ISDA Safe, Efficient Markets afme/

ISDA/AFME Comments on Hungarian Presidency compromise text of 17 March (EMIR)

25 March 2011

ISDA welcomes many elements in the most recent text from the Hungarian Presidency on EMIR. In particular, ISDA welcomes:

- The retention of language on **'phase-in'** of clearing requirements, which is key to ensuring an orderly transition to clearing, and seems likely to ensure convergence with the US approach to roll-out of mandatory clearing;
- The retention of a **scope** applying to all derivatives, and not just OTC derivatives. We believe this will 'future-proof' the Regulation and facilitate convergence with US legislation.
- The strengthening of language on the **specific characteristics of FX business** in recital 12b ('CCP clearing…..may not be the optimal solution for dealing with settlement risk');
- Amendments to the **top-down** approach (Article 4a), which we feel provide a more sensible approach when regulators feel that it would be beneficial for a specific class of derivatives to be cleared but no CCP is offering this service (it is suggested that the European Commission undertake an RFP process);
- The call, in recital 45, for **transparency in CCPs' risk management models** – which we feel will encourage robust (and hopefully, comparable) risk standards at CCPs;
- The **role provided for the CCP Risk Committee in advising on CCP participation requirements** (Article 35).

However there are a number of other issues of concern to us in this iteration of the text:

1. Backloading/Frontloading (Recital 12c, Article 3 & Article 4):

While we welcome the changes that have been made in relation to backloading, and while the 'legitimate expectation' issue has – partly – been addressed by making a clearing requirement applicable only to contracts entered into after the date of entry into force of EMIR, some important practical problems remain. Most obviously, the 'frontloading' obligation, is a problem because the obligation to clear would arise **before** derivatives or classes of derivatives are identified as eligible and subject to mandatory clearing requirements – meaning that considerable uncertainty would remain.

In addition, the fact remains that even if one of the counterparties to the contract wants to comply with the clearing requirement, there is no mechanism facilitating this if that's counterparty's counterparty will not agree (e.g. because of (new) pricing conditions and disagreement over which CCP to use) . We believe that the consequences regarding compensating for costs, and arguments over CCP venue should be adequately addressed in the Regulation if the Council wishes to maintain the frontloading preference. We add that (a) favourable regulatory capital treatment and (b) the fact that as more new trades enter clearing clients' trades may become more unbalanced mean that there will be commercial incentive for clients to back load voluntarily.

[In addition, we do not support Article 6(1)(a) which provides retrospective reporting obligations of all live [OTC] derivatives transactions. We expect some retrospective reporting to be applied, but the regulators should consider what level of retrospective reporting would be beneficial to identify systemic risk.]

2. <u>Access rules (Articles 5 and 5a)</u>

We are concerned that the latest iteration of Article 5 leaves too much scope for CCPs to block access from trading platforms (other than vertically integrated platforms) on unfair grounds. How can the claim of a CCP that 'such access would threaten the smooth and orderly functioning of the markets' be verified? We are also concerned (despite the helpful drafting of Article 32a on communication procedures) that the 'operational and technical requirements established by a CCP' required of such platforms could represent an unfair barrier to such access.

3. <u>Rules for non-financial institutions (Article 7)</u>

There remains some uncertainty in rules regarding clearing thresholds for non-financial institutions, which we believe it would be helpful to resolve.

In particular

- It is still not clear how long a non-financial institution has to be above the clearing threshold before a clearing obligation applies ('over a specified time period');
- Is a non-financial institution 'always caught' if caught during *one* period of time, by this clearing threshold?

It is also questionable whether it is proportionate to require non-financial institutions to clear all contracts – including those 'objectively measurable' as reducing risks – if surpassing the clearing threshold (if the clearing requirement is supposed to be risk-reducing).

4. <u>The clearing obligation (Article 3)</u>

We believe that settlement risk should be considered in assessing the overall risk associated with specific classes of derivatives, and hence the case for applying clearing requirements therein. As such we believe that this criterion should be reinstated.

We believe that the criterion of whether more than one CCP offers clearing services in a class should also be reinstated, as a means to ensuring a reasonable level of competition.

For this reason we also welcome the inclusion of a criterion on the 'the impact on competition'.

5. Reporting obligation (Article 6)

We note that modifications of contracts now have to be reported to trade repositories. Will the definition of this term form part of the technical standard referred to in Article 6.4 (this is not explicitly clear as Article 6.4 focuses on data needs for first-time reporting of a contract)?

6. CCP responsible risk management ('skin in the game')

We believe that, in some instances, wording that could otherwise promote responsible risk management processes by CCPs has been softened. For example,

- Article 41 on 'other financial resources' now says that 'other financial resources' held by CCPs that are used to cover losses exceeding the margin provided by defaulting clearing members *may* include dedicated resources of the CCP. We believe it should – this would make CCPs more risk averse.
- Furthermore in Article 42 (default waterfall), we believe that CCPs should use dedicated own resources before depleting the default fund (the text prefers the word 'may').

7. Segregation at CCPs (Article 37)

We believe it is important that Article 37 be respectful of the priorities of clearing members and clients, as well as facilitating the smooth management of any default at a CCP. It is not clear to us yet whether the latest draft Article 37 achieves this. ISDA buy- and sell-side members are attempting to draft language in this regard.

Furthermore, there are a number of other issues that have not been dealt with in the text which are very important:

Intra-group transactions: An exemption for intra-group transactions is currently being considered in rulemaking around mandatory clearing in the US. Proportionate treatment of intra-group transactions is vital for a number of reasons. In particular, we note that

- Clearing of intra-group transactions will actually increase operational risk (clearing of each intra-group transaction necessitates four transactions between CCPs and the different entities involved);
- Clearing of simple back-to-back trades within groups (which facilitate client hedging) does not generally reduce counterparty risk;
- Clearing of these trades will make such hedging transactions more expensive and less possible for end users to access, as centralised portfolio risk management by dealer firms becomes more problematic and costly (note we are including a briefing with this paper on this issue).

Territorial scope: We continue to be concerned that the draft Regulation continues to offer no clarity on its territorial scope. This at best creates uncertainty, and at worst raises the fear that many firms will find themselves facing duplicative regulatory requirements in the EU and other G20 jurisdictions, with worrying consequences for the competitiveness of EU financial business.

At the very least, if these issues are not to be addressed explicitly in the Regulation, it is important that some thinking should be done (and clarity provided) as to how these issues will be resolved.

To give an example of the uncertainty in this regard, we invite Council working group members to consider how/if EMIR would apply in the following circumstances:

- US Fund using a UK fund manager trading with a US bank for a $ or € IRS (interest rate swap)
- UK Fund using a US fund manager trades with a Japanese Bank for a Yen IRS or CDS
- US Fund using a UK fund manager trades with a Japanese Bank for a Euro IRS
- UK Bank trading with US Bank
- UK Bank trading with EU Branch of US Bank
- UK Bank trading with non-EU Branch of EU Bank
- Non-EU branch of UK Bank trading with US Bank
- UK Bank trading with EU Based subsidiary of US Bank
- UK Bank trading with Japanese Energy Company
- UK Bank trading with US Energy Company [latter subject to Dodd Frank]
- UK Bank trading with US Energy Company [latter not subject to Dodd Frank]

We are (again) enclosing a more extensive briefing on this issue with this email.

Indirect clearing: The proposed Regulation envisages that where an EU counterparty subject to the clearing obligation is required to clear an eligible OTC derivative contract it must do so either by becoming a clearing member or a direct client of a clearing member. However, it may not always be practical for EU counterparties to become clearing members or direct clients of clearing members, in particular where the relevant CCP is located outside the EU. In those cases:

- The non-EU CCP may not be able to admit EU counterparties as clearing members if they are not subject to local regulation (and, even where this is theoretically possible, EU counterparties may not be willing to submit themselves to local regulation because of the extent of third country supervision and rules that will apply to their business outside the third country).

- Clearing members of the non-EU CCP may not be able readily to transact business with all categories of EU counterparties, in particular because they may be prohibited from seeking business in the EU by local licensing requirements in the EU (see e.g. the European Commission's proposals as part of the MiFID review which appear to limit the ability of third country firms to deal with EU counterparties unless the third country firm meets a strict equivalence criterion and restricts its business solely to business with professional clients).

Within the EU, there are also likely to be financial counterparties that have significant volumes of OTC derivatives business with clients where the clients will themselves also be subject to the clearing obligation, but the counterparty does not wish to or is not able to become clearing members of every relevant CCP across the EU. In these cases, the counterparty may wish to use other clearing members to clear its own and its clients' trades, on an omnibus basis.

A similar issue arises today where EU counterparties wish to access third country futures exchanges and clear their transactions through a non-EU clearing firm that is a member of the third country exchange and its related CCP. In that case, the EU counterparty will often trade through an EU bank or investment firm that maintains an omnibus account with the third country clearing member. Corresponding issues arise for EU firms that wish to access an EU futures exchange where they do not wish to establish a direct relationship with the clearing member.

We attach a further briefing on this issue with this paper, suggesting amendments in this regard.