuing multi-currency CSA optionality – there is no way to incorporate these pricing differentials into the compression process itself.

- Even if a common pricing approach could be developed and agreed by all participants, a possible outcome may be that compression cycles are run in future to only include either counterparty who will clear all results, or counterparties who do not have to clear any of the results. This bifurcation or any reduction in the number of participants would substantially reduce the effectiveness of all such cycles in reducing outstanding notional and trade count.

- In addition, there would also be significant technical and operational challenges to overcome, particularly as it relates to clearing the resultant trades. There are two different approaches, each with their own challenges. The 'one-step' process would require the involvement of CCPs in the process itself to risk accept trades through compression. However, at present there is no connectivity or infrastructure in place between CCPs and multilateral compression providers. This would be necessary in order to clear trades straight out of a compression cycle, but would take some time to design and build, and would require the active participation of CCPs. It may potentially also require multiple CCPs to be connected for a single compression cycle where more than one clears the relevant products.

- A 'two-step' process would require that replacement trades are given back to counterparties who would then submit them to their chosen CCP for clearing as a separate step. But this would require bulk trade submission to CCPs, and for CCPs to be able to handle such submissions in a timely manner from multiple industry participants. Furthermore, if the products being compressed were subject to existing US real time clearing submission rules, or in future if they were to be subject to tight time constraints under Article 29 of MIFIR for clearing submission, it would be extremely challenging operationally to execute a compression, then negotiate backload pricing for resultant trades and submit for clearing within prescribed timelines. This approach would introduce substantial new intraday market, counterparty and operational risk for firms if any replacement

trades resulting from a compression failed to be accepted for clearing for any reason, a situation where the replacement trades would in theory need to be unwound in bulk.

- Subjecting resultant trades to the clearing obligation could also undermine other risk mitigation requirements required by EMIR. According to Article 14 of Commission Delegated Regulation (EU) 149/2013 (as required by Article 11 of EMIR), "financial counterparties and non-financial counterparties with 500 or more OTC derivative contracts outstanding with a counterparty which are not centrally cleared shall have procedures to regularly, and at least twice a year, analyse the possibility to conduct a portfolio compression exercise in order to reduce their counterparty credit risk and engage in such a portfolio compression exercise." If a counterparty has taken the decision to no longer trade OTC derivatives, firms will not engage in a bilateral compression of legacy trades, as it is unlikely that the counterparty will have set up a clearing arrangement, and cannot or will not clear the resultant trade. This would impede firms' ability to fulfil their obligations under Article 11 of EMIR.

Therefore, we believe ESMA should exclude from the clearing obligation and the margining of uncleared derivatives any replacement trades and amendments to trades (which could include notional increases or decreases) that result from portfolio compression and other post-trade risk reduction exercises. As a starting point, ESMA could define 'portfolio compression' as contained in Article 2(47) of MIFIR, which states:

> '*portfolio compression' means a risk reduction service in which two or more counterparties wholly or partially terminate some or all of the derivatives submitted by those counterparties for inclusion in the portfolio compression and replace the terminated derivatives with another derivative whose combined notional value is less than the combined notional value of the terminated derivatives*.

It should be noted, however, that while compression can result in some derivative transactions being reduced and terminated or terminated and replaced, compression can also (i) result in fewer transactions, without any reduction in notional amounts, for example, in the case of a compression re-couponing exercise or, (ii) involve the addition of new trades, which reduce counterparty credit risk.

ESMA should also define 'other post-trade risk reduction services' such that components of non-price forming post-trade risk reduction services which reduce non-market risks in derivatives portfolios shall mean only components of a compound transaction where:

- the transaction is designed to be overall market risk neutral for each participant;

- the participants of the transaction do not submit bids and offers to enter into a specific position;

- the transaction is cycle-based and multilateral (e.g. including at least two participants), and must be accepted in full by all participants or it will not be effected; and

- the transaction is designed to reduce secondary risks emerging from existing derivatives transactions, such as counterparty credit risk, operational risk and/or basis risk.

<u>Recognition of unique status of post trade risk reduction mechanisms in other regulations.</u>

We believe there is already recognition in other regulations of the unique status of post-trade risk reduction trades that serves as a precedent for excluding these trades from the clearing obligation:

- According to Recital 27 of MIFIR, the obligation to conclude transactions in derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation on a regulated market, multilateral trading facility, organised trading facility or third country trading venue should not apply to the components of non-price forming post-trade risk reduction services which reduce non-market risks in derivatives portfolios including existing OTC derivatives portfolios in accordance with EMIR without changing the market risk of the portfolios;

- According to the Questions and Answers – Implementation of the Short Selling regulation, Question 8g asked:

  "*A replacement trade is a practice used in compression service for CDS. They aims partially terminate a CDS and subsequently replace with a new swap corresponding in economic terms with the trades they replace. With respect to sovereign CDS concluded before 25 March 2012, are replacement trades on these CDS deemed to fall under the transitional measures set out in Article 46(2) of the Short Selling Regulation (sovereign CDS concluded before 25 March 2012 may be held until the maturity date of the contract even if such CDS result in an uncovered position)? Or should such replacement trades be subject to Article 14 of the Short Selling regulation (restriction to enter into an uncovered CDS)?*"

  The answer stated:

  "*Provided that the replacement trade does not extend the life or value of the sovereign CDS position beyond what they were when originally taken out before 25 March 2012, ESMA considers that it would be legitimate to treat the trade as an existing rather than a new contract and so not encompassed by the Regulation's prohibition on entering into uncovered sovereign CDS transactions*."

<u>EMIR objective to reduce systemic risk</u>

Furthermore, we believe that EMIR permits ESMA to exempt these trades from the clearing obligation. Recital 15 of EMIR states that, in determining whether a class of derivatives is subject to the clearing obligation, ESMA should take into account whether the clearing determination would reduce systemic risk. Additionally, recital 17 of EMIR states that, when determining which classes of OTC derivative contracts should be subject to the clearing obligation, ESMA should pay due regard to other relevant considerations, most importantly the interconnectedness between counterparties using the relevant classes of OTC derivatives and the impact on the levels of counterparty credit risk. Trades resulting from multilateral portfolio compressions both reduce interconnectedness and counterparty credit risk and, therefore, it is unnecessary from a risk-mitigation perspective to impose a clearing obligation on these transactions.

Interactions, inconsistencies and gaps

In recent years, ISDA has highlighted that the lack of international convergence and the lack of progress in addressing overlaps and inconsistencies has led to derivatives market fragmentation.

Issue 10 – Links between individual rules and overall cumulative impact

Example 1 – Capital Requirements

- Capital requirements should be globally consistent, coherent and appropriate to the risk of a given activity. A global capital framework was developed by the BCBS, but there are concerns that individual requirements may duplicate or even contradict the intention of other rules.
- For example, the leverage ratio under Basel III doesn't recognise the exposure-reducing effects of segregated client cash collateral for cleared derivatives transactions. The rules assume segregated client cash collateral can be used by a bank to fund its operations. That's despite strict rules that ensure client collateral is segregated from the FCM/clearing member's other assets, and cannot be used to fund the FCM/clearing member's own operations. Failure to recognise the exposure-reducing effect of properly segregated client cash collateral increases the amount of capital needed to support client clearing activities, and discourages banks from providing this service.
- **For example, credit institutions** might be **requested to face capital surcharges at international, at EU and at national levels.** While preserving a degree of flexibility to national authorities, **it is of crucial importance that** the **level of discretion allowed is clear and well defined** in order to ensure a coherent application of the rules and a level playing field across jurisdictions. Credit institutions have to deal with a regulatory environment which is highly uncertain, preventing them from assessing the joint impact of the ongoing capital related reforming actions and hence from adequately preparing to meet the new requirements. In such an uncertain scenario, banks may be forced to shrink their lending activities to achieve compliance with the different capital prudential rules and to cope with an unclear regulatory framework, weakening broad-based economic growth and job creation. It is of paramount importance therefore that the regulators and policymakers fully pursue the coordination at legislative and regulatory level, ensuring a clear and well calibrated capital framework which would allow banks to properly planning in advance their capital management activities and adequately support economic growth with lending to the real economy.

Example 2 – Recognition of third-country regulated markets under MiFID

- On 3rd **Country Regulated Markets**. Under MIFID I, unless the EC has determined a regulated market based in a third country as equivalent, derivatives traded on that regulated market by EU counterparties will be considered OTC derivatives, rather than exchange-traded derivatives. The EC has yet to deem equivalent any third country regulated markets under Article 19(6) of MIFID. This is particularly problematic for non-financial counterparties (NFCs) that trade on third country regulated markets, as those exchange-traded derivatives will now count towards the clearing threshold in EMIR, and could force such NFCs above the threshold and thus subject to the EMIR clearing and margin obligations.

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Example 3 – Application of margin rules to small counterparties under EMIR

- On **smaller counterparties under EMIR.** Many small market participants do not currently post variation margin (VM) or initial margin (IM) because of operational constraints, and the fact that many only use short-dated foreign exchange swaps and forwards for hedging purposes, which generate minimal exposure. The likely result of imposing VM requirements on these market participants is that they would be forced out of the market because they are not able to meet VM operational and documentation requirements. A mechanism needs to be established to permit non-systemic market participants to remain in the derivatives market.

Example 4 – Securitisation derivatives

- On **Securitisation derivatives.** Securitisations are used by key sectors of the economy (SMEs, mortgage lenders etc.) as essential funding tools. However, the requirement that OTC derivatives traded by securitisation vehicles be subject to bilateral margining (or indeed the clearing obligation) will ultimately reduce access to a substantial funding resource, and increase the costs of financing. Securitisation vehicles typically have limited functionality and resources and are also generally set-up as pass-through vehicles which do not retain excess cash from underlying assets to comply with material, operational requirements. Imposing margining requirements could result in significant amendments to the commonly accepted structures for many transactions with the potential to have inadvertent impact on other regulatory changes that have affected and will affect securitisation as a source of funding. It should also be noted that the European Central Bank and the Bank of England both believe that derivatives are an important ancillary service for securitisation vehicles, and that derivative collateralisation requirements for securitisation special purpose entities (SSPEs) should apply in the same way as for derivatives executed by covered bond issuing entities, "i.e. that all STS securitisation vehicles, meeting the definition of an SSPE under Article 4(1)(66) of the Capital Requirements Regulation should be exempted from the legislative requirements to provide collateral."[9]

  ISDA members note in this respect that the STS proposals include, in article 27(2), an amendment to EMIR so that securitisation swaps in the context of STS securitisation are exempted from the clearing obligation, which is welcome. However, we also note that two-way margining of securitisation swaps remains as well as the requirement to clear securitisation swaps in non-STS securitisations. In our view securitisation swaps should be exempted from both clearing and two-way margining for both STS and non-STS securitisations

Issue 11 – Definitions

Example 1 – Short Selling Regulation (SSR)

The European Short Selling Regulation imposes restrictions on trading of certain instruments (e.g. shares, government bonds and sovereign CDS) and aims to increase the transparency of short positions held by investors in EU sovereign debt and equities that are primarily traded in the European Union. The regulation also seeks to reduce settlement and other risks, and in particular, risks to the stability of sovereign debt markets (as a result of uncovered sovereign CDS positions).

ISDA members highlight that liquidity in CDS markets is extremely fragile. In a research note we published in January 2014, titled "Adverse liquidity effects of the EU uncovered sovereign CDS ban"[10], it is shown that the liquidity of the iTraxx SovX Western Europe index, the main hedging vehicle for European

[9] http://www.ecb.europa.eu/pub/pdf/other/ecb-boe_response_ec_consultation_on_securitisation20150327.en.pdf
[10] See http://www2.isda.org/search?headerSearch=1&keyword=short++selling ": Adverse Liquidity Effects of the EU Uncovered Sovereign CDS Ban", 30 january 2014.

sovereign risk, has significantly diminished in the period following the announcement of the political agreement on the ban and, more acutely, when the regulation became effective. We also note that with the implementation of the ban, the EU sovereign CDS market has become a specialist market as many market participants have stopped trading the product (for example, EU buy-side firms).

We think that a mitigation of the adverse effects of the ban could be achieved through an appropriate recalibration of the definition of market making. Indeed, market makers should not be prevented from engaging in legitimate market making transactions. For this purpose, the following two amendments to the Short Selling Regulation should be made:

- Amend the definition of “market making activities” under Article 2(k) of the SSR such that: a) it is clearer that the market making exemption only requires a firm to be a member of a single trading venue, rather than be a member of a trading venue where each instrument in which the firm makes markets is listed; b) it is clearer that the exemption is available in relation to market making in any “financial instrument” (per MiFID definition), rather than only in relation to market making in financial instruments positions in which must be taken into account when calculating a net short position in shares or sovereign debt. For instance the market making exemption does not include the ability to hedge corporate bonds with OTC derivatives, eg sovereign CDS. A similar issue arises in relation to certain securities not admitted to trading on an EU trading venue (eg ulisted structured products).
- Amend the definition of “market making activities” to permit non-EU market making firms to make use of the exemption automatically, given that the Commission has not made any equivalency determinations in this respect;
- Allow ESMA to revise its guidelines on the exemption to bring them in line with the interpretation currently adopted by several competent authorities, including the FCA and the BaFIN.

Another solution would be to address the practical complexity and restrictions faced by firms when complying with the definition of ‘**correlation**’. Under the SSR, the definition of correlation is the key element of the test that determines if the sovereign CDS is recognised as covered and therefore can be used for hedging investment risk.

In particular, an investor must establish ‘correlation’ to meet the requirement to cover a sovereign CDS. We believe that EC’s interpretation of the ‘correlation’ test in Delegated Regulation 918/2012 is a restrictive interpretation of when a position is considered to be sufficiently ‘correlated’ to relevant sovereign debt. We are concerned that it prevents investors from using sovering CDS for a broader range of legitimate hedging strategies, e.g. (i) hedging based on demonstrable economic comparables and analysis when historic correlation is challanging to be demonstrated or (2) cross- border hedging.

It is also a significant departure from both the text and the intent of the SSR and from the political agreement that was so carefully achieved during the negotiation of the text at Level 1:

- Firstly, the requirement that correlation between risks needs to be demonstrated on the basis of historic data reinstates conditions and restrictions of a type that were considered by the co-legislators during the Level 1 negotiation but not included in the SSR. The SSR was finalised recognising that past correlation may change over time or may not yet exist in situations of legitimate hedging of future risks (this principle of hedging is illustrated in a report published by Autorité des Marchés Financiers).11

11 Autorité des Marchés Financiers, La formation des prix sur le marché des CDS : les enseignements de la crise souveraine (2010-), Janvier 2012, http://www.amf-france.org/documents/general/10331_1.pdf?bcsi-ac-1411779732B63501=1E31317900000005V1+jExO8yNCUr0t6BCFt9hU8B707AAAABQAAAPRt6gBwYgAAPQQAANiLCQA

An example of a hedge of a future risk would be where a bank hedges a loan to a regional government with CDS referencing sovereign debt in the regional government's state. Since such a loan will be relatively illiquid and not traded in the market, it may not be possible to demonstrate an historical correlation even though it is clearly reasonable to anticipate that there will be a positive correlation between the region and its sovereign.

The proposal for an historic test is based on an assumption that the past is the only guide to the future. In other areas of financial markets (notably the provision of financial services to retail customers) this assumption is held to be unreliable (the phrase 'past performance is not a guide to future performance' is commonly used). This approach fails to recognise the key prudent behaviour principle of hedging future risks. It is more appropriate to focus on correlation based on demonstrable economic comparables instead.

- Secondly, the proposal requires that the obligor standing behind the hedged asset/claim (whether that obligor is a borrower or counterparty on derivatives) be located in the same Member State as the reference sovereign under the CDS.

  We believe that this geographical restriction has no legal basis in the SRR and it limits responsible risk management, as there may be sound reasons to hedge a risk in one jurisdiction through the use of a CDS instrument related to a reference entity in another. For example, an investor may lend to a parent entity in one Member State, but determine that the risk to that investment stems primarily from the performance of the subsidiary in another jurisdiction.

  It also contradicts core Single Market principles. A market participant could meet the SSR requirement that it holds 'correlated' assets, but still be prohibited from trading in a particular sovereign CDS purely because instruments had been issued in a different Member State.

  This discrimination could also affect the Treaty-based freedom of establishment as it encourages companies to do business in their home country, rather than through subsidiaries in other countries, because their counterparties are better able to hedge their exposures to entities in the home country.

  The geographic limitation also seems to contradict both the Basel III and the EU Capital Requirements (CRR) frameworks, with regard to the use of cross-country proxy hedging for counterparty credit risk. Article 375 of CRR explicitly includes the use of index CDS as an eligible hedge for the purpose of mitigating CVA risk (Credit Valuation Adjustment risk - the risk that the creditworthiness of the counterparty deteriorates). By limiting the geographic scope of CDS hedges, the use of indices such as the SovX to cross-country hedge CVA regarding exposures in several Member States seems to be excluded.

We then urge the European Commission to reconsider the definitions and scope of market making and of correlation in its upcoming review of the Short Selling Regulation and of the relevant delegated regulations and ESMA guidelines.

Issue 12 – Overlaps, duplications and inconsistencies and Issue 13 - Gaps

Example 1 – Data and Reporting

- Reporting requirements have been implemented in most financial centres but regulators are still no closer to being able to aggregate data between trade repositories and across borders due to different reporting rules between jurisdictions, variations in data reporting formats at the repositories, and inconsistencies in what is reported. As a result, international regulators still struggle to obtain a clear view of global activity. Data harmonisation and UTIs are critically important here. ISDA has notably played a leading role in developing standards through its product taxonomies, the development of a unique trade identifier prefix service (UTIPrefix.org), and ongoing developments to the FpML reporting standard.

Example 2 – Clearing

- Negotiations between US and European regulators over whether US clearing houses should be recognised by ESMA have stalled over technical differences in margin methodologies. The EC has smoothed over the problems by delaying a requirement for European banks to hold much higher capital against trades cleared through non-qualifying CCPs. But with Europe's first clearing obligation set to come into force early 2016, European firms will be unable to clear mandated products through clearing houses that aren't authorised or recognised by ESMA. We notably believe that immediate recognition should be given to CCPs that meet CPMI-IOSCO Principles for Financial Market Infrastructures

Example 3 – Trade Execution:

- Problems may occur in trading unless there's closer harmonisation between trade execution rules across jurisdictions. As it stands, a narrow interpretation of the Dodd-Frank SEF rules by the CFTC means there are significant differences between US rules and those proposed by Europe.

Example 4 – Margin Requirements for Non-cleared Derivatives

- The Basel Committee and IOSCO published a final global margining framework in September 2013. But a number of divergences have emerged in national-level proposals issued by European, Japanese and US regulators. Divergences in national-level rules will significantly add to the complexity of implementing the rules. Market participants will need to ensure the documentation they use complies with the specific regulation in each jurisdiction in which they are active. The greater the differences between the regimes, the more complicated the legal analysis and the documentation will become.
- Implementation of the margin rules will require significant changes to documentation, infrastructure and technology. ISDA has taken the lead in preparing the industry for implementation, notably through the development of a Standard Initial Margin Model (ISDA SIMM). In addition, existing ISDA CSAs and other collateral documentation will need to be replaced or revised in order to comply with the new non-cleared margin rules. These changes cannot be finalised, tested and implemented until final rules are published by national authorities

Rules giving rise to unintended consequences

The next couple of years will be largely devoted by the industry and regulators to the full implementation of many pieces of legislation, e.g. EMIR, MIFID II/ MiFIR, MAR, Financial Benchmarks, AIFMD, MMFs, Solvency II, CRD IV, BRRD, possibly CCP R&R, FTT.

The combination of all the requirements under these texts is difficult to assess at this stage and we highlight that if some unintended consequences are expectable, some others are not and will appear later.

Issue 14 - Risk

From ISDA members' perspective, the main political objective that lies behind the regulatory wave of the past six years is the capacity of EU regulators to have greater control and oversight (the purpose of all reporting and transparency regimes) enabling them to react rapidly to address disorderly markets or misbehaviour.

The main unintended consequence of the regulation described herein is that market liquidity may be reduced.

We believe that liquidty would be reduced if the following conditions exist: a) Europe implements rules that are much more constraining than other jurisdictions (or implements rules that simply do not exist anywhere else); b) EU financial services end-users cannot access services and the products they need in the ordinary course of their business, including, regarding derivatives, for the purpoe of hedging their market, operational or counterparty risks; c) Non-EU exchanges or non-EU financial services providers are able to provide equivalent services to EU clients.

Threats, in this regard, include:

Example 1 – EU Financial Transaction tax

- The **EU Financial Transaction Tax** is probably the most obvious. Participating countries and all Corporates, buy-side firms and banks located in the FTT zone will be significantly affected. No other jurisdiction in the world intends to implement such a tax whose ultimate impact is on end-users. See our response in the "market liquidity" section.

Example 2 – Regulatory distinction between cleared and non-cleared derivatives

- The **unavailability of non-cleared derivatives caused by inappropriate regulatory distinctions between cleared and non-cleared derivatives**. ISDA members are worried that the European Parliament seems to want to systematically make such a distinction based on the false assumption that non-cleared derivatives are riskier then cleared derivatives, which actually is wrong. Non suitability for clearing of OTC derivatives does not mean that they are riskier but simply that they fit the purpose of hedging specific risks of certain clients. If the CMU is to be a success whereby both investors and borrowers continue to benefit from the certainty brought by derivatives markets, it is important that tailored, non-cleared derivatives and standardized, cleared derivatives are both fostered and be made available to those who need to manage risk.

  It is therefore crucial that European policymakers do not attempt to introduce a false regulatory distinction, nor nurture asymmetric treatment of cleared and non-cleared derivatives inappropriately in regulation – which is currently the case in both Bank Structure and Money-Market reform proposals. For example, under Bank Structure reform proposals core credit

institutions may only use (to hedge balance sheet risk) and sell to client's clearing-eligible interest rate derivatives, foreign exchange derivatives, credit derivatives, emission allowances derivatives and commodity derivatives (Use of non-cleared derivatives real-life examples). This restriction of hedging tools to clearing eligible derivatives not only undermines banks' ability to provide 'simple' banking services on a cost-efficient basis, but also undermines the ability of clients to manage risk bilaterally, leading to an increase in risk and costs.

Given that regulators in Europe and at global level are close to finalisation of a robust collateral regime for non-cleared derivatives, such regulatory asymmetry would be extremely damaging.

This issue of inappropriate regulatory distinctions has also arisen in the context of EMIR, under which non-EU exchange traded derivatives are considered 'OTC' in the absence of recognition of the non-EU venues on which they trade. Ensuring that European businesses are able to make use of well-regulated and transparent futures products should be a focus of the CMU. As such, we believe it is crucial that European policymakers expedite the recognition of equivalent foreign trading venues to remove this unnecessary and erroneous regulatory distinction.

Example 3 – Commodity derivatives position limits under MiFID

- The European **commodity derivatives Position Limits** regime under MiFID II. ISDA members have always supported Policymakers and Regulators in their aim of preventing market abuse and disorderly markets. This requires appropriately calibrated position limits that provide the necessary regulatory tools but enable markets to function efficiently and effectively.

No jurisdiction other than the European Union and the United States of America intends to implement mandatory commodity derivatives position limits (and position limits were not a G20 commitment) and week after week it is clear that the US CFTC is not intending to implement its new regime in the near-to-medium term and that – ultimately - the US regime covers a limited number of contracts and of underlying commodities when compared to the European regime.

The concern of ISDA members who are commodity end-users (e.g. product and food manufacturers, airlines) is that the EU rules are so stringent that: a) banks will be forced out of the market – a few major banks already exited commodity derivatives markets in the past three years – making hedging tools unavailable; b) non regulated actors located outside the European Union may want to fill the gap but without being able to appropriately provide the tailored tools and at a low price; c) look-alike contracts on existing non-EU exchanges specialised in commodities (e.g. the Singapore Exchange) will mirror contracts traded in Europe and those exchanges will offer services without applying any position limits.

For all these reasons, ISDA members believe that the combination of the following factors proposed by ESMA could lead to the opposite outcome:

- Overly restrictive **netting rules** that will impact end users ability to risk manage. The removal of the ability to net non-MiFID and MiFID instruments does not recognise fundamental market dynamics as MiFID instruments are frequently used to manage physical risk and are recognised as fungible for risk management purposes.
- **Aggregation** rules that require the aggregation of positions taken by subsidiaries or separate businesses operating within a group on an extra-territorial basis and leading to aggregation of positions taken through independently managed businesses.
- The proposal to set **baseline limits for non-spot months** by reference to deliverable supply which, for contracts other than spot-months, is not an appropriate and workable metric. ISDA members welcomed that ESMA opted for open interest as the metric for non-spot months contracts but are worried that the European Parliament may ask ESMA to go back to the deliverable supply (see ISDA paper Position limits Open Interest vs Deliverable Supply).

Example 4 – Market Abuse Regulation

- Effective prevention of **Market Abuse**, access to information and capital markets – possible untinteded consequences of the draft Level 2 legislation for the Market Abuse Regulation

  We think, although this is not a fully implemented and applied legislation, that the following key points of the Market Abuse Regulation (MAR) Technical Standards (TS) and Delegated Acts (DA) are worth revisiting. ISDA members' focus is on effective rules ensuring market integrity, the alignment with the Level 1 text and better regulation agenda.

  We would support the proposed ESMA standards on conflict of interests under the investment recommendation requirements, on suspicious transactions and orders reporting and on insider lists.

  We however are concerned by the following proposed rules :

  - With regard to investment recommendations definition (MAR Art 3.1.(35)), investment firms and banks will be disincentivised to provide investors with trade ideas, market colour and sales notes if the current exemption under Market Abuse Directive 1 (MAD1) Implementing Directive2003/125/EC (ID) is removed. The ID (Recital 3) explicitly excludes from the scope of the definition of investment recommendation certain types of client recommendations produced from outside the research function of a firm/bank. This exemption has been enabling firms to provide clients with useful insights and we urge ESMA to reconsider any approach which may limit firms' ability to continue providing information to investors in this regard (draft RTS on investment recommendations).

    In particular, applying the same set of DTS disclosure standards to all MAR investment recommendations would additionally create major additional process and cost, particularly in the case of in-scope marketing communications, which might lead businesses to conclude that some types of recommendation should no longer be made available to clients. That would affect the amount of market information received by industry participants, trading volumes and liquidity.

  - On suspicious transaction and orders reporting, Article 16.2 of MAR refers only to 'orders and transactions'. Consequently we think that the addition of 'quotes' in the definition of 'orders' in Article 1.d of the DTS Annex XI goes beyond the scope of the regulation. Moreover, this addition is disproportionate as it would require a very large amount of additional systems development by affected firms, because (a) existing systems tend only to capture orders, and (b) the number of quotes given by an investment firm in any given period far exceeds the number of orders placed. Combined, this will greatly increase the risk of firms facing serious challanges to meet the requirement of being compliant by 3 July 2016.

  - Trading in own shares in buyback programmes is not considered market abuse under MAD 1 and MAR (safe harbour) if certain conditions are met. Under the technical standards, ESMA suggests that the MAR Level 1 text (MAR Art 5) does not allow buy-backs undertaken through derivatives to fall under the safe harbour. We believe this interpretation goes against the Level 1 text. On a legal reading, 'trading in own shares in buy-back programmes' includes trading in own shares via derivative instruments. The Level 1 texts of MAD 1 and MAR are in essence identical, but the interpretation proposed by ESMA in the context of MAR is opposite to the current Commission interpretation in the implementing text of MAD1. In addition, ESMA's draft technical standards on buy-backs suggests that in order to benefit from the exemption, transactions have to take place on a trading venue (therefore excluding OTC transactions from the safe harbour). This is problematic where the bank-client leg of the transaction is traded OTC (the bank buys shares on a venue and then sells to the client OTC).

This change may ultimately make the access to capital markets more difficult and more expensive for issuers.

- The proposed Level 2 restrictions for buy backs via derivatives and OTC transactions (draft RTS on buy backs) appear to be at odds with the objectives of the CMU to remove barriers to capital markets access and the non-binding resolution of the EU Parliament which encourages a wider range of investment choices and risk mitigation tools.
- We consider that the specification of indicators of market manipulation in the annex to the draft delegated acts recently published by the European Commission does not achieve the objective of better legal clarity (and, in particular, raises concerns about the burden of proof) and is aligned with the MAR Level 1 text (Art 12) only in some areas, potentially resulting in ineffective monitoring of suspicious transactions (for example all repo transactions being potentially caught as suspicious transactions). We would like to highlight that the UK Fair and Effective Market Review promotes legal clarity (as to what is a legal and illegal behaviour) as a means to prevent and detect market abuse.

Example 5 – PRIIPs Regulation

- ISDA members strongly support the Packaged Retail and Insurance-based Investment Products Regulation and notably agree the integration of the EU retail product market will produce "choice, transparency and competition in retail financial services to the benefit of European consumers". The implementationof the Key Information Document (KID) is an important step towards the development of this market, and we wish to see this initiative succeed.
- The scope of the regulation needs to be refined. The question of which products the regime applies to is critical. PRIIPS is expressed to apply to "investments", but this is not a term with an established EU law meaning. Our view is that the primary meaning of the term "investments" is products which an investor purchases to obtain a return on the amount invested – that is, a term investment product in which investment is made at the beginning of an investment period, a return is paid at the end of that period, and a return is calculated by reference to a formula. It is also clear that the definition is intended to be based on functional rather than legal characteristics. This interpretation is supported by Recital 1 and the definition of PRIIP in Art 4(1) of the Regulation.
- The PRIIPS regulation applies to sales of products to a wide variety of commercial entities - municipalities, local authorities and many commercial companies. These entities have a positive requirement for risk management or hedging products, as well as for foreign exchange forwards and derivatives. The production of KIDs for such products is not only extremely challenging; it is uninformative since these products are not purchased as investments, but as risk management tools. Consequently we believe that the imposition of a KID requirement on such products would significantly impede access by these entities to useful financial management tools.
- In our view, there are two ways in which this problem might be addressed. One would be to confirm that products which do not have an investment purpose are not "investments" and therefore do not require a KID to be prepared. Another might be to provide that, where a product is sold for risk management rather than investment purposes, a pro-forma KID making that fact clear would be required. Such a KID would omit the risk information required for a normal KID, and would simply state that the product concerned should not be regarded as an investment in the normal sense. It is also possible that there may be other available policy options. However, if something is not done to address this issue, the consequence may be to prevent the financial services system from providing essential risk management products to those who require them.