18 September, 2014

ISDA/FIA Europe submission on the ESMA Clearing Obligation for Credit Derivatives CP

Introduction

The International Swaps and Derivatives Association ("**ISDA**") and FIA Europe welcome this opportunity to respond to the consultation paper on the draft regulatory technical standards ("**RTS**") establishing a clearing obligation on certain credit OTC derivative classes.

We strongly support the overarching goal of reducing systemic risk in the OTC derivatives market by introducing an obligation to clear certain classes of OTC derivatives in central counterparties ("**CCPs**") that have been authorised or recognised in accordance with the requirements of Regulation (EU) No 648/2012 ("**EMIR**"). We hope that our comments in this response and follow-up discussions will assist ESMA with the preparation of the form of RTS which will be submitted to the European Commission (the "**Commission**"). This response is intended to continue the constructive ongoing dialogue between ESMA and derivatives market participants and to focus on the practical concerns and risks surrounding the implementation of the clearing obligation.

Whilst we are supportive of the classes of credit derivatives proposed in the RTS for mandatory clearing, we have significant concerns with some aspects of the RTS. Many of these concerns are equally relevant to the proposed RTS in respect of interest rate derivatives and have therefore been raised in our response to consultation paper no.1 (http://www.esma.europa.eu/consultation/Consultation-paper-Clearing-Obligation-no1-IRS#responses – the '**Rates Submission**') and we reiterate those concerns in this response.

In addition, the OTC credit derivative clearing market differs from and is less developed than the OTC interest rate derivatives market. Accordingly, we have a number of concerns which are specific to the proposed RTS establishing a clearing obligation on credit OTC derivative classes. In particular, we would like to highlight the following critical issues:

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A. Authorisation of ICE Clear Europe

The vast majority of cleared iTraxx index CDS is currently cleared at ICE Clear Europe. ICE Clear Europe is the only EU CCP which currently supports active client clearing of this type of CDS. If ICE Clear Europe is not authorised when the RTS enters into force, any index CDS declared subject to the clearing obligation on the basis of LCH.Clearnet SA's authorisation and cleared at ICE Clear Europe by a Category 1 or Category 2 firm during the relevant phase-in period would be subject to the frontloading obligation. Such index CDS would have to be cleared at an authorised CCP once the clearing obligation comes into force. If ICE Clear Europe is not authorised at this point, the index CDS subjected to the EMIR clearing obligation, which could have otherwise been cleared at ICE Clear Europe, would need to be migrated during the phase-in period to LCH.Clearnet SA (as the only CCP authorised under EMIR to clear those index CDS). This would cause market disruption as firms which are not already clearing members of LCH.Clearnet SA would need to establish links with it or to establish clearing arrangements with clearing members of LCH.Clearnet SA (which, in both cases, is unlikely to be a straightforward process and would take several months). In addition, unless off-setting trades are exempt from the clearing obligation, it may be impossible to migrate the risk to the authorised CCP.

Accordingly, we believe it would be imprudent to issue the RTS on the basis of the assumption that ICE Clear Europe will become authorised prior to the RTS entering into force. Please see our responses to Questions 1 and 2 below for further details.

B. Counterparty categorisation

As there is no overlap between those CCPs which are authorised to clear credit derivatives and those authorised to clear interest rate derivatives it is important that the counterparty categorisation for the purposes of the mandatory clearing obligation should be undertaken on an asset class basis. Please see our response to Question 1 below for further details.

C. Maturity of contract

Typically iTraxx Europe Main and Crossover indexes that have a roll date of September 20, are issued with a maturity date of December 20 occurring five years following the roll date. Similarly, indexes with a roll date of March 20 are issued with a maturity date of June 20 occurring five years following the roll date. This means that when a contract is issued in September or March, the contract actually has a maturity of 5 years and 3 months. This structural feature of standard index CDS contracts is not correctly reflected in the RTS. We therefore request that ESMA clarify that 'maturity' in respect of an index CDS refers to the actual curve that the trade references rather than the remaining maturity of the contract.

In addition, we would request that ESMA make a corresponding amendment to the minimum remaining maturity (MRM) as it pertains to the frontloading requirement for trades entered into before the publication of the RTS in the Official Journal of the

European Union (Period A). Currently, the MRM is set at 4 years and 6 months for the untranched index CDS classes. However, if the MRM for Period A is set at 4 years and 6 months as proposed, given the contract actually has a maturity of 5 years and 3 months, a contract traded on the index during Period A could still be subject to the frontloading requirement. Accordingly, we request that ESMA amend the MRM for untranched index CDS trades to 4 years and 9 months so as to exclude swaps traded in Period A from the frontloading requirement. Please see our response to Question 2 (sub-section C) below for further details.

D. Revocation of the clearing obligation

While we appreciate that ESMA has recognised that the current RTS amendment procedure is ill-suited to this task, until ESMA has the power to suspend or terminate from the clearing obligation a specific class (or contract within a class) as a matter of urgency, we believe it should take care in delineating the range of products which will be subject to the clearing obligation and should give careful consideration to contracts that are currently illiquid or that may become illiquid in the future, for example, off-the-run index-linked CDS products. It is important to note that this consideration applies equally to rates products which are currently or may become illiquid, for example long-dated basis swaps such as the 30-year GBP 6m/12m Libor basis swap. Please see our response to Question 3 below for further details.

E. De-authorisation/De-recognition of a CCP

More generally (and irrespective of the relevant class of derivative), we would encourage ESMA to provide clarity regarding the impact of de-authorisation/de-recognition of a CCP on the clearing obligation and existing cleared positions. In particular:

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

2. Offsetting trades (entered into to close-out the risk at a de-authorised or de-recognised CCP) should not be subject to the mandatory clearing obligation.

3. If a CCP is de-authorised and therefore ceases to provide clearing services, ESMA should ensure that members are provided with sufficient time to transfer and/or liquidate their positions. Specifically, ESMA should consult with clearing members and take into account (i) the relative size and importance of the de-authorised or de-recognised CCP in the market, (ii) the availability of capacity at alternative CCPs and (iii) the proportion of clearing members who already have arrangements in place with such alternative CCPs, before setting a time-line for transfer/liquidation.

4. If a CCP that 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 instrument to continue to be subject to mandatory clearing.

Please see our response to Question 4 (sub-section A) below for further details.

Question 1: Do you have any comment on the clearing obligation procedure described in Section 1?

It is not clear from the description of the clearing obligation procedure how ESMA intends to present draft RTS for different asset classes i.e. whether there will be one RTS on the clearing obligation, which will be modified each time ESMA determines that a new class of derivatives should be subject to the clearing obligation, or whether a separate, standalone, RTS will be proposed.

With regard to the two asset classes currently under consultation, we understand that there are two main alternatives:

1. **Option 1**: RTS on interest rate products are delivered to the Commission for adoption (taking the form set out in Annex 1 of the consultation paper no.1) and RTS on credit products are delivered to the Commission for adoption at a later date (taking the form set out in Annex 1 of consultation paper no.2). The Commission, however, will only adopt the second RTS.

2. **Option 2**: RTS on interest rate products are presented to the Commission, the Commission adopts the RTS and the RTS are published in the Official Journal. The RTS come into force 20 days later. The second RTS on credit products may later be adopted:

    a. as a standalone RTS, with a counterparty classification, phase-in periods and frontloading requirements specific to credit products; or

    b. as an RTS amending the RTS on interest rate products.

Paragraph 8 of consultation paper no.2 suggests that ESMA intends for interest rate and credit products to be presented in the same RTS (with these RTS taking the form set out in Annex 1 of consultation paper no.2). It is not clear, however, whether the Commission will be asked to adopt these combined RTS (Option 1) or whether the Commission will adopt RTS on credit products in accordance with either Option 2(a) or Option 2(b).

Moreover, it is not clear from either consultation paper how ESMA intends to present future RTS on other asset classes to the Commission for adoption. This issue needs to be clarified now so that market participants have certainty as to how they will be impacted by subsequent RTS. In particular, this choice will directly impact how firms build their internal systems to support compliance with the clearing obligation. For example, Option 1 would result in a single classification for counterparties across the interest rates and credit asset classes. Options 2(a) and

2(b), however, would potentially result in different counterparty classifications for interest rates and credit asset classes, thereby requiring firms to construct a different classification system to that required for Option 1. Firms need to know as soon as possible what systems they will need to build. We would urge ESMA to ensure that the RTS on the IRS Clearing Obligation it delivers to the Commission on or before 18 September 2014 clarifies this point.

For the reasons set out below we would encourage ESMA to adopt Option 2(b).

A. Option 1: single RTS, entities are assigned to a single category across asset classes

As a preliminary comment regarding Option 1, we note that it would be an odd result if the first RTS on the clearing obligation that ESMA is mandated by Article 5 of EMIR to deliver to the Commission for adoption are not adopted. This seems contrary to the purpose of Article 5 which prescribes a procedure for the introduction of the clearing obligation which is intended to provide market participants with some degree of certainty as to when a clearing obligation will be imposed.

Secondly, whilst we note that Option 1 would provide certainty as to the application of the counterparty classification, phase-in periods and frontloading requirement for both interest rate and credit products, it creates problems for counterparties which are clearing members for only one asset type at the date the RTS enter into force.

For example, a counterparty which is a clearing member at one CCP for a class of interest rate derivatives subject to the clearing obligation will be treated as a Category 1 counterparty for all interest rate and credit derivatives which are subject to the clearing obligation. Category 1 counterparties are subject to the shortest phase-in period and are subject to the frontloading requirement during this period. This clearing member, qualifying as a Category 1 counterparty, will need to become a clearing member at a new CCP or put in place additional clearing arrangements to ensure that it can clear any in-scope credit derivatives that it enters into. Whilst it will technically have the six month phase-in period within which to do this, the practical consequence of applying the frontloading requirement to contracts entered into during the phase-in period will be that the clearing member will need to obtain clearing capacity for these credit classes before the start of the frontloading period.

The problems are likely to be more pronounced due to the less developed nature of OTC credit derivative clearing market. Whereas for OTC interest rate derivatives, there are a total of 110 clearing members, clearing through five CCPs (paragraph 157 of consultation paper no.1), for credit derivatives there are only 20 clearing members at an entity level clearing through two CCPs - ICE Clear Europe, which is not yet EMIR authorised, and LCH.Clearnet SA, which though EMIR authorised does not currently support any client clearing activity (paragraph 103 of consultation paper no.2). There is therefore likely to be very little overlap between clearing members in OTC credit derivatives and interest rate derivatives. Furthermore, there is no overlap between those CCPs which are authorised (or, in the case of ICE Clear Europe, are likely to be authorised) to clear credit derivatives and those authorised to clear interest rate derivatives. As a result, a large number of clearing members who would be treated as Category 1 counterparties would need to establish arrangements with alternate CCPs.

It cannot be assumed that the process of Category 1 counterparties becoming members of CCPs in this period will be a seamless one, particularly given the need for legal opinions, technical convergence and satisfaction of all the other criteria required for admission to clearing under CCP rules. The process of joining a new CCP or CCP service takes time and potential delays in this onboarding period should not be overlooked, particularly in circumstances where several parties may be seeking to do so at the same time. Moreover, even if a counterparty is already a member of a relevant CCP, it may take a considerable length of time before it is able to extend its terms of membership to cover the clearing of additional classes at that CCP.

B. Option 2: multiple RTS options

(i) Option 2(a): multiple RTS, one for each asset class

Market participants have not had the opportunity to review and comment on a proposed form of standalone RTS for credit derivatives. In particular, it is not clear whether ESMA would propose the same counterparty classification, phase-in periods and frontloading requirement as those set out in the RTS for interest rate products. For example, it is unclear whether the phase-in periods would be aligned between the RTS on interest rates and the RTS on credit products so that the phase-in periods come to an end together. The adoption of subsequent standalone RTS would have the benefit, however, of resolving the issue identified above with respect to Option 1. Standalone RTS for credit products could be calibrated so that Category 1 only includes those counterparties which, at the date the RTS on credit products enter into force, are clearing members of an authorised CCP which clears one of the in-scope classes of credit derivatives.

(ii) Option 2(b): single RTS, multiple annexes (one for each asset class)

Our preference would be for ESMA to adopt a single RTS which is amended, through the addition of multiple annexes, as new classes of OTC derivatives are declared subject to the clearing obligation.

The additions of asset class specific annexes should be done separately so as to avoid creating confusion when each new asset class is added. As such we would not support specifically amending the annex covering interest rate products so as to bring credit products within scope of the clearing obligation. This would cause confusion in respect of the application of the clearing obligation to interest rate OTC derivatives (including, but not limited to, counterparty classification, phase-in periods and frontloading requirements) and it is vital that market participants are given an opportunity to review and comment on the form of RTS that will be presented to the Commission for adoption. Rather, we suggest credit products should be included as a separate annex, as detailed below, in order to keep the application of relevant effective dates and phase-ins specific to each class.

If ESMA's intention is to follow Option 2(b), this could be achieved by making the following amendments to the draft RTS:

- The classes of contracts subject to the clearing obligation should be separated by asset class into separate annexes to the RTS. For example, there should be one annex for interest rate derivatives and a separate annex for credit derivatives. This approach would allow for additional annexes to be added to the RTS as further classes of derivatives are consulted upon and declared subject to the clearing obligation.

- The classification of counterparties should be assessed on an asset class basis, meaning a counterparty could be a Category 1 counterparty for one asset class but a Category 2 or 3 counterparty for another. The test of classification of a counterparty in respect of a specific asset class would be whether a counterparty is a clearing member on the date the relevant annex comes into force for at least one of the types of OTC derivatives listed in the relevant annex, of at least one of the CCPs authorised before that date to clear at least one of the types of OTC derivatives listed in the relevant annex.

- The phase-in periods listed in Article 3 of the RTS should be separately stated for each Annex and by reference to the date each Annex comes into force.

- The minimum remaining maturity periods listed in Article 4 of the RTS should be separately stated for each Annex and by reference to the date each Annex comes into force.

The benefit of drafting the first RTS on the clearing obligation in the way described above is that it facilitates an amendment process whilst at the same time creating certainty as to how future clearing obligations will be brought into effect (particularly in respect of counterparty classification, phase-in periods and the application of the frontloading requirement). It also ensures that derivatives within an asset class are treated consistently (i.e. a clearing member for a European untranched index CDS will be treated as a Category 1 counterparty for all credit derivative products subject to the clearing obligation) whilst allowing for differentiation of counterparties between asset classes (i.e. it does not treat a counterparty as a Category 1 counterparty for all asset classes just because it is a clearing member for one asset class). This approach would also prevent the oddity described above for Option 1 whereby the Commission has to ignore the first RTS delivered to it by ESMA in favour of the second consolidated RTS.

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

Question 2: Do you consider that the proposed structure for the untranched index CDS classes enables counterparties to identify which contracts are subject to the clearing obligation as well as allows international convergence? Please explain.

No. We have significant concerns that the proposed structure for credit OTC derivative classes will not enable counterparties to identify which contracts are subject to the clearing obligation.

A. The two step approach

The RTS should be amended to **explicitly link the application of the clearing obligation to the requirement that a particular contract is "supported by CCPs"**. We welcome ESMA's statement in paragraph 22 of consultation paper no.1 that a particular contract will only be subject to the clearing obligation if it has the seven characteristics set out in Annex 1 of the draft RTS and is supported by CCPs. The current text of the credit RTS does not reflect this "two-step" approach. Without the explicit incorporation of the two-step approach, the RTS will have the following negative impacts on the market:

- Parties will be required to clear contracts which meet the seven characteristics listed in Annex 1 but which, in practice, cannot be cleared by any authorised or recognised CCPs. This will cause a "dead-zone" of contracts which parties can no longer trade because they will not be able to comply with the mandatory obligation to clear these contracts.

- There will be uncertainty in the market as to which contracts are subject to the clearing obligation. It is vital that the RTS create a structure which enables market participants to identify quickly and with as much certainty as possible whether a particular contract is subject to mandatory clearing. The current text of the RTS (which rely on the seven characteristics without any reference to whether a CCP will clear the contract) is insufficient to give market participants this certainty.

The RTS should **specify that "supported by CCPs" means that there are CCPs which are authorised or recognised to clear and actually clear a particular contract.** It is insufficient to simply refer to the authorisation of a CCP. Whilst a CCP may be authorised to clear a certain class of OTC derivatives, the actual contracts it will clear within this class will be constrained by the CCP's rulebook. All CCPs set and maintain detailed rules about the terms a contract must contain, or must not contain, to be clearable. A CCP's published authorisation may not reflect the granularity of these terms. The articulation of the two-step approach in this way would be consistent with the approach taken by the CFTC in the US - the relevant CFTC rule states that a swap will be subject to the mandatory clearing obligation if it meets certain characteristics and an eligible derivatives clearing organisation "accepts such swap for clearing".

The RTS should further take into account the critical requirement that **relevant middleware is available to support straight-through processing ("STP") technology for clearing of that particular contract**. Failure to take middleware STP operability into account in identifying which contracts should be subject to the clearing obligation will mean that whilst it may be technically possible to submit the particular contract for clearing using a manual method (for example, a manual spreadsheet upload), the use of such manual processes creates exactly the type of operational risk which ESMA and market participants are aiming to reduce. The lack of suitable middleware technology proved to be a problem for market participants in the initial months of the CFTC clearing mandate in the US. To prevent similar issues arising in the EU we recommend that an appropriate phase-in period is provided during which contracts subject to the clearing obligation do not have to be cleared if the necessary middleware is not available to support the STP of these contracts. We understand that this should only be an issue for a small number of bespoke contracts and that a period of three to six months should be sufficient time for the market to develop the necessary middleware technology.

A contract should only be subject to the mandatory clearing obligation if at least two CCPs are authorised or recognised to clear and actually clear that particular contract. We consider that there is inherent and demonstrable benefit in only mandating clearing of a product where there are multiple CCPs available to clear that product. For the reasons described in our response to question 4 below, it is essential that there are at least two authorised or recognised CCPs available to clear a contract for the clearing obligation to apply.

To ensure that market participants are able to assess whether a particular contract is subject to the clearing obligation, **greater transparency is needed as to what contracts can actually be cleared by authorised and recognised CCPs.**

Furthermore, while we appreciate ESMA's statement in paragraph 90 of consultation paper no.2 that it is expected that ICE Clear Europe will be authorised by the time the RTS enters into force, we believe it would be imprudent to issue the RTS on the basis of this assumption as we expect that the **market would face trading disruption if ICE Clear Europe is not in fact authorised when the RTS enters into force**.

Currently, the vast majority of cleared iTraxx index CDS is cleared at ICE Clear Europe and, as noted by ESMA, while LCH.Clearnet SA has an operational offer of client clearing services, there is currently no client clearing activity on the CDS business line. Any index CDS declared subject to the clearing obligation on the basis of LCH.Clearnet SA's authorisation and cleared at ICE Clear Europe by a Category 1 or Category 2 firm during the relevant phase-in period would be subject to the frontloading obligation. Such index CDS would have to be cleared at an authorised CCP once the clearing obligation comes into force. If ICE Clear Europe is not authorised at this point, the index CDS subjected to the EMIR clearing obligation, which could have otherwise been cleared at ICE Clear Europe, would need to be migrated during the phase-in period to LCH.Clearnet SA (as the only CCP authorised under EMIR to clear those index CDS).

This would cause market disruption as it may be impossible to migrate the risk to the authorised CCP. In order to transfer the risk, a firm will need to trade an offsetting derivative at ICE Clear Europe and then trade another derivative to reopen the position at the authorised CCP. However, under the RTS (as currently drafted) the offsetting derivative would also need to be cleared by an authorised CCP (in this respect we would refer you to our response to question 4 below) which would effectively preclude firms from offsetting the risk. While clearing members which are Category 1 firms by virtue of being members of LCH.Clearnet SA would be able to clear trades at LCH.Clearnet SA, Category 2 firms that are clearing at ICE Clear Europe may be forced to step back from trading during the phase-in period until they are able to set up alternative clearing arrangements at LCH.Clearnet SA, where there is currently, as noted by ESMA, no client clearing activity. As establishing clearing arrangements with an alternative CCP is not a straight-forward process (in this respect we would refer you to our response to question 4 below), Category 2 firms could find themselves shut out from the market for a prolonged period. We would also note that if, contrary to our preference, ESMA adopts Option 1 rather than Option 2(b) (see our response to Question 1 above), the same concerns would apply in respect of Category 1 firms who are not already clearing members of LCH.Clearnet SA's CDS service.

B. International Convergence

While we recognise that the scope of the clearing obligation is narrower than the determinations made by the Commodity Futures Trading Commission (CFTC) for the US clearing mandate, we agree with ESMA's exclusion of the iTraxx Europe HiVol 5Y and iTraxx Europe Main 10Y contracts from the clearing obligation, given the associated liquidity characteristics of the contracts.

C. Maturity of Contracts

Typically iTraxx Europe Main and Crossover indexes that have a roll date of September 20, are issued with a maturity date of December 20 occurring five years following the roll date. Similarly, indexes with a roll date of March 20 are issued with a maturity date of June 20 occurring five years following the roll date. This means that when a contract is issued in September or March, the contract actually has a maturity of 5 years and 3 months. This structural feature of standard index CDS contracts is not correctly reflected in the RTS.

First, the RTS needs to clarify the meaning of ‘maturity’ as a parameter for determining which index CDS contracts are subject to the clearing obligation. According to Annex 1, section 2 of the RTS, the last column can be read to mean the maturity of the contract (as is the case in the proposed RTS in respect of interest rate derivatives), rather than the actual curve that the trade references. Strictly speaking, this means that only a derivative with a maturity of exactly 5-years will be subject to the clearing obligation, whereas derivatives with other maturities (e.g. 5 years and 3 months) referencing the 5-year curve will not. We believe that ESMA should amend the RTS so that all trades referencing the 5-year index curve are subject to the clearing obligation.

Second, a corresponding amendment is also required to the minimum remaining maturity (MRM) as it pertains to the frontloading requirement for trades entered into before the publication of the of the RTS in the official journal (Period A). Currently, the MRM is set at 4 years and 6 months for the untranched index CDS classes. However, if the MRM for Period A is set at 4 years and 6 months as proposed, a contract traded on the index during Period A could still be subject to the frontloading requirement.

By way of example, the iTraxx Main Series 22 5Y is due to launch on 22 September, 2014 with a scheduled maturity date of December 20, 2019 (a maturity of 5 years and 3 months). If two Category 1 firms trade an iTraxx Main 5Y on this launch date, and the RTS is published in the Official Journal on 1 December, 2014, the clearing obligation could apply to Category 1 firms from June 1, 2015. As of this date, the iTraxx Main trade executed on 22 September 2014 would still have a MRM of 4 years 6 months and 19 days, and would thus be subject to the frontloading requirement. Therefore, we request that ESMA amend the MRM for untranched index CDS trades to 4 year and 9 months so as to exclude swaps traded in Period A from the frontloading requirement.

Question 3: In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to credit OTC derivatives?

Given the systemic risk associated to single name CDS, would you argue that they should be a priority for the first determination as well? Please include relevant data or information where applicable.

We agree that the classes of credit OTC derivatives proposed for mandatory clearing in the RTS appropriately address systemic risk. However, 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, it is ISDA's (though not FIA Europe's) view that, 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. 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.

While we appreciate that ESMA has recognised that the current RTS amendment procedure is ill-suited to this task (paragraph 67 of consultation paper no.1), until ESMA has the power to suspend or terminate from the clearing obligation a specific class (or contract within a class) as a matter of urgency, we believe it should take care in delineating the range of products which will be subject to the clearing obligation and should give careful consideration to contracts that are currently illiquid or that may become illiquid in the future, for example, off-the-run index-linked CDS products. It is important to note that this consideration applies equally to rates products which are currently or may become illiquid, for example long-dated basis swaps such as the 30-year GBP 6m/12m Libor basis swap. Trading volume in contracts referencing an on-the-run series of a CDS index falls sharply once such series becomes off-the-run, the table below illustrates the significant impact that the launch of a new series of a CDS index has on the trading volume of contracts referencing previous series of the same CDS index*.

Index	Roll Date	Pre-roll 5-day average trade count (old series)	Post-roll 1-5day average trade count (old series)	Change	Post-roll 6-10day average trade count (old series)	Change	Post-roll 11-15day average trade count (old series)	Change	Post-roll 16-20day average trade count (old series)	Change
itraxx Europe 5Y	20/03/2014	171.8	28.6	-83%	16.6	-90.3%	6.4	-96.3%	7	-95.9%
itraxx Crossover 5Y	20/03/2014	143.4	41.4	-71.1%	16.4	-88.6%	10	-93.0%	13.2	-90.8%

* Daily trade count data from publicly available DTCC SDR and Bloomberg BSDR

It is important to note that regulators in other jurisdictions have powers to act quickly to suspend a clearing obligation in exceptional circumstances. For instance, in the US the CFTC has the power to achieve a similar result through the means of no action letters. Therefore, as part of the 2015 review of EMIR, we believe ESMA should seek an amendment to EMIR which grants ESMA the power to terminate or suspend a clearing obligation in certain circumstances (including those described above). Similar mechanisms already exist in other pieces of EU legislation, such as the Short Selling Regulation (EU) No 236/2012 and Directive 2014/65/EU and Regulation (EU) No 600/2014 on markets in financial instruments. ESMA should also raise the issue in its forthcoming report to the Commission on the application of the clearing obligation under Title II (Article 85(3)(a) of No 648/2012).

ESMA should also request that the Commission give consideration during the 2015 review of EMIR to an amendment to EMIR introducing a grace period for counterparties excusing them from compliance with the risk mitigation techniques in Article 11 of EMIR for cleared contracts which were subject to the clearing obligation but for which the clearing obligation was later suspended or terminated. Until this amendment can be made to EMIR, we recommend that the ESAs consider including a phase-in period in the forthcoming RTS on margin requirements for uncleared OTC derivative transactions which would remove the need for counterparties to comply with the requirement to collect margin in respect of these trades. The phase-in period should be long enough to afford counterparties sufficient time within which to make any necessary amendments to the terms of their contracts to ensure they comply with the risk mitigation rules.

We welcome the decision to exclude single name CDS from the clearing obligation, and agree with ESMA's analysis in paragraphs 68 and 69 of consultation paper no.2.

Question 4: Do you have any comment on the analysis presented in Section 4.1?

A. Number of CCPs

We would reiterate our concerns which we raised in response to question 2 above in relation to the likely market disruption if ICE Clear Europe is not authorised by the time the RTS comes into force.

Whilst we agree with ESMA's analysis in paragraph 89 of consultation paper no.2 that ESMA has no legal basis on which to refuse to launch a clearing obligation procedure solely on the ground that a class of derivatives is cleared by a single CCP, we believe that ESMA is entitled to take this into account in its determination of whether a class of derivatives should be subject to the clearing obligation. In our view, the clearing obligation should only be imposed when at least two authorised or recognised CCPs clear a particular class of derivatives. We support this view for the following reasons:

- To avoid the risk of monopoly situations. If a clearing obligation can be imposed where only one CCP clears a particular class of derivatives, CCPs will be commercially incentivised to develop clearing offerings which diverge from other CCPs to ensure that it can dominate a particular segment of the market.

- To avoid 'bottleneck' situations. A single CCP may not have the capacity to clear all the contracts in the class for which it is the only CCP. This concern is exacerbated by the proposed frontloading requirement, which may lead to a large backlog of contracts which will need to be cleared by the end of the phase-in period. A single CCP may not be able to handle such a backlog.

- To mitigate the impact on clearing members if a CCP loses its authorisation or recognition. Whilst we recognise that a clearing obligation will cease to apply if there is no longer a CCP authorised or recognised to clear a particular class of derivatives, there will nevertheless be negative practical implications if a single CCP authorised or recognised to clear a particular class of derivatives loses its authorisation or recognition. In particular, because no other CCP will be authorised or recognised to clear this class of contract, clearing members will be unable to move existing contracts to another CCP. For prudentially regulated firms, this could dramatically increase the amount of capital required to be held against these positions (as exposures to non-authorised/recognised CCPs command higher risk weights under Regulation (EU) No 575/2013 ("**CRR**")).

- To mitigate the impact on clearing members if a CCP stops clearing a particular class of OTC derivatives. Whilst Article 5(6) of EMIR states that "if a class of OTC derivative contracts no longer has a CCP which is authorised or recognised to clear those contracts under [EMIR], it shall cease to be subject to the clearing obligation", EMIR does not address cases where a CCP remains authorised or recognised to clear a class of OTC derivatives but the CCP stops actually clearing this class. Should there be no other CCPs clearing this class of OTC derivatives, counterparties will be subject to a clearing obligation which is impossible to comply with in practice.
- To mitigate systemic risk in clearing member default and/or CCP resolution scenarios. In a default scenario, it would be helpful for the orderly functioning of the market if clearing participants had another CCP to fall back on while the affected CCP deals with the default. Additionally, the existence of a second CCP may make it more likely for clearing participants to provide hedges to the affected CCP. The existence of a second CCP is even more important in a CCP resolution scenario as a successful resolution process for a failed CCP is likely to involve the transfer of positions to other CCPs.

We also request that ESMA, in the situation where at least two CCPs are authorised or recognised, explicitly allow market participants to liquidate positions if one of the CCPs were to lose its recognition or authorization. In order to liquidate the risk at a de-authorised CCP, irrespective of the impacted asset class, firms would need to clear offsetting exposures at the CCP; however, as the RTS is currently drafted, those new swaps will still be subject to the clearing obligation and hence need to be cleared at an authorised or recognised CCP. Therefore, it would be impossible to close-out the risk at the de-authorised CCP and reopen the positions at the authorised CCP. As set out in our response to Question 8 below under the heading "Treatment of trades that result from systemically risk-reducing processes", in our view it is vital that offsetting trades of this type are excluded from the scope of the clearing obligation.

Even if offsetting trades are excluded from the scope of the clearing obligation, there may still be circumstances in which clearing members may wish to retain outstanding positions at the relevant CCP rather than liquidate or transfer the positions. If all clearing members were required to immediately liquidate and/or transfer their positions upon the de-authorisation or de-recognition of a CCP this could have a detrimental impact on financial stability. Specifically, the authorized and/or recognised CCPs for the relevant asset classes (to whom the positions would need to be transferred) may not have the risk management capacities and scalability to respond to a sudden substantial increase of clearing demand/volume. These problems would be aggravated if the de-authorised or de-recognised CCP cleared the majority of the flow in the relevant clearable instruments and the remaining CCPs are comparatively small.

Accordingly, ESMA should clarify that to the extent a clearing obligation is still in force a firm may either (i) liquidate its positions on the de-authorised or de-recognised CCP or (ii) where the CCP (notwithstanding the de-authorisation or de-recognition) continues to provide clearing services in respect of the relevant contracts, retain its outstanding positions at the relevant CCP. In addition, if a CCP is de-authorised and therefore ceases to provide clearing services, ESMA should ensure - in order to mitigate the impact on the markets - that members are provided with sufficient time to transfer and/or liquidate their positions and are not required to do so immediately. Specifically, ESMA should consult with clearing members and take into account (i) the relative size and importance of the de-authorised or de-recognised CCP in the market, (ii) the availability of capacity at alternative CCPs and (iii) the proportion of clearing members who already have arrangements in place with such alternative CCPs, before setting a time-line for transfer/liquidation. In our view, this approach would be consistent with EU policy objectives as set out in other EU legislation - in particular Regulation 575/2013, which provides for a period of time in which CMs may continue to calculate their exposure with beneficial qualifying-CCP capital treatment even following revocation of CCP status.

Finally, we would note that if a CCP that 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 instrument to continue to be subject to mandatory clearing. In this regard we would reiterate our concerns (outlined in response to Question 3 above) in relation to ESMA's inability to dis-apply the clearing obligation.

B. Number of clearing members

We agree that the number of clearing members clearing a class of derivatives should be regarded as a vital part of ESMA's assessment of whether a clearing obligation should be imposed on that class. We would stress, however, that the number of clearing members for a class should be monitored on an ongoing basis to ensure that the continued imposition of the clearing obligation remains appropriate.

As stressed in response to question 4 in the Rates Submission, it is vital that there is a timely mechanism for removing classes from the clearing obligation when necessitated by market events, including when the number of clearing members clearing a particular class diminishes

Question 5: Do you agree with the proposal to keep the same definition of the categories of counterparties for the credit and the interest rate asset classes? Please explain why and possible alternatives.

The effectiveness of the proposed classification of counterparties to ensure a smooth implementation of the clearing obligation must be assessed in the context of the proposed phase-in periods and approach to the frontloading requirement. In our view, these elements cannot be assessed in isolation. When assessed together, we believe that that the proposed approach to counterparty classification and the frontloading requirement undermine the purpose of the phase-in period for Category 2 counterparties.

To preserve the effectiveness of the phase-in period for Category 2 counterparties and other counterparties which need time to put in place clearing arrangements, we recommend ESMA adopt the same alternative proposal detailed in our Rates Submission for the credit asset classes. Section A below sets out the key elements of our alternative proposal and the sections that follow provide further explanation as to the reasons why this alternative should be adopted.

A. Alternative proposal

Because of the uncertainty and market disruption that will arise from the frontloading requirement for Category 2 counterparties during the 18 month phase-in period, **the frontloading requirement should not be imposed on Category 2 counterparties** (see below, under section B, for a description of the uncertainties and market disruption). This can be achieved by setting the minimum remaining maturity of contracts entered into during the phase-in period (where at least one counterparty to the contract is a Category 2 counterparty) using the approach proposed by ESMA for Period A, thus excluding Category 2 counterparties from the frontloading requirement.

To ensure that Category 2 counterparties are encouraged to establish clearing arrangements as soon as possible, **the phase-in period for Category 2 counterparties should be shortened to nine months**. As a practical consideration, the length of the phase-in period should be set to avoid an end-date which falls at the end of the calendar year. A shortened phase-in period will counterbalance the lack of a frontloading requirement for Category 2 counterparties.

The frontloading obligation should only apply to contracts entered into or novated between two Category 1 counterparties. These counterparties will already be clearing members as of the date of entry into force of the RTS and clearing the vast majority of clearable inter-dealer business.

The phase-in period for transactions entered into with third country entities established in jurisdictions yet to be granted equivalence under Article 13 of EMIR, which would be Category 2 counterparties if established in the EU, should be extended for an extra six

months, without a frontloading period (i.e. for a 15 month period after the entry into force of the RTS). This would mitigate the problems caused by the delayed timetable of the equivalence determinations under Article 13 of EMIR.

To ensure that sufficient time is available for the equivalence assessments under Article 13 of EMIR, consideration should be given to the treatment of cross-border inter-affiliate trades. These trades should not be prejudiced by the delayed timetable of the equivalence assessments. **We recommend that ESMA include in the RTS a three year phase-in period for cross-border inter-affiliate trades, during which the clearing obligation and the frontloading requirement will not apply**. A transaction between an EU counterparty (which is subject to the clearing obligation) and a third country entity (which would be subject to the clearing obligation if established in the EU) should benefit from this phase-in period if all the conditions in Article 3 of EMIR are satisfied except for the requirement that the Commission has adopted an equivalence determination for the relevant third country. **If an equivalence determination is made during the course of this three year phase-in period, parties should be given sufficient time to prepare, submit and have approved applications to rely on the intragroup exemption. Therefore the phase-in period should extend for six months after an equivalence determination is made.** Additionally, we would urge ESMA to reach out internationally to other regulators to encourage the alignment of intragroup exemptions. For example, the intragroup exemption under the CFTC mandatory clearing regime is due to expire on 31 December 2014.

If ESMA does not support our primary proposal as described above and the frontloading obligation is applied to a broader range of counterparties than Category 1, as a fallback proposal we would urge ESMA to extend the length of Period A for Category 2 counterparties.

Whilst we recognise that the industry is generally aware of the impending commencement of the frontloading period, for many participants the full implications of the frontloading requirement cannot be assessed until the RTS is published in the Official Journal. Given the significant changes that a move to clearing will present for many Category 2 counterparties, the 20 day period between publication of the RTS in the Official Journal and its entry into force will not provide sufficient time for these counterparties to prepare for the commencement of the frontloading obligation. Therefore, if our proposal for the treatment of the frontloading requirement as set out above is not adopted, we believe that Period A should be extended to six months after the entry into force of the RTS. This would provide Category 2 counterparties with more time to put in place the necessary processes and documentation to ensure compliance with the clearing obligation, without having to consider the frontloading obligation during this period. We would stress, however, that this fallback position would not adequately address all of the uncertainties and difficulties faced by Category 2 counterparties (as described below in section B) and for these reasons we would urge ESMA to adopt our alternative proposal as described above.

B. Rationale for alternative proposal – preserving the effectiveness of the phase-in period for Category 2 counterparties

When assessed together, we have significant concerns about the effectiveness of the proposed classification of counterparties, phase-in periods and minimum remaining maturity to achieve a smooth implementation of the clearing obligation. Whilst we strongly welcome ESMA's initiative to mitigate the impact of the frontloading requirement during Period A, the proposed application of the frontloading requirement to financial counterparties during Period B will significantly impact Category 2 counterparties to such an extent that the objective of the phase-in period will be undermined.

Even though counterparties entering into or novating OTC derivatives in Period B 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 during Period B 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.

- 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 credit default 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). It is therefore commonplace that derivatives denominated in one currency are collateralised with different currencies, and thus valued using different discount rates. 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 will 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.

- While this pricing approach is typically employed by dealers when valuing 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.

- Period B frontloading will de facto impose 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.

- 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, the trade may end up having to be terminated (see below).

- The upshot of being unable to price OTC derivatives accurately means that trades will undergo pricing adjustments when frontloaded into CCPs, forcing market participants to make rebalancing payments. If a large part of the industry (i.e. Category 2 counterparties) were to backload their trades on the date that the clearing obligation takes effect (at the end of the 18-month phase-in period) 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 by the time the clearing obligation takes effect, 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. The legal and operational process surrounding this mass termination exercise would 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.

It will, therefore, be difficult for counterparties to enter into uncleared OTC derivative contracts in Period B that will be affected by the frontloading requirement. This is likely to mean that counterparties will, in practice, need to immediately submit these contracts for clearing and to price their transactions accordingly. This would significantly undermine the value of the phase-in period for counterparties that were intended to benefit from it.

If the only practical response to the frontloading requirement for these contracts is for counterparties to submit them for clearing, this could also undermine the other objectives of the phase-in period. For example, it would mean that the CCPs initially authorised to clear that class would have less opportunity to scale up their capacity to meet demand and, in particular these CCPs may face a bottleneck as they attempt to onboard the number of entities wishing to become clearing members or extend the terms of their existing CCP memberships to cover new services. Moreover, it would give a competitive advantage to the first CCPs authorised to clear a particular class of contracts, as they would gather a volume of business which may not readily migrate to competing CCPs that are authorised at a later date.

Our concerns regarding the long phase-in period and proposed application of the frontloading requirement for Category 2 counterparties are exacerbated by the broad scope of this category. The size of Category 2 is estimated to be substantially larger than either Category 1 or 3, with estimates ranging between 3,000 to 6,000 counterparties. Whilst we firmly believe that Category 2 counterparties will be forced to voluntarily clear during the phase-in period if the frontloading requirement is imposed for the reasons outlined above, we would also note that CCPs and clearing members would be put under huge pressure if a large proportion of Category 2 counterparties did leave backloading to the last minute and try to clear 18 months' worth of trades at the same time, potentially creating a bottleneck. If, either as a result of insufficient resources for firms to backload these contracts fast enough or as a result of no clearing members wanting or being able to clear for a client (for example, as a result of a clearing member's limited financial balance sheet stemming from the CRR) a large number of trades may have to be terminated.

We would also note that the imposition of the frontloading requirement on Category 2 counterparties would impact pension funds notwithstanding the exemption in Article 89(1) of EMIR. Article 89(1) of EMIR relates to OTC derivative contracts that are "objectively measurable as reducing investment risks directly relating to the financial solvency" of the pension scheme. Some pension schemes, such as institutions for occupational retirement provision ("**IORPs**"), are permitted to enter into derivative transactions for other reasons. For example, under the Directive 2003/41/EC (the IORP Directive), IORPs, are permitted to enter into derivative transactions which "contribute to a reduction of investment risks or facilitate efficient portfolio management". Therefore, not all trades by IORPs will benefit from the Article 89(1) exemption from the clearing obligation e.g. trades for efficient portfolio management. Unless the frontloading requirement is mitigated for Category 2 counterparties as described above in our alternative proposal, IORPs will be subject to the frontloading requirement in respect of their non-exempt trades. This seems contrary to the intention behind the exemption in Article 89(1) of EMIR which aims to mitigate the negative impact of the clearing obligation on pension schemes until a suitable technical solution for the transfer of non-cash collateral as variation margin is developed by CCPs to address the fact that pension schemes typically do not hold cash. The imposition of the frontloading requirement during the phase-in period for Category 2 counterparties would undermine this objective.

Additionally, we would note that the end of the 18 month phase-in period for Category 2 counterparties will likely coincide with the industry's implementation of MiFID2/MiFIR. To ensure the smooth implementation of the clearing obligation, counterparties should be encouraged to establish clearing arrangements as soon as possible. A shortened phase-in period for Category 2 counterparties would also encourage these counterparties to put in place clearing arrangements before the proposed 1 December 2015 date for margin requirements.

We therefore believe that it is imperative that the intended benefit of the phase-in period for Category 2 counterparties is preserved by removing the frontloading requirement for this category of counterparties. As indicated in our alterative proposal described above, this can be achieved by setting the minimum remaining maturity of contracts entered into during the phase-in period using the approach proposed for Period A, thus excluding Category 2 counterparties from the frontloading requirement. To ensure that Category 2 counterparties are encouraged to establish clearing arrangements as soon as possible, the phase-in period for Category 2 counterparties should be shortened to nine months. A shortened phase-in period will counterbalance the lack of a frontloading requirement for Category 2 counterparties.

C. Rationale for alternative proposal: treatment of third country entities and cross-border inter-affiliate trades

As indicated above, we believe that the phase-in period for transactions entered into with third country entities established in jurisdictions yet to be granted equivalence under Article 13 of EMIR, which would be Category 2 counterparties if established in the EU, should be extended for an extra six months, without a frontloading period (i.e. for a 15 month period after the entry into force of the RTS). Additionally, we recommend that ESMA include in the RTS a three year phase-in period for cross-border inter-affiliate trades, during which the clearing obligation and the frontloading requirement should not apply.

Third country entities should be given different treatment for the following reasons:

- The clearing obligation will apply to contracts between EU counterparties and third country entities (as described in Article 4(1)(a)(iv) of EMIR), including intragroup transactions, and certain contracts between two third country entities (as described in Article 4(1)(a)(v) of EMIR).

  It was expected that the equivalence determinations under Article 13 of EMIR would mitigate the impact of the clearing obligation on these transactions. The lack of any equivalence determinations by the Commission to date, however, means that a much wider class of entities than initially expected will be affected by the first clearing obligation under EMIR. This problem is exacerbated by the fact that the intragroup exemption for the clearing obligation will not apply to transactions with a third country entity until an equivalence determination is adopted by the Commission for the relevant third country. Whilst it is possible that some equivalence determinations will be made before the RTS enters into force, there are many jurisdictions which have not even been examined yet and for which an equivalence determination is extremely unlikely before the RTS enters into force.

  An extended phase-in period for third country entities established in jurisdictions yet to be granted equivalence under Article 13 of EMIR which would be Category 2 counterparties if established in the EU and a phase-in period for cross-border inter-affiliate trades will reduce the number of entities looking to set up clearing arrangements during the early stages of the phase-in period (i.e. the stage that overlaps with the phase-in periods for Category 1 and EU Category 2 counterparties). This will reduce the risk of a 'bottleneck' scenario at CCPs and clearing members offering direct client clearing arrangements.

- As stated in paragraph 202 of consultation paper no.1, the obligation in Article 4(1)(a)(iv) of EMIR to clear lies with the counterparty established in the EU. As third country entities are not directly subject to the clearing obligation, they do not have the same incentives as EU counterparties to put clearing arrangements in place quickly. This means that EU entities may struggle to persuade their third country counterparties to clear transactions, which has implications for continuity of trading and availability of liquidity in the market.

- EU CCPs have prioritised much of the legal enforceability analysis of their rulebooks for clients in EU member states and have not focused on whether their clearing structures are fully in line with third country regimes. Some CCPs have already stated that certain account types would not be suitable for certain third country clients. It may, therefore, be difficult for non-EU clients to obtain clearing arrangements until CCPs address this issue in their clearing offerings.

D. Classification on an asset-class basis

As indicated in our response to question 1 above, we believe that counterparty classifications should be undertaken on an asset class basis. It should be possible for one entity to be a Category 1 counterparty for interest rate OTC derivatives and a Category 2 or 3 counterparty for credit OTC derivatives. We would encourage ESMA to adopt this approach (for example, by framing the RTS in the way proposed in Option 2(b) of our response to question 1 above) and, to provide clarity to the market, consider establishing a register of clearing members (which includes their LEIs) which would assist market participants when establishing whether a particular counterparty is a Category 1 counterparty for a given asset class. Alternatively, CCPs should be encouraged to publish lists of their clearing members (including their LEIs) as of the date each RTS comes into force.

The current proposal, which would see clearing members for one asset class also treated as Category 1 counterparties for another asset class (regardless of whether they are clearing members for this second asset class), would require clearing members to become members of new CCPs, extend the terms of their existing CCP membership to cover new services (if this is possible) or put in place clearing arrangements with other clearing members. Whilst such counterparties will technically have the six month phase-in period within which to do this, the practical consequence of applying the frontloading requirement to contracts entered into during the phase-in period will be that the clearing member will need to obtain clearing capacity for the additional asset class before the start of the frontloading period.

It cannot be assumed that the process of Category 1 counterparties becoming members of CCPs in this period will be a seamless one, particularly given the need for legal opinions, technical convergence and satisfaction of all the other criteria required for admission to clearing under CCP rules. The process of joining a new CCP or CCP service takes time and potential delays in this onboarding period should not be overlooked, particularly in circumstances where several parties may be seeking to do so at the same time. Moreover, even if a counterparty is already a member of a relevant CCP, it may take a considerable length of time before it is able to extend its terms of membership to cover the clearing of additional classes at that CCP.

We would note that it may be appropriate for ESMA to take an alternative approach to applying the counterparty classification test for other asset classes, such as the commodity asset class, to avoid prejudicing the position of corporate end users that are clearing members of authorised or recognised CCPs for a narrow range of commodity derivative products. In such asset classes, it may be appropriate to treat a firm as a Category 1 counterparty for one type of commodity derivative but not for another if the commodity derivative products for which a given firm is a clearing member are easily ascertainable from the CCP clearing member list(s) that are made available for the purposes of identifying Category 1 counterparties. We do not, however, believe that this approach is necessary for the credit OTC derivative class.

E. Treatment of AIFs

(i) Genuine hedging transactions by AIFs

We believe that ESMA has underestimated the extent to which many funds, for example real-estate and private equity funds, regularly enter into derivatives for the purpose of hedging exposures associated with their underlying assets in a similar way to industrial corporations. As such, we strongly disagree with ESMA's statement in paragraph 194 of consultation paper no.1 which states that "it is difficult to establish a link between the activity of a fund and those described in the hedging definition, therefore AIFs falling under the NFC category should qualify their OTC trading as 'non-hedging'".

Indeed, the fact that funds can enter into derivatives for hedging purposes is recognised in Directive 2011/61/EU on alternative investment fund managers ("**AIFMD**") and Commission Delegated Regulation (EU) No 231/2013 ("**AIFMD Level 2 Regulation**"). Article 8(2) of the AIFMD Level 2 Regulation requires alternative investment fund managers ("**AIFM**") to include hedging arrangements in their calculation of the exposures of an AIF. Furthermore, Article 8(6) sets out conditions which must be met for a hedging arrangement to be taken into account in the calculation of an AIF's exposures.

We therefore urge ESMA to reconsider its statement in paragraph 194 of consultation paper no.1 and indicate that it is possible for AIFs to enter into hedging transactions. Failure to do so could create uncertainty regarding the legitimate classification of AIFs as non-financial counterparties when counting transaction volumes towards the thresholds in Article 10 of EMIR. This point is relevant for both those non-financial counterparties described in paragraph 191 (EU AIFs) and for third-country AIFs as described under paragraph 204 of consultation paper no.1. For those entities, we encourage ESMA to confirm that the assessment of whether they are above or below the clearing threshold in Article 10 of EMIR is not in any way impacted by the structure of the classification used for the purposes of the clearing obligation start dates.

(ii) Status of non-EU AIFs managed by non-EU AIFMs

We understand from paragraph 204 of consultation paper no.1 that non-EU AIFs managed by non-EU AIFMs are to be regarded as third country entities which would be non-financial counterparties if established in the EU, even if such AIFs are marketed in the EU pursuant to Article 42 of the AIFMD.

Whilst we note that ESMA has recently clarified, by way of General Question 4 in its Q&A, that non-EU AIFs managed by non-EU AIFMs are third country entities for the purposes of EMIR (because they are not established in the EU and are not managed by an authorised or registered AIFM), it would be useful if ESMA could amend the Q&A to add that such AIFs are third country entities which would be non-financial counterparties if established in the EU. This is a significant interpretation of EMIR and it is important that a permanent record of this interpretation is maintained to ensure consistent application by national competent authorities ("**NCAs**") and market participants across the EU.

(iii) Counterparty classification of AIFs

We have concerns regarding the practical implementation of ESMA's proposal that AIFs which qualify as non-financial counterparties which are subject to the clearing obligation should be included in Category 2.

From a practical implementation standpoint, market participants have been focussed on building and adopting internal processes and controls that classify clients and counterparties in accordance with the framework set out in EMIR (i.e. financial counterparty, non-financial counterparty above the clearing threshold and financial counterparty below the clearing threshold). From a practical and operational perspective, it will be extremely challenging for market participants to add an additional layer to this taxonomy for the purposes of the clearing obligation only. The systemic risk of adding this additional layer of classification to the existing categorisation process is that market participants mistakenly assign AIFs which are subject to the clearing obligation to Category 3 (as opposed to Category 2). The significant efforts required by the industry to cater for this change to the EMIR counterparty taxonomy is a misallocation of resources when compared to the reduction in systemic risk it is likely to achieve.

The significant implementation challenges outlined above would be avoided if ESMA implements a counterparty categorisation of AIFs which is based solely on their status as a financial counterparty or non-financial counterparty which is subject to the clearing obligation (provided that an appropriate transitional period is provided for AIFs which are non-financial counterparties in Category 3 moving to Category 2 when they become financial counterparties as a result of their AIFMs being authorised under the AIFMD).

In any event, we would note that treating AIFs which are non-financial counterparties as Category 2 counterparties does not achieve ESMA's aim of treating all AIFs equally. Unless the frontloading requirement for all Category 2 counterparties is mitigated, as described above, AIFs which are non-financial counterparties will have the full benefit of the phase-in period (as the frontloading requirement does not apply to non-financial counterparties) whilst AIFs which are financial counterparties will be subject to the frontloading requirement.

F. Categorisation of third country entities

We broadly welcome ESMA's analysis in paragraphs 202 to 204 of consultation paper no.1 as to how third country entities should be treated for the purposes of the RTS on the clearing obligation. However, we have concerns that the Credit Derivatives RTS does not reflect this analysis in a clear and transparent way. To prevent any market uncertainty we recommend that the treatment of third country entities should be explicitly set out by making the following amendments:

1. The categories of counterparties in Article 2 of the RTS should be exhaustively defined. The current use of the word "includes" suggests that the categories may also include other counterparties not listed in the RTS.

2. Category 1 should explicitly refer to financial counterparties and non-financial counterparties meeting the conditions referred to in Article 10(1)(b) of Regulation (EU) No 648/2012 as the term "counterparties" is not defined in the RTS.

3. The treatment of contracts falling within the scope of Articles 4(1)(a)(iv) and 4(1)(a)(v) of EMIR should be explicitly set out.

The following drafting suggestions are indicative of how the RTS could be amended to explicitly set out the application of the clearing obligation to contracts where at least one counterparty is a third country entity. However, it does not include drafting to reflect our proposal, as described above, that an additional six month phase-in period should be granted for transactions entered into with third country entities established in jurisdictions yet to be granted equivalence under Article 13 of EMIR which would be Category 2 counterparties if established in the EU. If ESMA is minded to support this proposal, we would be happy to assist ESMA with a drafting proposal.

Our suggested drafting amendments are as follows:

- Paragraph 1(a) of Article 2 of the RTS should be amended as follows:

  "(a) Category 1 ~~which includes~~ counterparties are financial counterparties and non-financial counterparties meeting the conditions referred to in Article 10(1)(b) of Regulation (EU) No 648/2012 which, on the date of entry into force of this Regulation, are clearing members, within the meaning of Article 2(14) of Regulation (EU) No 648/2012, for at least one of the classes of OTC derivatives listed in Annex 1, of at least one of the CCPs authorised before that date to clear at least one of the classes of OTC derivatives listed in Annex 1;"

- Paragraph 1(b) of Article 2 of the RTS should be amended as follows:

  "(b) Category 2 ~~which includes~~ counterparties are:

  [...]."

- Paragraph 1(c) of Article 2 of the RTS should be amended as follows:

  "(c) Category 3 ~~which includes~~ counterparties are [...]."

- The following paragraphs should be added to Article 3 of the RTS:

  "3. Where a contract is entered into between a financial counterparty or a non-financial counterparty meeting the conditions referred to in Article 10(1)(b) of Regulation (EU) No 648/2012 and an entity established in a third country that would be subject to the clearing obligation if it were established in the Union, the date from which the clearing obligation takes effect for that contract shall be the date from which the clearing obligation would take effect under paragraphs 1 and 2 of this Article if the third country entity were established in the Union.

  4. Where a contract is entered into between two entities established in one or more third countries that would be subject to the clearing obligation if they were established in the Union and the contract is one to which Article 4(1)(a)(v) of Regulation (EU) No. 648/2012 applies, the date from which the clearing obligation takes effect for that contract shall be the date from which the clearing obligation would take effect under paragraphs 1 and 2 of this Article if both the third country entities were established in the Union."

In paragraph 202 of consultation paper no.1 ESMA states that the obligation in Article 4(1)(a)(iv) of EMIR to clear "lies with the counterparty established in the EU". This is a significant interpretation of an EMIR obligation. It is important that a permanent record of this interpretation is maintained to ensure that uncertainty regarding the application of the clearing obligation to third country entities does not arise in the future, when the value of a statement in a consultation paper may be questioned. We therefore recommend that ESMA include this interpretation as a recital to the RTS or, alternatively, in an ESMA Q&A. Given the importance of this interpretation, our preference would be for ESMA to include this statement in the RTS so that it guides readers' understanding of the operative provisions of the RTS.

G. Treatment of clearing members of recognised CCPs

Category 1 will capture counterparties which, on the date of entry into force of the RTS, are clearing members for at least one of the classes of OTC derivatives listed in Annex 1, of at least one of the CCPs authorised before that date to clear at least one of the classes of OTC derivatives listed in Annex 1.

Whilst we note that a clearing obligation procedure can also be triggered by the recognition of a third country CCP, we welcome ESMA's proposal to define Category 1 by reference to authorised CCPs only. Given the uncertainty as to when third country CCPs will be recognised, we agree that it would not be appropriate to define the counterparty classifications by reference to this uncertain event.

Question 6: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

No. Please see our response to question 5 above. We believe that the phase-in period for Category 2 counterparties should be reduced to nine months, with an extended phase-in period of 15 months for third country entities established in jurisdictions yet to be granted equivalence under Article 13 of EMIR which would be Category 2 counterparties if they were established in the EU (provided, in both cases, that the frontloading requirement is alleviated as described in our response to question 7 below).

In addition, we would reiterate our proposal for a phase-in period of three years for cross-border inter-affiliate transactions. Please see section C of our response to question 8 for further details of our proposals for a phase-in period for cross-border inter-affiliate trades.

Question 7: Do you consider that the proposed approach on frontloading ensures that the uncertainty related to this requirement is sufficiently mitigated, while allowing a meaningful set of contracts to be captured? Please explain why and possible alternatives compatible with EMIR.

A. Proposed approach to frontloading in Period A

Subject to two modifications, we support the proposed approach on frontloading and the minimum remaining maturity for contracts entered into or novated during Period A.

Firstly, we recommend, as a matter of legal certainty, that Period A should be set as the period between the notification of a class of derivatives to ESMA and the date of entry into force of the RTS introducing the clearing obligation for that class of derivatives (which is also the reference date for the test as to whether an entity falls within Category 1). It should not, as the current drafting of the RTS mandates, end on the date the RTS is published in the Official Journal. The consequential impact of this change, as described below, is that Period B should commence on the date of entry into force of the RTS.

This recommendation is in line with ESMA's proposal on frontloading to the Commission in its letter dated 8 May 2014 (ESMA/2014/483) and supported by the Commission in its return letter dated 8 July 2014 (JC/tb D(2014) 2392454). As recognised by ESMA and the Commission, the principle of legal certainty requires that parties know sufficiently in advance when the frontloading obligation will start. This cannot be achieved by using the date of publication in the Official Journal as publication does not happen at a pre-defined date and time. This means that publication on a particular day will not be known until after the event. In particular, this creates uncertainty about the potential retroactive application of the frontloading requirement to transactions entered into during the hours before publication in the Official Journal.

Secondly, we request that, for the reasons set out at Section C of our response to question 2 above, the minimum remaining maturity for untranched index CDS be amended to 4 years and 9 months.

B. Proposed approach to frontloading in Period B

For the reasons of legal certainty described above in respect of Period A, we recommend that Period B should be set as the period between the date of entry into force of the RTS introducing the clearing obligation and the date of application of the clearing obligation.

As described more fully in our response to question 5 above, we recommend that ESMA make the following amendments to the frontloading requirement in Period B:

1. To ensure that Category 2 counterparties receive the intended benefit of the phase-in period, the purpose of which is to ensure that these counterparties have time to adjust to the clearing obligation and establish the necessary clearing arrangements, the minimum remaining maturity of contracts entered into during the phase-in period (where at least one counterparty to the contract is a Category 2 counterparty) should be set using the approach proposed for Period A, thus excluding Category 2 counterparties from the frontloading requirement.

2. The phase-in period for Category 2 counterparties should be shortened to nine months to encourage these parties to establish clearing arrangements as soon as possible and counterbalance the proposal that frontloading should not apply to Category 2 counterparties during the phase-in period.

3. Given the lack of progress of the equivalence assessments under Article 13 of EMIR:

    a. third country entities established in jurisdictions yet to be granted equivalence under Article 13 of EMIR, which would be Category 2 counterparties if established in the EU, should benefit from a longer phase-in period of 15 months (without a frontloading requirement); and

    b. a phase-in period of three years should be introduced for cross-border inter-affiliate trades (in the absence of an equivalence determination, or otherwise subject to a six-months phase-in period after an equivalence determination is made prior to the expiry of the three year period). During this period such trades should not be subject to the clearing obligation or the frontloading requirement.

However, if contrary to our proposal above, the frontloading obligation affects a broader range of counterparties than Category 1, we would urge ESMA to extend the length of Period A for Category 2 counterparties.

C. Treatment of non-financial counterparties

We welcome ESMA's conclusion in paragraph 112 of consultation paper no.2 that "frontloading is not applicable to contracts for which at least one of the counterparties is a non-financial counterparty". This is a significant interpretation of an EMIR obligation. It is important that a permanent record of this interpretation is maintained to ensure that uncertainty regarding the application of the frontloading requirement to non-financial counterparties does not arise in the future, when the value of a statement in a consultation paper may be questioned. We therefore recommend that ESMA include this interpretation as a recital to the RTS. For completeness, this recital should also clarify that the frontloading requirement does not apply to contracts for which at least one counterparty is a third country entity which would be a non-financial counterparty if it were established in the EU.

Based on ESMA's interpretation of the application of the frontloading requirement to non-financial counterparties, we believe that paragraph 3 of Article 4 of the RTS is redundant and potentially misleading. Its inclusion in the RTS is not consistent with ESMA's interpretation that for non-financial counterparties "no contract concluded before the date of application can be subject to the clearing obligation".

Alternatively, if the frontloading requirement is restricted to just Category 1 counterparties, Category 2 and Category 3 counterparties could be treated in the same way for frontloading purposes during Period B (i.e. the minimum remaining maturity should be set at such a level that no contracts entered into during the phase-in period will be subject to the frontloading requirement). This would have the benefit of expressly confirming that these counterparties are not subject to the clearing obligation.

Question 8: Please indicate your comments on the draft RTS other than those already made in the previous questions.

A. Treatment of trades that result from systemically risk-reducing processes

New and amended trades that result from systemically risk-reducing processes such as multilateral portfolio compression cycles which result from original trades which are not subject to the clearing obligation should be exempt from the clearing mandate. 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; 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 counterparties 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 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.

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 SSR, 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 [SSR] (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 [SSR] (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*."

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.

B. SPVs

Securitisation and other structured finance SPVs should not be required to clear derivative transactions that they enter into. There are a number of other ways in which counterparty credit risk can be, and currently is, mitigated in transactions with SPVs for structured finance or securitisation transactions. For example, the documentation for SPVs generally provides that:

- the swap counterparty has a first ranking security interest over all the assets of the SPV, along with the SPV's other secured creditors;
- the swap counterparty generally has a senior claim with regard to cash flow payments (although where the derivative terminates as a result of counterparty default, any payments due to the counterparty will usually rank junior to other third party creditors);
- securitisation SPVs are intended to be bankruptcy-remote vehicles and are structured such that they have a limited and identifiable list of creditors;
- counterparties to SPVs typically sign-up to limited recourse provisions pursuant to which it is contractually agreed that the SPV shall not be deemed to owe amounts in excess of the assets that it holds; and
- in many cases any derivatives transactions are entered into for hedging purposes and hence the value of the underlying asset which creditors have security over (or any liability mismatch against the assets) is itself protected by the derivative. Hence, there is no need to impose a clearing requirement upon SPVs to mitigate counterparty credit risk. For example, the SPV will be protected by the various triggers in the swap documentation and the swap counterparty is protected by the security package and payment waterfall.

In addition, these SPVs have limited functionality and resources and are generally unable to comply with the requirements of clearing, in particular the operational burden that this would involve. Securitisation SPVs 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 clearing obligations 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.

Furthermore, derivative transactions entered into by SPVs are, generally, not sufficiently standardised or liquid in nature for clearing to be appropriate or, in many cases, possible – in particular (i) transactions facing SPVs often have a variable or contingent notional amount that may be linked to complex underlying assets; and (ii) even where the derivative transaction itself may appear to be vanilla from a purely economic perspective, securitisation and other structured finance derivatives generally include highly bespoke terms such as rating agency driven downgrade provisions and unilateral collateral posting requirements, limited recourse provisions and break clauses and other provisions that are closely linked to a broader transaction, but that at the same time form an intrinsic part of the economic terms of such derivatives.

While it is the expectation that most SPVs would not be obliged to comply with the clearing obligation by virtue of their status under EMIR, the analysis in this respect is not always straightforward and an explicit exemption from clearing for derivative transactions with SPVs in securitisation and structured finance transactions would be helpful in providing clarity to the structured finance and securitisation market. This would be a logical extension of the position that ESMA has helpfully taken with respect to covered bond derivatives. If clearing were to apply to derivative transactions with SPVs, this would prevent these vehicles from entering into derivatives which would deprive the securitisation and structured finance sector of a valuable hedging tool and significantly impair the securitisation and structured finance markets.

C. Intra-group exemption

Article 4(2) of EMIR provides an exemption to the clearing obligation for intragroup transactions. The application of this exemption is still subject to a number of uncertainties which will need to be resolved before the first RTS on the clearing obligation enters into force.

In particular, further guidance is needed on the meaning in Articles 3(1), 3(2)(a)(iv) and 3(2)(d) of EMIR of "appropriate centralised risk evaluation, measurement and control procedures". Whilst ESMA has provided further guidance by way of 'OTC Answer 6(d)' of the ESMA Q&A, further guidance is needed as to the standards which will need to be met by a group in order to satisfy NCAs that the group has in place appropriate centralised risk evaluation, measurement and control procedures. In particular, it should be sufficient for groups to have centralised risk management functions in respect of external exposures.

ESMA should confirm by way of a Q&A that counterparties should have in place intragroup exemptions from the clearing obligation by the date the clearing obligation applies to them (i.e. by the end of the applicable phase-in period) and not at the time the contract is entered into if the contract is entered into during the frontloading period (after the end of the frontloading period, counterparties wishing to rely on the intragroup exemption for a particular trade should have the exemption in place at the time the contract is entered into). As some NCAs are unlikely to start accepting applications for the clearing obligation before the entry into force of the first RTS on the clearing obligation, it would be impracticable to expect counterparties to have intragroup exemptions in place in advance of the frontloading period.

'OTC Answer 6(b)' of the ESMA Q&A indicates that the Commission must have adopted an equivalence determination under Article 13 of EMIR in respect of a relevant third country in order for transactions with counterparties established in that third country to qualify as intragroup transactions for the purposes of the intragroup exemption to the clearing obligation. We have significant concerns that the Commission will not have adopted any, or a sufficient number of, equivalence determinations before the entry into force of the first RTS on the clearing obligation. Even if the other requirements of Articles 3 and 4(2) of EMIR are met, this means that EU counterparties will not be able to benefit from the intragroup exemption when dealing with any affiliates established outside the EU and will instead need to clear these contracts.

Of particular concern is the situation where an EU counterparty enters into an OTC derivative transaction subject to the EMIR clearing mandate with a non-EU affiliate which is mandated under its national clearing rules to clear the trade. For example, where the other counterparty is a

US entity, the transaction could be mandated under Dodd-Frank to be cleared on a US CCP which is not recognised under EMIR due to the lack of a US equivalence determination by the Commission under Article 13 of EMIR. In this scenario, it may be impossible for both counterparties to satisfy their respective clearing obligations. Unless a phase-in period is provided for such cross-border inter-affiliate trades, the only option available to such counterparties is to cease trading contracts which fall within the scope of both the EU and US clearing obligations.

To mitigate this and to ensure sufficient time is given to the equivalence assessments under Article 13 of EMIR, we recommend that ESMA include in the RTS a three year phase-in period for cross-border inter-affiliate trades, during which the clearing obligation and the frontloading requirement will not apply. A transaction between an EU counterparty (which is subject to the clearing obligation) and a third country entity (which would be subject to the clearing obligation if established in the EU) should benefit from this phase-in period if all the conditions in Article 3 of EMIR are satisfied except for the requirement that the Commission has adopted an equivalence determination for the relevant third country. If an equivalence determination is made during the course of this three year phase-in period, parties should be given sufficient time to prepare, submit and have approved applications to rely on the intragroup exemption. Therefore the phase-in period should extend for six months after an equivalence determination is made. Additionally, we would urge ESMA to reach out internationally to other regulators to encourage the alignment of intragroup exemptions.

D. Changing counterparty status

Should the frontloading obligation apply to a broader range of counterparties than Category 1 counterparties, it is important that ESMA makes it clear through a recital that the frontloading obligation is only applicable to contracts which would, in the absence of the phase-in period, be subject to the clearing obligation at the time the contract is entered into. This should address the problem of changing counterparty status during the phase-in period (for example, if an AIF changes from being a non-financial counterparty to a financial counterparty because its manager becomes an authorised or registered AIFM or a non-financial counterparty obtains a new licence to become a regulated entity and as such a financial counterparty), together with an appropriate transitional period for AIFs which change category as a result of their AIFMs being authorised under the AIFMD. It is vital that counterparties are able to verify at the time the contract is entered into whether the frontloading requirement applies and for AIFs to be given sufficient time after authorisation of their AIFMs to prepare for clearing and notify counterparties of their change in category.

We would also note that our proposal for counterparty classifications to be assessed on an asset class basis would prevent a counterparty changing category from, for example, Category 2 or 3 to Category 1 as further asset classes are made subject to the clearing obligation. This can be achieved by adopting the clearing obligation procedure outlined in Option 2(b) in our response to Question 1.

E. Exemption for group restructuring

In view inter alia of the forthcoming regulatory reforms in numerous major jurisdictions affecting structures of financial entities and groups (including most notably the EU Bank Recovery and Resolution Directive 2014/59/EU and the European Commission's proposal on Banking Structural Reform), we propose that derivatives be exempt from the clearing obligation if such derivatives are entered into or novated as part of a wholesale restructuring of a corporate group. Without such an exemption, such restructurings will become significantly more costly and disruptive to clients and in some cases may not be economically feasible.

F. Novations

We would encourage ESMA to clarify that, with respect to derivative contracts that are novated, the maturity of such contracts should be assessed for the purpose of determining whether they are subject to the clearing obligation at the point of their novation.

G. Treatment of lifecycle events

We would encourage ESMA to provide further guidance to market participants on whether certain 'life-cycle' events would trigger the clearing obligation, such as partial novations or partial terminations of derivative transactions that were not required to be cleared when they were entered into (for example, trades entered into before the date of application of the clearing obligation).

Where original counterparties wish to novate or terminate a derivative in part (a "partial novation" or "partial termination" respectively) they may agree to an amendment that reduces the notional amount of the derivative. The remaining portion of the derivative between the original counterparties after such reduction is commonly referred to as the "**Stub**". We would urge ESMA to expressly confirm in the RTS that a partial novation or partial termination should not require the Stub to be cleared. This is consistent with the approach taken by the CFTC in the US.

As described above, the Stub is the remaining part of a derivative that was not required to be cleared when entered into. The terms of the original derivative, including 'money' terms that define the remaining cash flows, continue to govern the Stub (apart from the reduction in the notional amount of the swap). Because the amendment that gives rise to the Stub remainder of the prior historic position does not constitute an agreement of the original counterparties on the full set of terms necessary to define a derivative, the Stub should not be regarded as a new derivative that is 'executed' after the clearing obligation has come into effect (or during the frontloading period, if applicable). Furthermore, imposing clearing on the Stub would create distorted incentives for risk and investment management decisions. The cost of clearing the Stub (commensurate with the remaining notional amount) would be imposed as the cost of reducing a position by a totally unrelated amount. For example, if a party wishes to reduce the notional amount by 10, from 100 to 90, it must incur the cost of clearing on the remaining 90.

This proposed interpretation is consistent with the stated purpose of the EMIR clearing obligation which is the reduction of counterparty risk. A partial termination by its nature reduces the counterparty credit risk in a derivative transaction, because it reduces the size of that derivative. A partial novation reduces the size of the derivative between the original parties (the novated portion, however, may be subject to the clearing obligation depending on the date of novation and the category of counterparties to which the derivative is novated).

In addition, we would note that parties will face significant practical challenges to submitting Stubs for clearing. Amendments that result in the Stub remainders of prior historic positions are not processed in the same manner as the execution of new transactions. The time and costs incurred in developing and implementing robust systems and processes for submission of Stubs across the industry would not be proportionate to the limited gains to be achieved from a risk-reduction perspective.

A second example of a type of derivative contract that should not be subject to the clearing obligation is derivatives entered into under the terms of an agreement entered into prior to the application of the clearing obligation (or frontloading period, if applicable), such as the exercise of a swaption. These trades will have been priced on the basis that the resultant derivative will not be cleared. This approach would have the benefit of ensuring consistent treatment of such trades with the CFTC clearing mandate. Pursuant to the CFTC regime, where a swaption has been entered into before the date of the clearing mandate, the resultant swap is not subject to mandatory clearing.

Question 9: Please indicate your comments on the Impact Assessment.

We have no comments on the impact assessment.

About ISDA
Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC 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 including exchanges, clearinghouses 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 web site: www.isda.org.]

About FIA Europe
FIA Europe, formerly the Futures and Options Association (FOA), represents some 175 firms involved in the exchange-traded and centrally-cleared derivatives markets – including banks, brokers, commodity firms, exchanges, CCPS, vendors, law firms and consultants. FIA Europe works with its members to maintain constructive dialogue with government and regulatory authorities and deliver high standards of industry practice. FIA Europe, last year, formed an affiliation with FIA under a new structure – FIA Global. Under this arrangement, FIA, FIA Europe and FIA Asia have strengthened their influence on cross-border issues, substantially increasing the coordination and information flow between regions and providing a powerful global voice to express the views of their members. The organisations preserve their ability to deal with legislative, regulatory and market issues in their respective time-zones and continue to operate with their own leadership and staff, separate boards of directors and distinct memberships.