ISDA-FIA response to ESMA's Clearing Obligation Consultation paper no. 6, concerning intragroup transactions

1. The International Swaps and Derivatives Association ("ISDA") and the Futures Industry Association ("FIA") welcome the opportunity to respond to ESMA's consultation paper on Clearing Obligation under EMIR (no. 6).

2. Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

3. FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's member firms play a critical role in the reduction of systemic risk in global financial markets.

4. In particular, we wish to highlight the following points, which we elaborate on in the body of our response:

    a. We strongly welcome the move to extend the derogation from the clearing obligation for intragroup transactions concerning third-country entities based in jurisdictions which do not benefit from an equivalence determination under Article 13(2) of EMIR. Were the derogation not extended, particularly in the time available before the expiry of the current exemption, the impact on the ability of European derivative market participants to operate on a cross-border basis would be severe.
    b. We note that ESMA proposes to extend the derogation for G4 IRS to 21 December 2020, and to align the expiry of the derogations from the other clearing obligations with this date. For the reasons set out below, we suggest that a 2 year extension that could be extended by the European Commission by a year, on a rolling basis, would be a more prudent approach. This would preserve the policy intent to exclude intragroup transactions from the clearing obligation, and to allow the Commission the time it needs to carry out equivalence determinations.

c. More broadly, we consider that the existence of an equivalence determination for the relevant non-EU jurisdiction should not be a pre-condition to an intragroup transaction involving a group entity from a non-EU jurisdiction to be defined as an intragroup transaction for the purpose of benefiting from the exemption. We would support an amendment to EMIR removing this pre-condition altogether (rather than having to rely on time-limited derogations in the longer term), given that the possible risks associated with intragroup transactions are already properly addressed by the risk management requirements provided by EMIR under Articles 3 and 11. We note, however, that such a change would require a level 1 amendment, which is outside of ESMA's competency, and there are no such proposals under the EMIR REFIT.

Question 1: Do you consider that the proposed extension of the temporary intragroup exemption is justified? Please explain.

5. ISDA, FIA and their members agree that an extension of the temporary intragroup exemption is justified. In the absence of such an extension, particularly in the time until the expiry of the current exemption, there would be major practical obstacles to clearing intragroup transactions. It is possible that such obstacles could result in European banks and investment firms withdrawing from cross-border derivatives activity in affected derivative contracts.

6. We elaborate on our reasoning for supporting an extension of the temporary exemption below. However, we suggest an alternative approach to the 2 year extension and alignment to 21 December 2020 as proposed by ESMA.

7. Equivalence decisions have historically taken a number of years to carry out and be agreed. It would be prudent to factor this in to any extension of the existing exemption. Indeed, the original temporary exemption considered that equivalence decisions could take up to 3 years to be made. We are not aware of the Commission currently carrying out any Article 13(2) equivalence assessments, and so the necessary time for equivalence assessments to be carried out from start to finish should be considered when extending the exemption.

8. We also note that, as detailed in our response to question 2, a survey of ISDA members suggests that ISDA members rely on the temporary exemption from clearing for intragroup transactions for transactions with third-country entities based in at least 50 jurisdictions. We consider that it is unlikely that the European Commission would be able to carry out this number of equivalence assessments in the 2 years proposed by ESMA.

9. Further, the European Union is currently in the process of reviewing its legislative, policy and procedural approach to granting third-country equivalence determinations across all financial services legislation, beyond EMIR. Indeed, the Commission, Council, and European Parliament have all produced reports proposing changes to equivalence. Given this ongoing review, it seems unlikely that the Commission will grant EMIR equivalence determinations in the foreseeable future, and not until the future of equivalence is more stable.

10. We also note that intragroup transactions that benefit from the temporary exemption have been approved by the investment firm's Competent Authority, and are required to be in compliance with the risk management and mitigation obligations in Articles 3 and 11 of EMIR. Any perceived risks of extending the clearing exemption for those intragroup transactions are therefore mitigated.

11. Given this, we suggest that an extension of the temporary exemption to 21 December 2020 may not give sufficient time for the necessary equivalence determinations to be conducted. Amending RTS is a procedurally complex and lengthy process, and so a more flexible approach may be warranted.

12. We therefore suggest that there should be some flexibility embedded in to the RTS to allow the Commission to extend the exemption by a further 1 year, on a rolling basis, should there not be sufficient equivalence determinations in place by 21 December 2020, without having to amend the RTS. So, if during 2020 the Commission were to consider that the initial 2 year extension has not allowed sufficient time to carry out the necessary Article 13(2) equivalence determinations, it could initiate an extension of the temporary exemption by 1 year (subject to objection from the Council and Parliament). It could continue to initiate 1 year extensions on a rolling basis until such a point that the Commission considers sufficient equivalence determinations are in place. This would give EU institutions the appropriate control of this process and avoid an open-ended exemption, whilst granting the Commission the necessary time to carry out equivalence determinations on a significant number of jurisdictions (see our response to question 2).

13. We note that there is precedent for such an approach in other legislation including EMIR and CRR. The policy intent of EMIR is clear that intragroup transactions are not intended to be subject to the clearing obligation, and we expand on the reasoning for this below. This more flexible approach would ensure that the procedurally complex process of extending the derogation by amending the RTS would not need to be initiated in the event that equivalence decisions in all key markets are not in place by 21 December 2020. There are a number of examples of deadlines being extended in EU regulations where circumstances warrant it, and we suggest that this proposal could work in a similar way to the temporary exemption from the clearing obligation for Pension Scheme Arrangements under the existing version of EMIR and as proposed in the EMIR REFIT proposals. EMIR and the EMIR REFIT both propose certain provisions which allow the Commission to extend the exemption by a number of years should a solution not be found by the expiry of the first extension period.

14. We note that in carrying out equivalence determinations, the Commission would still maintain control over which third-country intragroup transactions can benefit from the temporary derogation as the Commission could at any point adopt a negative equivalence determination. The Commission would also still retain the power to withdraw an equivalence determination at a later point if it finds that a third-country jurisdiction is no longer equivalent. Accordingly, any risks associated with a longer extension can be mitigated, and a longer extension allows the Commission to carry out its work effectively.

15. Irrespective of the specific approach taken, below we elaborate on the reasons we believe that an extension of the existing temporary derogation from the clearing obligation is justified.

<u>Justifications for extending the temporary exemption</u>

16. **Imposing clearing requirements on intragroup transactions will impede centralised risk management at group level and negatively impact the international activity of European and other**

banks: International financial groups operate through a network of subsidiaries and branches[1], both within the EU and across third-countries. This network allows international groups to operate in different markets, with the various entities and branches facing clients in that locality. However, in order to offer liquidity in multiple jurisdictions, international financial groups need to be able to centrally manage the risk associated with cross border trading.

17. In the derivatives industry it is common for risk to be centrally managed. This allows for more efficient hedging and management of the risks that the financial group is exposed to. It also enables the use of central infrastructure, rather than having to build separate systems in each jurisdiction. This is not to say that firms do not manage risk or comply with regulatory obligations in the jurisdiction they are trading in. Rather, booking models are used which allow effective management of prudential risks to the group, and central management of derivative risk.

18. The management of this risk is facilitated by trades between group entities. These are not client facing trades, are not price forming, and do not alter the market or credit risk exposure. Rather, they are a block transfer of risk within the group. Client facing trades would remain subject to clearing requirements, where those trades fall in scope. The counterparties to the intragroup transaction are also subject to an appropriate centralised risk evaluation, measurement and control procedures.

19. Intragroup transactions are an essential tool in the ability of financial groups to offer derivatives business across borders. They allow central management of liquidity, which is key to enabling firms to offer the most favourable prices to their clients. The ability of EU investment firms to carry out intragroup transactions without being required to clear those transactions allows EU financial markets to remain competitive. Were this not the case, the collateral cost to EU investment firms could make central risk management models prohibitively costly, and impede investment firms' ability to operate in international derivative markets. The original EMIR legislation clearly recognized the importance of this tool in making available the option for an exemption from the clearing obligation for intragroup trades.

20. **Liquidity drain on investment firms:** The intragroup exemption is only available where the counterparties are subject to consolidated supervision and are already subject to appropriate centralised risk management. As discussed above, firms manage their group and counterparty risk at a consolidated level and it is not clear what a requirement to exchange collateral would add to this, other than reducing firms' flexibility to manage their own risk. This could potentially increase the risk to which an EU firm is exposed where it deals with a group entity in a jurisdiction where netting may be problematic.

21. In addition, requiring clearing of intragroup transactions would require collateral to be posted by both entities within the group, creating additional liquidity demands for firms engaging in such transactions. As already stated above, imposing clearing requirements on intra-group transactions where firms are already taking appropriate steps to manage the risks associated with these transactions would make central risk management models prohibitively costly and impede investment firms' ability to operate in international derivatives markets.

[1] Transactions within the same legal entity (e.g. between an entity in Member State x and a branch of that entity in third country jurisdiction y) are not of concern in relation to this issue. What is of concern is clearing and collateralization requirements between different group legal entities.

22. **Requiring clearing of intra-group transactions would create more operational risk, and have little benefit in terms of reducing counterparty risk facing the client:** We consider that requiring clearing of intragroup contracts will actually increase risk (contradicting the aims of EMIR). A clearing requirement would have to be applied unnecessarily to intragroup transactions, creating the necessity for multiple additional transactions with the CCP, with the extra operational risk this implies.

23. Most groups will have only a small number of entities that are clearing members of a CCP. In some group structures, these CCP clearing members are not the group's risk aggregation entities, nor are they client-facing entities. Thus, in the absence of an exemption, an intragroup transaction between a client facing entity ('CFE') and a risk aggregation entity ('RAE') would have to be cleared by both CFE and RAE. To do this, each of these entities would have to transact with the group's clearing member ('CM'). This means that one trade, between the CFE to RAE, would effectively generate four separate transactions, CFE to CM, CM to CCP, CCP to CM, and CM to RAE.

24. The operational burdens and costs associated with this are considerable. Moreover, it multiplies rather than eliminates intragroup transactions: one intra-group trade CFE to RAE has become two intra-group trades, CFE to CM and CM to RAE. Thus there is no obvious reduction in counterparty risk facing the client.

25. In addition, if a contract falls within the scope of the clearing obligation it will be cleared at least once. Typically, if it is (1) a dealer-to-dealer contract, clearing will result in each dealer facing the CCP. If it is (2) a client trade – with the client subject to a clearing requirement – then the client will face the group CM who will present the trade to the CCP for clearing and the appropriate segregation model will apply for this trade. For both types of trade - either (1) dealer-to-dealer or (2) dealer-client - one of the entities within the group is clearing the trade facing the CCP. If that entity then reallocates that risk to another entity within the group it should not be required to clear that trade yet again.

26. As firms manage counterparty risk at consolidated level and report information to local regulators, regulators already have the information necessary for oversight of all of the group entities as well as of the consolidated risk position.

27. **Significant operational uplift in relation to the expiry of the derogation from clearing intragroup transactions:** There is insufficient time for firms to put in place the necessary clearing arrangements and related documentation to ensure that all affected group entities are able to clear by December 2018.

28. Further, it is likely that a significant number of entities that would be brought in to scope of the clearing obligation would not even be able to become clearing members. This could be for a number of reasons, including:
    - not having the necessary regulatory authorisations;
    - not being sufficiently capitalised on a standalone basis to have direct access to a CCP; or
    - not having sufficiently embedded risk management frameworks and models on a standalone basis, as this is currently managed at group level.

29. We consider for the same reasons that it is also possible that some entities would not even qualify to be clients of group clearing members. Not renewing the derogation could bring entities in to scope of the clearing obligation that cannot practically or legally comply with it, and hence lock those entities out of trading.

30. **Intragroup transactions are key to rolling out the clearing obligation:** Intragroup transactions are also important for firms to implement mandatory clearing requirements. Local market regulation often requires market participants to interact with locally established firms (as opposed to international firms without a legal presence/entity in that jurisdiction), which may be subsidiaries of international groups, but which may not themselves be clearing members. If the trades involved fall into a class of derivatives subject to the clearing obligation, the local unit will have to enter into a transaction with a subsidiary within the group which is a clearing member, in order to get the trade cleared. If this intragroup trade also has to be cleared, the cost of entering the trade will be increased for each counterparty, and may become uneconomic, particularly given that each cleared trade requires creation of a number of new transactions.

31. **The derogation was intended to give the Commission time to produce equivalence decisions. With longer time required for these equivalence decisions to be produced, the expiry of the derogation is premature:** The original derogations from the clearing obligation (and margin requirements) allowed time for third-country jurisdictions (beyond the CFTC in the USA) to finalise their own rules to implement global standards. Further, it was a proactive decision to allow the Commission sufficient time to carry out equivalence determinations.

32. It is therefore premature to allow the derogation from the clearing obligation to lapse. Instead, sufficient time should be allowed for the Commission to conduct equivalence determinations with third countries. To date, the Commission has only made one equivalence decision in respect of the CFTC's margin rules and this is only a partial equivalence determination, only covering part of the USA's regulatory regime.[2]

33. **Link to Article 28 MiFIR: A withdrawal of the clearing exemption would trigger the trading obligation:** The general starting point for the trading obligation under Article 28 of MiFIR is that it applies only to:
    a. OTC derivative contracts which are subject to the clearing obligation under EMIR; and
    b. entities which are subject to the clearing obligation under EMIR.

34. The trading obligation does not currently apply to intragroup transactions, because intragroup transactions are currently exempt from the clearing obligation.[3] The removal of the temporary exemption from the clearing obligation for intragroup transactions involving a third-country entity would therefore bring such intragroup transactions in to the scope of the trading obligation. This would be contrary to the protections built in to MiFIR, as it would require large non-price forming risk trades to be executed on venue. Also, requiring intragroup transactions to take place on a trading venue is likely to further exacerbate the issues outlined above.

35. **Removing the clearing exemption could create an obstacle to facilitating client clearing:** There has been a significant drive across a number of EU regulations to foster an environment favourable to

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[2] To date, the only Article 13(2) equivalence determination that has been made was to the CFTC. However, the CFTC equivalence decision is not a complete solution for EU/US intragroup transactions as it only covers the margin rules. This equivalence determination also raises further complications in that it is only in relation to CFTC authorised swap dealers and CFTC swaps, so at a jurisdictional level the USA has only been granted partial equivalence (i.e. to the CFTC framework, but it does not cover other US regulators such as the SEC and US prudential regulators).

[3] As confirmed by ESMA in the [2017 Policy Statement on the MiFIR trading obligation](), paragraph 6, page 7.

providing client clearing services. This has also been a topic of FSB and BCBS-IOSCO work that is currently taking place. A substantial increase in collateral assigned to clearing is counterproductive to this effort, and likely to result in a reduction of clearing capacity in the system.

36. **Fragmentation may result as internationally active banks withdraw from some markets:** As noted, should EU market participants be required to clear intragroup transactions, the costs in collateral uplift could make cross-border derivative activity uneconomical for EU market participants.

37. For example, should an EU market participant offer an interest rate swap (IRS) to a client based outside of the EU through a third-country subsidiary, they would need to hedge their exposure to the underlying rate. This would often require an intragroup transaction. After executing an IRS with the third-country client, an investment firm would seek to offset the exposure in the inter-dealer market. It is unlikely that the entity which faces the inter-dealer market will be the same entity as the third-country subsidiary facing the client, given the very different markets and regulatory requirements associated with these two types of transactions. Typically only a limited number of entities within a group will have the regulatory permissions for and be operationally established as clearing members, and local regulations may mean it is not possible for the existing clearing members to clear intragroup transactions on behalf of affiliates in certain jurisdictions. An intragroup transaction is therefore required.

38. As discussed above, if the clearing obligation was applied to the intragroup transaction, this would have the effect of creating multiple transactions subject to duplicative rules, and a corresponding uplift in collateral. This is likely to lead to either:
    a. Prohibitive costs to offering such a cross-border services resulting from multiple clearing and margin requirements generated by a single transaction; or
    b. EU market participants only offering services on a national/regional basis.

Question 2: Do you identify other benefits and costs not mentioned above associated to the proposed approach? If you advocated for a different approach in the responses to the previous question, how would it impact this section on the impact assessment? Please provide details.

39. ISDA has conducted a survey of its members to understand the home jurisdictions of third-country group entities with whom ISDA member firms rely on the temporary exemption for intragroup transactions.[4]

40. This data does not give an impression of the volume of activity between EU entities and those third-country group entities. However, as ISDA members currently rely on the temporary exemption from clearing for intragroup transactions with entities based in a large number of third-country jurisdictions, we suggest that in advance of the expiry of the temporary exemption it is prudent that the European Commission should at least consider assessing (and have sufficient time to assess) the relevant jurisdictions for Article 13(2) equivalence determinations.

[4] A small number of firms in the sample submitted amalgamated data for entities that would be brought in to scope of the clearing obligation or margin requirements, were the temporary derogation from margin requirements to expire. Accordingly, it is possible that a small number of entities submitted would be brought in to margin requirements were that temporary derogation to expire, but would not actually be brought in to the clearing obligation.

41. Based on a sample of 13 firms surveyed, 50 jurisdictions were listed as having third-country entities with whom ISDA member firms rely on the temporary exemption for intragroup transactions. Of those 50, 20 third-country jurisdictions were submitted by more than one firm. These third-country jurisdictions are listed below, ordered by the number of firms who carry out intragroup transactions that rely on the temporary exemption with entities based in those third-country jurisdictions.

Order	Third-country jurisdiction
1	Switzerland
1	USA
2	Japan
3	Australia
4	China
4	Mexico
4	Singapore
5	Brazil
5	Canada
5	Cayman Islands
5	Hong Kong
5	Malaysia
5	Mauritius
6	Bermuda
6	Chile
6	Jersey
6	Peru
6	Russia
6	South Korea
6	Taiwan