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Steven Maijoor,
Chair,
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2 June, 2020

Dear Executive Vice-President Dombrovskis,

Dear Chairman Maijoor,

EMIR – Time-limited derogation under the Clearing Regulatory Technical Standards[1] (Clearing RTS) for intragroup transactions

The International Swaps and Derivatives Association (**ISDA**), the European Banking Federation (**EBF**) and the Futures Industry Association (**FIA**) (hereinafter referred to as 'the associations') welcome the steps that the European Commission and the European Securities and Markets Authority (ESMA) have taken so far to ensure that EU derivatives counterparties can rely on the intragroup exemption from clearing under EMIR when dealing with non-EU affiliates. However, the associations would like to take this opportunity to emphasise the continued importance of intragroup transactions both for the ability of EU financial groups to operate, compete (with other financial groups) and make capital available in non-EU jurisdictions and to manage risks on a centralised basis therein. Intragroup transactions are also vital to enable non-EU financial groups to provide capital needed to underpin investment within the EU-27, and to manage risk associated with this activity.

Therefore, in view of the forthcoming expiry in December 2020 of the intragroup exemption from the clearing obligation under EMIR, we ask both that *1) the necessary equivalence decisions be adopted as a matter of urgency in relation to all jurisdictions that have implemented clearing rules in line with the G20 commitments and 2) that the Clearing RTS should be amended to extend the current temporary derogation from clearing requirements for intragroup transactions with non-EU affiliates for a further 3 years for all other jurisdictions.* Ideally these steps would be taken as soon as possible during the first half of 2020 in order to prevent market participants from having to initiate and execute costly operational, legal and contractual compliance processes, while also dealing with the uncertainty around

1 Commission Delegated Regulation (EU) 2015/2205, Commission Delegated Regulation (EU) 2016/592 and Commission Delegated Regulation (EU) 2016/1178

the application of the EMIR clearing obligation to intragroup transactions after 21 December 2020 and the demanding conditions faced by market participants in relation to the COVID-19 crisis.

Intragroup transactions are crucial for centralised risk management at group level by EU entities which operate on a cross-border basis

As mentioned in the joint associations' letter of 30th April 2020 in relation to extension of the temporary intragroup derogation from the margin obligation under EMIR, intragroup transactions are an essential tool for enabling financial groups to offer derivatives business across borders. They allow central management of risk and liquidity, which is key to enabling investment 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 or margin those transactions allows EU financial markets to remain competitive. If this was not the case, the collateral cost to EU investment firms would make central risk management models prohibitively costly and impede their ability to operate and compete in international derivative markets. We discuss the reasons for this cost increase further below.

International financial groups operate through a network of subsidiaries and branches, 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 multiple localities. 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.

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 in which group entities operate, without compromising on risk management or on compliance 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.

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 transfer of risk within the group. Client facing trades would remain subject to clearing (or margin) requirements, where those trades fall in scope of the relevant requirement.

In order for a firm to rely on the intragroup exemption from the clearing obligation, EMIR requires that the risk management procedures of the counterparties are adequately sound, robust and consistent with the level of complexity of the derivative transaction in question, and that the counterparties to the intragroup transaction are subject to appropriate centralised risk evaluation, measurement and control procedures and included in the same consolidation on a full basis.

It is important that ESMA and EC act quickly to eliminate uncertainty as to whether and to what extent market participants will have to clear trades between EU and non-EU affiliates from 21 December 2020. If market participants do not receive early clarity, they will need to redeploy internal resources to prepare for implementation which may detract from their role in continuing to provide liquidity to counterparties and clients inside and outside the EU at this critical time when disruption associated with the COVID-19 pandemic is creating financial pressure on market participants. The vital role of financial intermediaries in financing the real economy is clear to market participants and policymakers alike, in the current context. The potential compliance requirements associated with the loss of the intragroup derogation are legally, operationally and financially demanding and will take many months to put in place.

Intragroup transactions are key to implementing 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 place of business in that jurisdiction), which may be subsidiaries of international groups but which may not themselves be clearing members[2]. If the trades involved fall into a class of derivatives subject to the clearing obligation, the local firm will have to enter into a transaction with a subsidiary within the group which is a clearing member, in order to submit the trade for clearing.

The costs incurred in relation to each cleared transaction include clearing fees, capital cost, increase in default fund contribution, initial margin requirements and related funding costs. These costs are likely to be increased during periods of market stress, as seen during the COVID-19 related market turmoil where large price movements prompted large margin calls from central counterparties (CCPs).

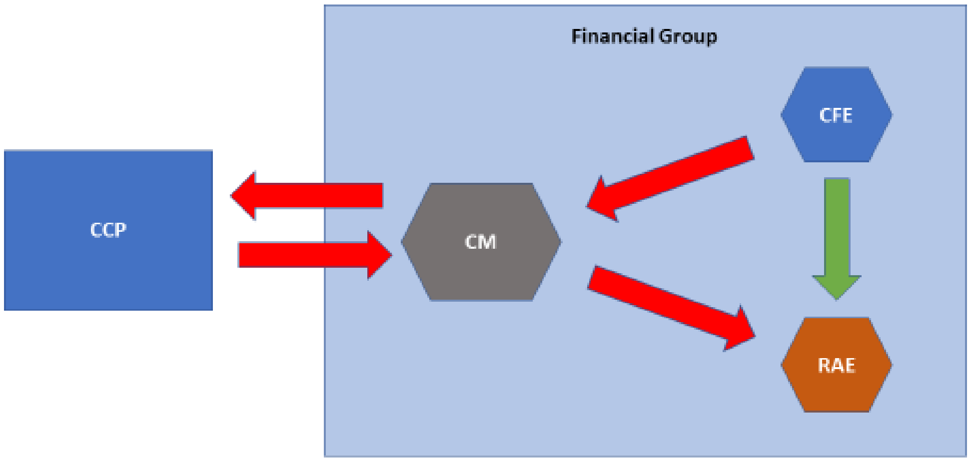
Not renewing the derogation could also create obstacles to facilitating client clearing for non-intragroup transactions as well, as a result of the substantial increase in collateral that will need to be assigned to clearing, as well as other constraints such as leverage ratio and balance sheet size. All of this will reduce clearing capacity in the system.

Requiring clearing of intragroup transactions would create more operational risk and have little benefit in terms of reducing counterparty risk

There is a strong argument that requiring clearing of intragroup transactions will actually increase risk (undermining the aims of EMIR). A clearing requirement would have to be applied unnecessarily to these transactions, creating the necessity for multiple additional transactions with the CCP, with the extra operational and counterparty risk this implies.

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 and the RAE, would effectively generate four separate transactions, CFE to CM, CM to CCP, CCP to CM, and CM to RAE. Depending on how the CM has organised the client clearing accounts for group companies, these two transactions (CFE-CM and RAE-CM) are likely to net out in an omnibus account at the group CM. The clearing requirement therefore would likely add no benefits in terms of risk reduction, but would add additional operational effort and risk.

[2] For example, a corporate in Italy may wish to enter into an interest rate swap with a US-based bank. However, the US bank may not have authorisation to do business in Italy. As a result, the US bank's German passported subsidiary will transact with the Italian corporate and then enter into a back to back transaction with the US bank. This latter transaction requires the protection of the intragroup exemption.



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.

Withdrawal of the intragroup derogation from the clearing obligation would also trigger the trading obligation under Art 28 MiFIR

The trading obligation procedure under Art 32 MiFIR requires ESMA to develop regulatory technical standards specifying the date or dates from which the trading obligation under Art 28 MiFIR will take effect, "including any phase-in and categories of counterparties to which the obligation applies where such phase-in and such categories of counterparties have been provided for in regulatory technical standards in accordance with Article 5(2)(b) of [EMIR]". In line with this requirement, the technical standards specifying the classes of derivatives subject to the trading obligation[3] state that the trading obligation shall take effect from the later of 3 January 2018 or "the date referred to in Article 3 of [the relevant clearing RTS] for that category of counterparties".

Article 3 of each of the Clearing RTS provides for the intragroup derogation, meaning that so long as the intragroup derogation is available in relation to the clearing obligation, it will also be available in relation to the trading obligation.

As a result, the removal of the intragroup derogation for transactions involving a third-country entity would therefore bring those transactions into the scope of the trading obligation as well as the clearing

[3] Commission Delegated Regulation (EU) 2017/2417

obligation. This would be contrary to the protections built into MiFIR, as it would potentially require large non-price forming trades to be executed on-venue. In addition, requiring intragroup transactions to take place on a trading venue is likely to further exacerbate the issues outlined above.

Equivalence decisions should be adopted in relation to all jurisdictions which have implemented G20 compliant clearing obligations

We urge the European Commission to adopt equivalence decisions as soon as possible for all jurisdictions that have implemented clearing obligations that aim to comply with the G20's OTC derivative market reform agenda.

The original purpose of the temporary derogation included in the Clearing RTS in 2015 was to give the European Commission time to adopt equivalence decisions in relation to any relevant third countries. However, while ESMA has delivered technical advice regarding the equivalence of the clearing obligations in a number of jurisdictions, no equivalence decisions have yet been adopted. While many jurisdictions only completed implementation of their own clearing rules after adoption of the Clearing RTS, a significant number of jurisdictions have now had clearing obligations in force for several years, including Argentina, Australia, Canada, Hong Kong, India, Japan, Mexico, PRC, Singapore, South Africa, South Korea and Switzerland. These jurisdictions are important trading partners of the EU and important markets for EU financial institutions.

For some very small or closed jurisdictions (e.g. jurisdictions employing currency or capital controls), it may not be appropriate or efficient to apply a clearing obligation locally (see the ISDA paper "Clearing in Smaller or Closed Jurisdictions")[4]. Such jurisdictions may not ever adopt a clearing obligation. As such, we believe consideration should be given as to whether it is appropriate at all to expect intragroup transactions involving group entities located in such jurisdictions to be cleared.

We would welcome confirmation as soon as possible from the European Commission that it is investigating jurisdictions which may have equivalent clearing obligations and that it is intending to seek technical advice from ESMA regarding the potential equivalence of the clearing obligation in the jurisdictions listed above or in any other jurisdictions.

We further add that equivalence should be outcomes-based, and therefore should not be caveated by a long list of conditions relating, for example, to aspects of regulation of derivatives activity where prospective beneficiaries of equivalence would be required to comply with EU regulation rather than the regulation applying in the jurisdiction concerned (where there are differences). Such conditionality has the effect of undermining the benefits of equivalence (by inflating legal and compliance costs). To the extent such conditionality is attached to equivalence decisions, it should focus on the most systemic risk-related aspects of uncleared derivatives business.

Extension of the current derogation

Article 3(2) of each of the Clearing RTS currently provides for a temporary intragroup derogation from the clearing obligation, so that where an EU counterparty and a third-country counterparty to an OTC derivative subject to the clearing obligation meet the conditions for an intragroup transaction, and where

[4] https://www.isda.org/a/tsvEE/ITC-Small-Jurisdictions-final.pdf

no equivalence decision has been adopted in respect of the relevant third country under Article 13(2) of EMIR, the clearing obligation shall take effect from a date 3 years after the date of entry into force of the relevant Clearing RTS.

Commission Delegated Regulation (EU) 2019/667 amended each of the Clearing RTS so that the clearing obligation would take effect from 21 December 2020.

While the associations welcome this extension of the temporary derogation, we are concerned that it will be necessary to extend the temporary derogation further in order to protect EU counterparties which enter into OTC derivatives with non-EU affiliates located in jurisdictions which have adopted clearing requirements but for which the European Commission has not adopted an equivalence decision by 21 December 2020 and in jurisdictions which have not yet adopted clearing requirements equivalent to those under EMIR. Even if equivalence decisions will be adopted for a number of other G20 jurisdictions, the justification for having a derogation for cross-border intragroup transactions will continue to exist for many other jurisdictions. If the derogation is not extended, the impact on the ability of European derivative market participants to operate on a cross-border basis would be severe.

In order to address the risk of market fragmentation and instability resulting from termination of the temporary derogation in the absence of equivalence decisions, we would ask the European Commission and ESMA to take steps urgently to extend the temporary derogation beyond 21 December 2020, until 21 December 2023, in order to ensure that EU firms have certainty regarding their continued ability to rely on this derogation and in order to ensure a level playing field between EU firms whose group is entirely within the EU and EU firms which operate on a global level and so have affiliates in multiple non-EU jurisdictions.

Such an extension would allow time for the European Commission to continue its work on assessment of the appropriateness of finding these jurisdictions equivalent. It would also allow other important jurisdictions more time to develop their regulatory frameworks with respect to OTC derivatives business, such that they are more aligned with the EU standards. Such an extension of the derogation would also maintain the competitiveness of EU supervised entities engaged in derivatives business with and in these third countries.

If the Intragroup derogation is not extended further under the Clearing RTS, ESMA should consult separately (and as soon as possible) on the expiry of the Intragroup derogation

If the European Commission and ESMA do not amend the Clearing RTS to extend the derogation, we urge ESMA to (as soon as possible) conduct a full public consultation addressing whether or not the cross-border intragroup derogation should be extended. We believe that ESMA should also, at that point (and certainly no later than 30 June 2020), make a statement to the effect that national competent authorities should not prioritise their supervisory actions in relation to compliance with the clearing obligation for intragroup transactions between EU and third-country entities, and should encourage them to further apply their risk-based supervisory powers in day-to-day enforcement of these requirements in a proportionate manner towards group entities that have benefited from the derogation until after this consultation has run its course and sufficient time has passed to either to effect any legislative changes deemed appropriate, or to give market participants time to put in place necessary infrastructure and documentation to apply this requirement should the consultation conclude that it is appropriate for the derogation not to be extended.

We believe that such a statement would be necessary as it seems unlikely that ESMA could – at this stage – hold a consultation and draw conclusions from that consultation sufficiently early to give market participants adequate time to comply with the requirement to apply the clearing obligation between group entities in different jurisdictions by 21 December 2020. Compliance with this requirement would be complex and costly.

We believe it would be unusual for such an impactful requirement to be applied to market participants without any further formal consultation having been held as to its appropriateness.

If the EU applies the clearing obligation to cross-border intragroup transactions it will be an outlier in comparison with other major jurisdictions

The clearing obligations of the US CFTC[5], Australia, Canada, Hong Kong, Singapore and South Korea, among others, provide exemptions for transactions between affiliates. In this regard, we would ask the European Commission to consider – for the purpose of future revision of EMIR Level 1 - whether it continues to be appropriate for EMIR to require OTC derivatives transactions between affiliates to be cleared through a CCP or whether it would be appropriate to amend EMIR Level 1 to provide a permanent exemption for transactions which qualify as intragroup transactions.

We thank you for your consideration of this letter, and would be happy to discuss this issue further at your convenience.

Yours sincerely,

`Scott O'Malia	Wim Mijs	Walt Lukken
CEO, ISDA	CEO, EBF	President and CEO, FIA

5 The exemption under the US CFTC clearing obligation is currently time-limited, but the CFTC has proposed changes to its rules making this a permanent exemption.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 73 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.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting **32 national banking associations** in Europe that together represent some **3,500 banks** – large and small, wholesale and retail, local and international – employing about **two million people**. **Website: www.ebf.eu**

About FIA

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 about 50 countries as well as technology vendors, law firms and other professional service providers.

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 clearing firm members play a critical role in the reduction of systemic risk in global financial markets.