ISDA Safe, Efficient Markets

FINAL – 13 August 2015

ISDA response to the European Commission EMIR Review Consultation

INTRODUCTION & EXECUTIVE SUMMARY

The International Swaps and Derivatives Association ("**ISDA**") welcomes the opportunity to respond to the consultation paper on the review of Regulation (EU) No 648/2012 (the "**EMIR Review**").

We have summarised the key points raised in our response below. However, we would like to note in particular the following five priority concerns for ISDA members:

Single sided reporting

Dual-sided reporting (DSR) has fallen short of providing regulators with accurate data thus undermining the ability of regulators to effectively assess systemic risk. ISDA believes that the adoption of a single-sided reporting (SSR) regime will significantly reduce the operational complexity of the current framework, and the burden for less sophisticated derivatives users to report, which will lead to a vast improvement in the availability of accurate data to regulators.

Indirect clearing:

In particular:

- We believe that the indirect clearing rules, as set out in Regulation 149/2013, are unworkable from a clearing member perspective, and undermine the efficacy and objectives of the approach. The rules need to be redesigned (as discussed in our response below) to help ensure that smaller derivatives users in Europe can access central counterparties (CCPs).**We firmly believe that clearing members should not be forced to offer indirect clearing arrangements**; and
- The leverage ratio requirements proposed by the Basel Committee on Banking Supervision (BCBS), are not appropriate for cleared client transactions as they ignore the risk mitigating impact of segregated margin. This acts as a significant disincentive to central clearing. The rules will constrict the capacity of CMs to offer clearing arrangements to market participants, forcing some to stop using derivatives, thus increasing risk in the system and reducing liquidity in hedging instruments. The leverage ratio should be amended to recognise the exposure reducing effect of segregated margin.

By way of a very high level overview, we would propose redesigning the indirect clearing rules in order to achieve the following critical objectives:

- Ensure that indirect clients are able to choose to use recognised CCPs (and not just authorised CCPs) in order to satisfy the EMIR clearing obligation.
- Ensure that indirect clearing requirements take account of complexities introduced by non-EEA regimes which may become relevant because of the location of the clearing member, indirect clearer or indirect client.
- Ensure that appropriate acknowledgement is given to the heightened risk profile of OTC derivatives, as to default profile and liquidity, when considering the risks assumed by clearing member and/or indirect clearer under an indirect clearing arrangement. In particular, limitations upon the obligation to make leapfrog payments for the prompt/direct return of assets to indirect clients should be explicitly acknowledged.
- The requirement to facilitate the porting of positions of assets of indirect clients should be removed.
- Clearing members should not be obligated to offer net omnibus segregated accounts (NOSA).

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

ESMA powers to terminate or suspend the clearing obligation
ESMA should be given the ability to terminate or suspend the clearing obligation as a matter of urgency: ISDA believes that it is of great concern that ESMA does not have the ability to terminate or suspend as a matter of urgency (i.e. within a few days) the clearing obligation in respect of a specific class (or contracts within a class). 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, or in the event that a CCP that clears a specific class of instruments is de-authorised or de-recognised.

Equivalence determinations
Article 13 Equivalence – mechanism to avoid duplicative or conflicting rules
The absence of equivalence decisions, particularly for the purposes of clearing and margin requirements, could put the international operations of many firms at a competitive disadvantage by requiring, for example, that margin be posted and collected multiple times. Such an outcome would harm not only banks but their clients too, many of which are major European corporates that make significant contributions to outbound and inbound trade and investment flows from Europe to non-EU markets.

Therefore, ISDA believes that it is essential the Commission work closely with other regulators in third countries to develop plans for equivalence and further clarify the practical application mechanics of equivalence.

ISDA also has some concerns about the practical application of Article 13 Equivalence determinations, as it is not fully clear how Article 13 would apply in practice to trades with counterparties established in, or subject to the rules of, an equivalent jurisdiction. In particular, ISDA believes:

- That when EU counterparties trade with counterparties established in, or subject to the rules of, an equivalent jurisdiction, the parties should be permitted to mutually agree which set of equivalent rules would apply to a particular trade between them;
- That Article 13(3) should allow for separate equivalence determinations to be adopted regarding the obligations contained in EMIR Articles 4, 9, 10 and 11, instead of a single all-encompassing equivalence determination, and that any assessment of equivalence for the purpose of EMIR Article 13 should follow an outcomes-based approach.
- That while the EC should seek to engage with third country regulators, it should not be a requirement for third countries to have to apply for an EC equivalence determination.

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Article 25 Equivalence – recognition of third country CCPs
ISDA welcomes the recent extension of the CRR transitional period. We also welcome the first sets of 'equivalence decisions' for the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore. With the CRR transitional period extended by a further six months we would encourage the EC to continue its work with other jurisdictions, like the US, to ensure that positive equivalence assessments are complete as soon as possible so that ESMA is able to recognise CCPs at the latest by 15 December 2015 for all jurisdictions where CCPs have applied to ESMA for recognition.

We would also like to stress the importance of EU leadership when it comes to equivalence decisions for jurisdictions whose CCPs may not yet have applied for recognition but are adhering to the Committee on Payments and Market Infrastructures and International Organisation of Securities Commissions' (CPMI-IOSCO) Principles for Financial Market Infrastructures (PFMIs).

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

We also believe that some of ISDA members' concerns can be alleviated by:

- Decoupling the link between CCP recognition under EMIR and QCCP treatment under the Capital Requirements Regulation, so that third-country CCPs that do not apply for EMIR recognition can still qualify as QCCPs, which would allow non-EU affiliates or subsidiaries of EU firms to continue clearing at such third-country without incurring punitive capital requirements on their exposures.
- Permitting EU firms to be clearing members of unrecognised CCPs provided that the CCP complies with the CPMI-IOSCO's PFMIs (with the caveat that such clearing member will not be allowed to clear house business subject to the EMIR clearing obligation through such an unrecognised CCP).
- Clarifying that not all OTC derivatives cleared by non-EU recognised CCPs will potentially become subject to the mandatory clearing obligation.
- Allowing a third-country regime to be considered equivalent in respect of all CCPs established in that third country or just a particular class of CCP (or CCP service).
- Adopting a pragmatic approach with regards to EMIR Article 25(2)(d) requirement, which is too inflexible.

A high level summary of the other key points addressed in our response is set out below:

CCP liquidity:
ISDA believes that access to central bank liquidity facilities would be extremely helpful to CCPs in dealing with potential stress events, and will further strengthen the ability of CCPs to manage their liquidity risks, and create safer, more robust CCPs in Europe. We believe such access should include access to central bank investment or settlement accounts, and that such access should be available regardless of whether or not the CCP is an authorised credit institution. However, while we would support provisions facilitating access by CCPs to central bank liquidity facilities, we do not consider that it would be appropriate to make access to central bank liquidity facilities a pre-condition for authorisation or recognition.

Non-financial firms:

- ISDA supports and endorses the response of FIA Europe regarding portfolio hedging.
- NFCs should not be required to double count intragroup OTC derivative transactions for the purposes of calculating the clearing threshold. In addition, NFCs in a group whose parent

undertaking is outside the EU should only be required to count towards the threshold any OTC derivatives entered into by group members incorporated in the EU or by non-EU group members with a counterparty who is an FC or NFC.

CCP colleges:
ISDA believes that greater transparency is needed with regards to the authorisation process for EU CCPs. In particular, ISDA would welcome greater visibility and communication of the expected timeline for authorisation of a CCP (or authorisation of a CCP to clear additional classes), either in the form of a public calendar, periodic status updates or meeting agendas.

Procyclicality:
ISDA believes that the three options prescribed by ESMA (under Article 28 of Regulation 153/2013) intending to limit the procyclical effects on CCPs resources are not adequate in addressing such procyclicality due to interpretational issues or differences in implementation. ISDA believes that measures to address procyclicality rules should be principles-based and not prescriptive measures, which have been insufficient to work in the context of the full range of in-scope cleared derivatives products.

CCP margins and collateral:
CCP policies have developed in line with the fragmentation in market practice and liquidity engendered by other regulations. As such there are considerations we would like to see further developed in an appropriate way. In particular:

- Confidence interval: exchange-traded derivatives that exhibit the same risk characteristics as OTC derivatives be subject to at least a 99.5% confidence interval
- Look-back period: a look-back period should be long enough to ensure that the scenarios underlying margin determination are sufficiently diverse, and CCPs should scale historical prices to reflect current market prices and volatility. This would ensure that margin requirements are never unnaturally low.
- Liquidation period: We recommend that the time horizon for the liquidation period should be based on the longer of the time taken to close-out (as demonstrated by fire-drills) or hedge the defaulting member's positions.
- Portfolio margining: we believe that Article 27 is far too prescriptive, by basing its criterion to provide offsets based on stable correlations. Correlations are a fundamentally flawed way of determining relatedness in markets, where the forces driving market levels can change over time. Consequently a more common sense method of allowing portfolio margining is necessary, such as market levels being driven by the same or related market drivers. CCPs must demonstrate that offsets are based on strong economic rationales that show that the underlying relationships persist in both normal and stressed markets.
- Liquidity and concentration add-ons: We recommend that either through separate add-ons or through robust initial margin models, CCPs should address concentration/liquidity risk in member portfolios.
- Amendments to the spectrum of eligible collateral: Broadly speaking, we consider that “eligible collateral” should ideally have the following characteristics:

    - high credit quality;
    - demonstrable and measurable high market liquidity or trading volume (by objective and independent standards);
    - low price volatility and high transparency of pricing; and
    - have low correlation with the exposure being collateralised.

Collateral with these features, along with minimum cash thresholds and concentration limits by instrument/maturity/single issuer at both member and aggregate CCP level, would help ensure both adequate liquidity and loss coverage at the CCP in the event of a CM default. Examples of assets that have the above features include:

- cash in the currency in which the trades are settled or other G4 currency; and
- direct obligations of, or obligations guaranteed by the sovereign of the jurisdiction in which the CCP resides or other highly-rated sovereigns, i.e. A or above (including senior debt of certain government-sponsored entities assuming it met objective parameters noted above).

We recognise, nevertheless, that it is important to acknowledge the significant liquidity reduction in certain non-cash assets if eligible collateral for every CCP was limited strictly to those non-cash assets of 'demonstrable and measurable high market liquidity or trading volume (by objective and independent standards)'.

Scope:
There has been considerable uncertainty about when governmental and public bodies and international and treaty organisations are subject to obligations under EMIR and equally when FCs and NFCs (and other persons subject to Title II e.g. third country entities in the limited circumstances specified in the RTS under Articles 4 and 11) dealing with such bodies and organisations are required to comply with the obligations under EMIR, in particular the operational risk mitigation and margin obligations in Article 11. There has also been particular uncertainty about the treatment of individuals (natural persons). The FAQs and Q&A from the Commission and ESMA have not fully resolved the questions about the scope of EMIR in this regard.

Definitions:
ISDA would welcome clarification of the following definitions under EMIR:
- OTC derivative
- Non-financial counterparty
- Group
- Intragroup transaction

Clearing obligations:
- A mechanism for the liquidation of contracts at a CCP that has lost its authorisation/recognition needs to be created;
- Treatment of trades that result from systemically risk-reducing processes should be exempted from the clearing mandate and rules governing the margining non-cleared derivatives;
- Trades entered into by securitisation vehicles or other structured finance SPVs should not be subject to the clearing obligation or margin requirements for non-cleared derivatives;
- Trades resulting from group restructurings should be exempted from clearing and margining requirements;
- At least two CCPs should clear a given class of derivative before a mandatory obligation can be imposed; and
- Product suitability assessments for central clearing should be more granular and take into account risk characteristics.

Trade reporting:

- In addition to the comments regarding development of a single-sided reporting regime above, ISDA recommends that the requirement to backload dead trades should be removed as it is operationally complex and of limited value.

Risk mitigation techniques:

ISDA is concerned that although the Commission has confirmed via FAQs that the timely confirmation rules do not impose hard deadlines, nevertheless hard deadlines remain in the RTS, and it is not clear how firms can confidently consider themselves compliant. We believe the rules should be amended such that trades facing NFCs have a deadline to despatch confirmations (rather than to reach formal agreement), allowing firms to have policies and procedures in place designed to achieve two-way agreement by T+2. The deadlines should also be amended to take into account trades that need to be confirmed on paper.

Exchange of collateral:

- ISDA would welcome an amendment to the Level 1 text to ensure that third country non-financial entities below the clearing threshold will not be subject to the margin rules.
- ISDA also wanted to highlight to the Commission the numerous implementation challenges that firms will face as they prepare to come into compliance with the margin rules. We have attached our response to the ESA's second consultation on the margin rules for reference.

Cross-border activity in OTC derivatives markets:

ISDA believes that the following points should be addressed:

- Categorisation of non-EU counterparties;
- Indirect clearing arrangements with non-EU counterparties;
- Treatment of non-EU exchange-traded derivatives; and
- Transactions between two third country entities.

Requirements for CCPs:

- CCP risk committees – ISDA believes that EMIR is not sufficient with respect to the role of CCP risk committees. We have proposed some amendments to ensure that CCP risk committees are effective in directing the CCP executives.
- CCP regulatory capital requirements – regulations governing capital requirements at CCPs should be revisited to appropriately capture risks assumed by CCPs.
- CCP default funds:
    - We suggest that CCPs should determine Cover N based on the distribution of risk (concentrated vs. uniform distribution) exposures across members. CCPs should publicly disclose the risk distribution based on uncovered stress losses and initial margin to justify the coverage being adopted. As a minimum, we believe the current Cover 2 requirement should be retained.
    - We believe there should be consistency in the time interval at which CCPs and members are required to replenish the default fund - in normal and default scenarios. Like CCPs, we believe clearing members should also only be required to replenish their contribution to the default fund within one month if such resources have been depleted, and that CCPs should be required to replenish each time clearing members are asked to replenish the default fund.
    - We recommend that if insufficient reliable data is available to determine the size of the default fund based on historical scenarios, CCPs should be required to extrapolate

to 30 years based on similar products and generate hypothetical scenarios. A CCP should also scale historical prices to reflect current market prices and volatility.
    - We believe that CCPs should consult clearing members, as well as the risk committee, before making any material changes to the framework for the determination of the size of the default fund.
- Clearing member exposure to CCPs should be limited.
- CCP liquidity requirements – ISDA believes that a threshold should be imposed on the extent to which a CCP can rely on credit lines from members (as a proportion of total liquid resources).
- CCP skin in the game – We recommend that CCP skin in the game is risk-based and scales with the level of activity. We believe further work is needed in determining appropriate CCP SITG, and urge the Commission to explore alternative measures such as a percentage of the default fund, percentage of stressed losses or CCP profits etc. We remain at the disposal of the Commission to provide input into developing alternative measures but also encourage coordination with regulators in other jurisdictions to ensure consistency.
- Investment policy - We believe that CCPs should have sufficient capital and/or insurance to cover all non-default losses, and that clearing members should not have any responsibility for these losses as only the CCP is able to quantify and manage these risks. We have set out in our response our recommendations for achieving this.
- Independent validation of models –
    - We believe that independent validation of models should be undertaken on a regular basis and should be performed by an external party;
    - We believe that backtesting should involve static portfolio backtesting;
    - We recommend that CCPs should take into account additional risk factors when stress testing.
- Highly secure arrangements for the deposit of assets received as collateral and default fund contribution – CCPs should have the option to either deposit assets received as collateral and DF contributions within a direct account at a securities settlement system (SSS), or use a highly secured arrangement, such as depositing the said assets at an SSS via a securities account operated in the name of the CCP.

PART 1

QUESTION 1.1: CCP LIQUIDITY

(i) Is there a need for measures to facilitate the access of CCPs to central bank liquidity facilities?

Yes. We believe that access to central bank liquidity facilities would be extremely helpful to CCPs in dealing with potential stress events, and will further strengthen the ability of CCPs to manage their liquidity risks, and create safer, more robust CCPs in Europe. We believe such access should include access to central bank investment or settlement accounts.

The Committee on Payment and Market Infrastructures and International Organisation of Securities Commissions (CPMI-IOSCO) requires that CCPs should:

> "*effectively measure, monitor, and manage its liquidity risk, and maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the financial market infrastructure in extreme but plausible market conditions.*"

In the process of managing such liquidity risk CCPs typically manage cash collateral received by conducting repos on a daily basis. However, repo settlement processes introduce cash management concerns because there is a point during the settlement process at which the settlement bank is exposed to uncollateralised risk. If the settlement bank were to default during such an uncollateralised period, it would have the potential to expose the CCP to significant losses.

We also note that the daily repo trades for cash management of a CCP introduce huge operational, investment and fraud risk. The current discourse about CCP recovery and resolution show that such risks are very large and can default a CCP. Central bank access could help in two ways: by providing investment accounts so CCPs can invest cash safely without the operational risks of repo transactions, and – should a CCP accept more (bankruptcy remote) securities as collateral – by providing liquidity if needed.

CCPs are, rightly, responsible for liquidity risk management and must comply (among other things) with requirements to comply with "cover one" or "cover two" rules, as relevant. Such risk management is an inherent responsibility of CCP management and should not be factored into any central bank liquidity provision. However, it is theoretically possible (if practically unlikely) that there could be a shortfall between a CCP's available liquid resources, determined in line with relevant rules and liquidity stress tests, and the liquidity shortfalls to which it is exposed. It is that shortfall in excess of the CCP's available resources which should be provided for as part of central bank liquidity facilities, available to CCPs as a recovery tool.

However, we also believe that care should be taken with any instrument introduced in EMIR to facilitate access to central bank liquidity facilities to ensure that the authorisation or recognition of a CCP is not necessarily pre-conditioned on access to central bank liquidity facilities. A lack of access to central bank liquidity facilities should not be viewed as a proxy for a deficient liquidity risk

framework. The management of liquidity risk encompasses many different tools, of which access to central bank liquidity facilities is but one.

Given the systemic importance of CCPs, we also believe that CCPs should not be precluded from accessing central bank liquidity facilities if such CCP is not an authorised credit institution.

(ii) If your answer to is yes, what are the measures that should be considered and why?

QUESTION 1.2: NON-FINANCIAL FIRMS

(a)(i) Are the clearing thresholds for non-hedging transactions (Article 11, Regulation (EU) No 149/2013) and the corresponding definition of contracts objectively measurable as reducing risks directly relating the commercial activity or treasury financing activity (Article 10, Regulation (EU) No 149/2013) adequately defined to capture those non- financial counterparties that should be deemed as systemically important?

No.

(a)(ii) If your answer to question i. is no, what alternative methodology or thresholds could be considered to ensure that only systemically important non-financial counterparties are captured by higher requirements under EMIR?

Portfolio hedging

ISDA supports and endorses the response of FIA Europe with regards to the issue of portfolio hedging.

Intragroup transactions

NFCs will often have large numbers of intragroup OTC derivative transactions. As discussed in Annex 1, large companies with numerous operating affiliates generally employ a model whereby the hedging transactions of affiliates are executed with a centralized treasury unit (CTU) which will then aggregate exposures (and net where appropriate). The CTU will then enter into a smaller number of street facing transactions. The CTU is a proven model that actually reduces systemic risk and complexity.

Article 10(3) of EMIR currently has no provision for dealing with intragroup transactions, with the result that NFCs are required to double count these intragroup transactions when calculating the threshold. Article 10 should be amended either to exclude intragroup transactions from the threshold calculation or to expressly state that such transactions only need to be counted once when determining the size of the group's OTC derivatives portfolio.

In addition, NFCs in a group whose parent undertaking is outside the EU should only be required to count towards the threshold any OTC derivatives entered into by group members incorporated in the EU or by non-EU group members with a counterparty who is an FC or NFC.

(b) Please explain your views on any elements of EMIR that you believe have created unintended consequences for non-financial counterparties? How could these be addressed?

(c) Has EMIR impacted the use of, or access to, OTC derivatives by non- financial firms? Please provide evidence or specific examples of observed changes.

QUESTION 1.3: CCP COLLEGES

(a) What are your views on the functioning of supervisory colleges for CCPs?

(b) What issues have you identified with respect to the college system during the authorisation process for EU CCPs, if any? How could these be addressed?

ISDA believes that greater transparency is needed with regards to the authorisation process for EU CCPs. In particular, greater visibility and communication of the expected timeline for authorisation of a CCP (or authorisation of a CCP to clear additional classes), either in the form of a public calendar, periodic status updates or meeting agendas, would allow market participants to better prepare to meet regulatory requirements associated with the authorisation of a CCP. Ideally this information should be made available on ESMA's website, which should be regularly updated so as to allow ESMA to provide advance warning to the industry of when a CCP will be authorised, or a new product extension is to be authorised, such that the industry is able to prepare and act proactively, rather than reactively. Clearing members have previously experienced difficulties in being able to be prepared to comply with requirements that come into force on an unknown date – for example, clearing members are required to offer clients the choice between omnibus and individual segregation under Article 39, from the date the CCP is authorised.

QUESTION 1.4: PROCYCLICALITY

(a)(i) Are the requirements under Article 41 EMIR and Article 28 *Regulation (EU) No 153/2013* adequate to limit procyclical effects on CCPs' financial resources?

No. ISDA believes that the three options prescribed by ESMA (under Article 28 of Regulation 153/2013) intending to limit the procyclical effects on CCPs resources are not adequate in addressing such procyclicality due to interpretational issues or differences in implementation. For example, some CCPs that apply 25% buffer margins typically do not disclose a systematic approach to suspending or depleting the buffers during volatility spikes and, as such, margins continue to scale during times of stress. Hence we believe that anti-procyclicality rules should be principles-based and not prescriptive measures, which have been insufficient to work in the context of the full range of in-scope cleared derivatives products.

(a)(ii) If your answer to i. is no, how could they be improved?

In particular, we believe that:

- Procyclicality should be defined so as to enable CCPs to determine targets to be achieved; and
- CCPs should adopt appropriate and conservative anti-procyclicality measures, taking into account the specific characteristics of cleared contracts and at least ten years of history of patterns in changes in volatility regimes.

We also believe it is crucial that the governance and transparency around the process by which CCPs develop and design such measures should be robust. It will be helpful to require CCPs to provide transparency to members/ participants on approaches used to address procyclicality and place the onus on the Governance process to ensure that the CCP utilises the appropriate framework (depending on product/ portfolio) for addressing procyclicality. To this point, we agree with the European Systemic Risk Board (ESRB) that CCPs should produce a documented policy on the overall tolerance for procyclicality, which should make the policy of the CCP transparent to their competent authorities, and in an appropriate manner and degree of detail to the clearing members. We agree that such policy should make clear how the different components of a CCPs risk management system (initial margins, collateral haircuts, add-ons, etc.) interact with each other under a procyclicality perspective. To the extent that CCPs select one framework to address procyclicality over the other, the CCP should justify to its governing bodies and its regulators the suitability of the framework proposed and the rationale for its choice.

We also believe that it is critical that the CCP risk committee approves such procyclical measures.

(b)(i) Is there a need to define additional capacity for authorities to intervene in this area?

We consider additional measures that clarify the responsibility of CCP supervisors in this regard to be a positive addition to EMIR.

(b)(ii) If your answer to i. is yes, what measures for intervention should be considered and why?

QUESTION 1.5: CCP MARGINS AND COLLATERAL

(a)(i) Have CCPs' policies on collateral and margin developed in a balanced and effective way?

CCPs policies have developed in line with the fragmentation in market practice and liquidity engendered by other regulations. As such there are considerations we would like to see further developed in an appropriate way.

(a)(ii) If your answer to i. is no, for what reasons? How could they be improved?

CCP Margins

1. Confidence Interval [Article 41 of EMIR; Article 24 of Regulation 153/2013]

Regulation 153/2013 requires that a minimum confidence interval of 99.5% be applied for all OTC derivatives products, however, confidence intervals should be a function of the risk of the product rather than classification of products into OTC vs. non-OTC. Thus, ESMA allows that where a CCP clears OTC derivatives that have the same risk characteristics as derivatives executed on regulated markets or an equivalent third country market, it may use an alternative confidence interval of at least 99 % for those contracts if the risks of OTC derivatives contracts it clears are appropriately mitigated using such confidence interval. A similar provision should be added requiring exchange-traded derivatives that exhibit the same risk characteristics as OTC derivatives be subject to at least a 99.5% confidence interval.

2. Look-back period [Article 25 of Regulation 153/2013]

Regulation 153/2013 requires a minimum look-back period of 12 months, which we believe is inadequate for capturing a full range of market conditions. ISDA believes that data used for calculating historical volatility should capture a full range of market conditions, including periods of stress. Therefore, we believe that a look-back period should be long enough to ensure that the scenarios underlying margin determination are sufficiently diverse, and CCPs should scale historical prices to reflect current market prices and volatility. This would ensure that margin requirements are never unnaturally low. The determination and design of a look-back period should be approved by the CCP Risk Committee and be made transparent to clearing members and other participants, and subject to robust governance standards.

3. Liquidation period [Article 26(b) of Regulation 153/2013]

Regulation 153/2013 requires an estimated time horizon for liquidation period to include the period that the CCP would require to close-out or hedge the position prescribed in the default management plan of a CCP and proven by fire-drills. We recommend that the time period should be based on the longer of the time taken to close-out (as demonstrated by fire-drills) or hedge the defaulting member's positions. As mentioned in (1), rather than categorise products as exchange-traded vs. OTC and then assume that exchange-traded are more liquid and less risky, we propose that products be subject to longer holding periods driven by product liquidity, portfolio complexity, market concentration and volatility of underlying asset irrespective of the market in which they are traded. Such an approach would be consistent with CPMI-IOSCO's Principles for Financial Market Infrastructures, which explicitly provide that "close-out periods should be set on

a product-specific basis because less-liquid products might require significantly longer close-out periods" (PFMI p. 53 paragraph 3.6.7. on close-out period) .

4. Portfolio Margining [Article 27 of Regulation 153/2013]

Member contributed margin is the first line of defence. Hence, prudent determination of IM is important to ensure default losses are covered by the participant IM to the extent possible. Portfolio margining of multiple products allow CCPs to grant margin offsets to participants leading to lower margin collection than otherwise. It is critical that any margin offsets should be realised in a default event when market conditions are expected to be stressed. If that does not happen, it is highly probable that IM collected from a defaulted member would prove to be insufficient in meeting default losses which in turn would lead to higher utilisation of other layers of default waterfall and perhaps, leading to contagion risk.

Therefore, we believe that Article 27 is far too prescriptive, by basing its criterion to provide offsets based on stable correlations. Correlations are a fundamentally flawed way of determining relatedness in markets, where the forces driving market levels can change over time. For example, the correlation between the 2Y and 10Y swap rates in a given currency are generally high and stable, particularly when the main driver of rates in overall market level ("parallel shift" market driver), but from time to time – in times of stress – the correlation can break down as a new market driver emerges, characterized by predicting bank policy will lower rates. Consequently a more common sense method of allowing portfolio margining is necessary, such as market levels being driven by the same or related market drivers. Correlations between product prices based on purely statistical relationships (for example, offsets between AUD and gold or offsets between USD/EUR IRS and peripheral currencies) which tend to break during stress scenarios, should never be the primary support for margin offsets. Rather, CCPs must demonstrate that offsets are based on strong economic rationales that show that the underlying relationships persist in both normal and stressed markets. By not having the provision prescriptive, it will not lead to more robust offsets.

5. Liquidity and concentration add-ons

EMIR does not explicitly require CCPs to factor in liquidity and concentration risks in portfolios by calculating initial margin add-on charges. We recommend that either through separate add-ons or through robust initial margin models, CCPs should address concentration/liquidity risk in member portfolios. A CCP determines the minimum period of risk for margin that will allow for the liquidation of the vast majority of its members portfolios. For the remaining members whose risk is larger than the vast majority of the others, the margin period of risk will be longer and consequently an additional margin buffer will be required. For example, if the period is twice as long, the margin will need to be multiplied by the square root of two under normal distributions of market assumptions (a portfolio with a liquidation period of five days should have margins 2.2 times the margin required for a liquidation period of only one day, while a liquidation period of 10 days should have a margin requirement 3.1 times the margin required for a one day liquidation period).

It is crucial that CCPs are transparent in how they determine such add-ons and communicate such policies to their members and other participants. Such policies should also be approved by CCP risk committees.

(b)(i) Is the spectrum of eligible collateral appropriate to strike the right balance between the liquidity needs of the CCP and its participants?

It is essential that EMIR set the standard for more progressive collateral policies which are commensurate with today's market infrastructure and the mechanics of liquidation of collateral, and not rely fully on historical performance of assets as indicators, which can be misleading. While in general ISDA believes that the spectrum of eligible collateral as detailed in EMIR and the associated technical standards is appropriate, we believe that eligible assets should be of high credit quality; frequently/heavily traded and liquid; characterised by low volatility; should not be highly correlated with the exposure being collateralised, and can be posted at a central bank or under credit arrangements to access a liquidity facility.

We believe that the overwhelming priority of EMIR and associated technical standards is the stability of CCPs. As such, we feel it is critical that acceptable collateral should be determined by considering the circumstances in which such collateral would have to be liquidated, including:

- The default of a client of a clearing member;
- The default of a clearing member; and
- The default/resolution of a CCP.

It is important that collateral accepted by a CCP can be quickly liquidated in these circumstances, maintaining, to a significant degree, its pre-default value. If clearing members (or clients of clearing members) post margin in assets other than cash, the CCP can become undermargined due to changes in the value of the collateral. The risk of this undermargining depends on the volatility of the price of the collateral: the greater the volatility, the greater the risk of under-margining. It also depends on the correlation between the value of the collateral and the value of the collateralized positions. If the assets posted as collateral tend to decline in value when the associated position loses money, the risk of under-collateralization is greater. The risk also depends on the liquidity of the collateral. A CCP runs the risk of forcing down the price of collateral when it sells it to cover a defaulter's obligations: this risk is greater, the less liquid the collateral.

Accordingly, broadly speaking, we consider that "eligible collateral" should ideally have the following characteristics:

- high credit quality;
- demonstrable and measurable high market liquidity or trading volume (by objective and independent standards);
- low price volatility and high transparency of pricing; and
- have low correlation with the exposure being collateralised.

Collateral with these features, along with minimum cash thresholds and concentration limits by instrument/maturity/single issuer at both member and aggregate CCP level, would help ensure both adequate liquidity and loss coverage at the CCP in the event of a CM default. Examples of assets that have the above features include:

- cash in the currency in which the trades are settled or other G4 currency; and

- direct obligations of, or obligations guaranteed by the sovereign of the jurisdiction in which the CCP resides or other highly-rated sovereigns, i.e. A or above (including senior debt of certain government-sponsored entities assuming it met objective parameters noted above).

We recognise, nevertheless, that it is important to acknowledge the significant liquidity reduction in certain non-cash assets if eligible collateral for every CCP was limited strictly to those non-cash assets of 'demonstrable and measurable high market liquidity or trading volume (by objective and independent standards)'. However, while certain CCPs also accept other non-cash assets with meaningful haircuts, we recommend the following:

- Eligible assets should be subject to conservative credit, market and liquidity risk parameters. Such parameters should include enhanced collateral haircuts that factor in the price moves of stressed markets and concentration limits on acceptable collateral to assets that bear a high degree of positive correlation to the exposures they collateralise (for example. certain equities collateral pledged as initial margin for equity derivatives clearing);

- While corporate bonds might be retained as a form of eligible collateral, we believe that CCPs should only accept such bonds if they are eligible to be posted at a central bank or to a committed liquidity facility provider. CCPs should be able to demonstrate sufficient recourse to diversified liquidity lines away from clearing members. Such bonds should also be subject to strict concentration limits, given that in stressed periods, the liquidity of such instruments can evaporate; and

- Other forms of collateral (for example, gold, corporate bonds, and equities etc.) should be subject to strict concentration and usage limits (except in cases where the collateral creates a right-way risk position against the underlying exposure – for example a right-way risk equity portfolio held against an equity index). We recommend (i) corporate bonds, equities and gold form no more than 5% of initial margin posted by an individual participant, except in cases where the collateral is deliverable against the collateralized exposure and (ii) alternative forms of collateral form no more than 10% of (1) initial margin posted by an individual participant and (2) aggregate initial margin posted at the CCP.

(b)(ii) If your answer to i. is no, for what reasons? How could it be improved?

PART 2:

QUESTION 2.1: DEFINITIONS AND SCOPE

(i) Are there any provisions or definitions contained within Article 1 and 2 of EMIR that have created unintended consequences in terms of the scope of contracts or entities that are covered by the requirements?

Yes.

(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Scope

There has been considerable uncertainty about when governmental and public bodies and international and treaty organisations are subject to obligations under EMIR and equally when FCs and NFCs (and other persons subject to Title II e.g. third country entities in the limited circumstances specified in the RTS under Articles 4 and 11) dealing with such bodies and organisations are required to comply with the obligations under EMIR, in particular the operational risk mitigation and margin obligations in Article 11. The FAQs and Q&A from the Commission and ESMA have not fully resolved the questions about the scope of EMIR in this regard.

In addition:

- The application of EMIR clearing and risk mitigation obligations to FCs dealing with non-EU central banks is an obstacle to EU banks participating fully in international markets, in particular where they operate through branches in other jurisdictions. The process for extending the exemption to additional non-EU central banks has not been effective to address these issues. It will become significantly more problematic when the clearing obligation and rules for margin on uncleared derivatives begin to apply.

- There has been uncertainty about whether Article 1(5) should be read as imposing reporting obligations under Article 9 on entities that are not financial counterparties or non-financial counterparties (even though ESMA has indicated that the obligations in Article 9 are limited to FCs and NFCs). There has also been concern about whether imposing such obligations on international organisations operating in the EU is appropriate. In addition, imposing reporting obligations on these entities does not add significantly to the information in trade repositories as they will usually be entering into contracts with FCs that will themselves be subject to reporting obligations.

- There has been uncertainty about the scope of Article 1(5)(b) and its application to non-EU entities.

Furthermore, there has been particular uncertainty about the treatment of individuals (natural persons). ESMA's Q&A has indicated that these persons are not undertakings when not carrying out an economic activity (although this is not explicitly stated in EMIR) but has not clarified the extent to

which the obligations in Article 11 apply to an FC or NFC when dealing with such an individual. We believe that this point should be clarified by amending the definition of "non-financial counterparty" to specify what is meant by an "undertaking" for the purposes of EMIR.

We consider that Article 1 should make clear that the following entities are not subject to any obligations under EMIR, regardless of whether they are established, formed or resident in the EU:

- Central governments;
- Regional governments;
- Municipalities and local public authorities;
- Central banks;
- Public bodies charged with or intervening in the management of the public debt at national, regional or municipal or local authority level;
- The Bank for International Settlements;
- International and supranational organisations formed pursuant to a treaty or other international agreement, including but not limited to the multilateral development banks currently referred to in Article 1(5)(a);
- The entities currently referred to in Article 1(5)(b);
- The EFSF and ESM;
- Natural persons who, in transactions covered by EMIR, are acting for purposes which are outside their trade, business or profession (wording based on the consumer credit directive).

It should also make explicit that undertakings subject to the obligations in Title II EMIR are not subject to the clearing obligation or the obligations under Article 11 when entering into OTC derivative contracts with the above entities (although those undertakings will be subject to the reporting obligation).

Definitions

OTC derivative (EMIR Article 2(7)) is defined as "a derivative contract the execution of which does not take place on a regulated market within the meaning of Article 4(1)(14) MiFID or on a third-country market considered as equivalent to a regulated market in accordance with Article 19(6) of MiFID". However, under MiFID I, unless the EC has determined a regulated market based in a third country as equivalent, derivatives traded on that regulated market by EU counterparties will be considered OTC derivatives, rather than exchange-traded derivatives. The EC has yet to deem equivalent any third country regulated markets under Article 19(6) of MiFID. This is particularly problematic for non-financial counterparties (NFCs) that trade on third country regulated markets, as those exchange-traded derivatives will now count towards the clearing threshold in EMIR, and could force such NFCs above the threshold and thus subject to the EMIR clearing and margin obligations. We welcome Article 27(b) of the Securities Financing Transactions Regulation, which amends EMIR so that the definition of OTC derivatives be amended in order to ensure that the same type of derivatives contracts are identified as either OTC derivatives or exchange-traded derivatives irrespective of whether those contracts are traded in the Union or third-country markets, and we urge the EC to as soon as practically possible grant equivalence decisions to third-country regulated markets for these purposes.

Non-financial counterparty (EMIR Article 2(9)) is defined as "an undertaking established in the Union other than the entities referred to in points (1) and (8) (of Article 2). However, the definition of 'undertakings' is not drawn from EMIR, but derives from competition case law and includes, among others, natural persons. ISDA's recent Clarification Letter sets out how the concept of 'undertakings' interacts with EMIR: "Accordingly, the EC asserts that the term "undertaking" would be addressed to activities instead of entities and that, against this background, the term "undertaking" would include entities, regardless of their legal status, performing economic activities in the market."

This approach has a number of unintended consequences, in capturing entities that we believe should not be in-scope of EMIR. Consequently, we believe that EMIR should specifically exclude natural persons from the definition of "non-financial undertakings". This would clearly demarcate entities that are intended to fall within the scope of EMIR from those that are to be excluded. This is particularly important given that firms must implement EMIR across a range of counterparties within very tight timeframes.

We note that those market participants do not pose systemic risk and are not comparable in prudential terms to firms or indeed to systemically important financial institutions. The insolvency of a natural person has not and does not result in the non-viability of major market participants. This can be illustrated by looking at actual examples of private individuals' economic activities that are caught by EMIR: for example being a sole trader. Such individuals do not form a substantial part of the financial system, in terms of the volume or amount of their trades, to potentially have significant adverse effects on the economy.

If EMIR continues to include natural persons in its scope, we note that firms providing services to those persons will be forced in many instances to either withdraw services for such clients or to increase their fees, driving those same clients out of the derivatives market. In addition, timeframes prescribed by EMIR (e.g. timely confirmations by T+2) assume both availability of people and sophistication of infrastructure that is the standard for financial firms, but is not to be expected by market participants such as private individuals. Conversely it is undesirable for firms to rely on representations made by individuals as to their status under EMIR without greater legal clarity. Therefore, the existing lack of clarity and potential inclusion of natural persons as in-scope of EMIR would undermine such market participants' ability to access open markets and effectively manage their own investments, through the use of financial instruments designed to manage risk.

Taking the above considerations, we recommend that EMIR Article 2(9) is amended to include the emboldened text: ""non-financial counterparty" means an undertaking established in the Union other than (i) natural persons and (ii) the entities referred to in points (1) and (8)". An alternative approach would be to include natural persons under Article 1(4) as wholly exempt entities.

Group (EMIR Article 2(16)) is defined as "a group of undertakings consisting of a parent undertaking and its subsidiaries within the meaning of Articles 22(1) to (5) of Directive 2013/34/EC or the group of undertakings referred to in Article 3(1) and Article 80(7) and (8) of Directive 2006/48/EC. However, there has been significant concern as to when SPVs should be treated as part of a "group" for the purposes of EMIR, in particular as regards the calculation of the clearing threshold under Article 10 and the corresponding tests of a group in the clearing and margin RTS. Therefore, we consider that the definition of a "group" in Article 2(16) EMIR should be amended to specify that a "securitisation special purpose entity" shall not be regarded as a member of a group. For these purposes, we suggest adopting the definition of "securitisation special purpose entity" in Article 4(1)(an) AIFMD.

In addition, we consider that it should be made clear in EMIR itself that investment funds should not be regarded as part of a "group" under EMIR in the circumstances set out in Article 5 GEN (3) of the ESAs June 2015 consultation paper on margin for uncleared derivatives. There should be a consistent treatment of investment funds for the purposes of the "group" definitions as used in Article 10 and the group tests in the clearing and margin RTS. We support the language proposed by ESMA at Article 2(3) of the Clearing RTS, and suggest the Commission adopt this language for purposes of the clearing threshold and the initial margin thresholds.

Intragroup transaction (EMIR Article 3). We understand that it is likely that decisions on equivalence under Article 13(2) will be taken on a rule-by-rule basis (e.g. a jurisdiction may be found equivalent for the purposes of Article 4 only if it only has an equivalent clearing obligation) rather than for all rules in Title II. Therefore, it will need to be made clear that the intragroup transaction exemption is available for transactions with affiliates in a non-EU state where the relevant non-EU state has been found equivalent for the rule-set in question, i.e. if the jurisdiction has been found to have equivalent clearing rules, the intragroup exemption will be available under Article 4 even if it is not available under Article 11.

- Article 3(2)(a)(i) should make clear that it applies where "the other counterparty is established in the Union or if it is established in a third country…."
- Article 3(2)(a)(ii) should make clear that it applies where the other counterparty is a financial counterparty, a third country entity that would be a financial counterparty if it were established in the EU, a financial holding company …. ".
- Article 3(2)(d) should make clear that it applies to "an OTC derivative contract entered into with a non-financial counterparty (or a third country entity that would a non-financial counterparty if it were established in the EU) which is part of …."

QUESTION 2.2: CLEARING OBLIGATIONS

(a)(i) With respect to access to clearing for counterparties that intend to clear directly or indirectly as clients; are there any unforeseen difficulties that have arisen with respect to establishing client clearing relationships in accordance with EMIR?

Yes. In particular:

- We believe that the indirect clearing rules, as set out in Regulation 149/2013, are unworkable from a clearing member perspective, and undermine the efficacy and objectives of the approach. The rules need to be redesigned, as per (a)(ii) below. ISDA is keenly aware that as a result of concerns that smaller derivatives users in Europe may be unable to access central counterparties (CCPs) due to potential capacity constraints of clearing members (CMs) that regulators view indirect clearing as a mechanism to help solve the access problem. Redesigning the current ruleset, as set out below, will allow CMs to offer indirect clearing arrangements without being exposed to undue and unquantifiable risks. **However, we also firmly believe that clearing members should not be forced to offer such arrangements**; and

- Current leverage ratio requirements, promulgated by the Basel Committee on Banking Supervision (BCBS), are not appropriate for cleared client transactions as they ignore the risk mitigating impact of segregated margin. This acts as a significant disincentive to central clearing. The rules will constrict the capacity of CMs to offer clearing arrangements to market participants, forcing some to stop using derivatives, thus increasing risk in the system and reducing liquidity in hedging instruments. The leverage ratio should be amended to recognise the exposure reducing effect of segregated margin.

(a)(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Indirect Clearing – current requirements for OTC derivatives need to be redesigned & clearing members should not be mandated to offer such arrangements

Why current indirect clearing rules need to be redesigned:

The aim of allowing indirect clearing as a means to satisfy the clearing obligation under EMIR is to increase the flexibility of access to clearing on commercially reasonable terms, without diminution of client choice and embedding full transparency. ISDA and its members engaged extensively with ESMA in original discussions to interpret the concept of indirect clearing as referred to in Article 4 of EMIR and the resulting EMIR RTSs – 149/2013. We raised various concerns regarding the meaning of the conditions in Article 4 and the more detailed conditions which were eventually included in the RTS.

We welcomed the removal of the original proposal that all clearing members should be obliged to offer indirect clearing – we were concerned that requiring all clearing members to provide such a difficult offering would cause many clearing members to reconsider their ability to remain clearing members at all, and this was acknowledged by ESMA. However, in relation to the requirements

which remain for those who wish to offer indirect clearing, we believe that EMIR Level 1 should be amended to allow sufficient flexibility to specify requirements for indirect clearing which are less problematic and therefore more likely to be implementable in practice than those detailed in Regulation 149/2013.

As proposed, the current ruleset is extremely challenging for CMs to offer in practice. In considering these arrangements, it is important first to note two factual elements which are specific to indirect clearing arrangements:

a) The nature of indirect clearing is one in which there may be, at least, two intermediate brokers in a chain of back-to-back principal relationships, between the end client and the CCP. Any end-client protections therefore need to contemplate outcomes in the event of a default of (i) the clearing member, (ii) the indirect clearer, and (iii) the clearing member AND the indirect clearer at the same time.

b) In this chain of entities, it is very likely in many cases that more than one jurisdiction is involved. Hence, any approach needs to take account of a multiplicity of national insolvency regimes.

The concept behind Regulation 149/2013, in applying EMIR arrangements (as detailed in Article 39 and 48) at the indirect client level, was described essentially as one in which the role of the CCP as contemplated in Title IV EMIR is "shifted down" a level, so that the clearing member is expected to deliver the same level of record-keeping, segregation, porting, as a CCP would for direct clients of a clearing member.

However, this is problematic because:

1. CCPs have the benefit of various legislation, national and at EU level, which protect their actions taken on a clearing member default from the risk of insolvency challenge.

   Porting necessarily involves the transfer of positions and / or assets for the benefit of the end client where the interests of an intermediate entity in default (i.e. normally the clearing member) might give rise to insolvency-based challenges. Even in this environment, the delivery of robust and practical porting mechanisms in an international context is not straightforward.

   No such similar protections would be available to clearing members when acting to port assets and positions in the event of a failure of their immediate client, the indirect clearer. We do not believe that Regulation 149/2013 has the effect of overriding national EU member state insolvency regimes in this regard (and one must, in any event, cater for circumstances where an intermediary is not based in an EU member state, since non-EU entities may well also find themselves subject to the clearing obligation, directly or indirectly).

   We note that certain EU jurisdictions have taken or are considering steps to recognise indirect clearing arrangements in their national insolvency regimes. However, in our experience, these steps are unlikely to be sufficient in light of the range of circumstances they need to cater for and their likely cross-border nature.

It is unreasonable to expect clearing members to take on such an unquantifiable insolvency risk. It presents commercial, risk and regulatory capital concerns that are likely to make such an offering non-viable.

2. CCPs assume no obligations to the clients of clearing members. In the event that a clearing member defaults and there is not another clearing member available to step into its shoes and cover the liability of the CCP in full, the CCP is not obliged to port positions and will simply liquidate positions in accordance with its default rules.

   By contrast, clearing members under indirect clearing arrangements contemplated under Regulation 149/2013 are required to provide "a credible mechanism for transferring the positions and assets to an alternative client or clearing member, subject to the agreement of the indirect clients affected."

   As noted above, we would expect this to need to be present on a clearing member default or an indirect clearer default. A clearing member default is more straightforward, since the indirect clearer should be able to benefit from CCP-level provisions protecting it as a client of the clearing member so that the indirect clearer can transition the entire book of its indirect clients and supporting collateral to a transferee clearing member (assuming it has arranged one).

   Upon an indirect clearer's default however, the clearing member immediately has uncovered risk for the open positions of entities whom it has not taken on as clients. If the indirect clearer were just an ordinary client of the clearing member, the clearing member would immediately liquidate the position to preserve its own risk position.

   Any arrangement which anticipates that clearing members take on indirect client risk for any period of time, in order to facilitate porting, fundamentally undermines the clearing member's ability to protect itself (and its other clients). These are novel and material risks.

3. We understand that Article 4(2) of Regulation 149/2013 has been interpreted so that any indirect clearing must have a range of choices for the end client which include an ISA lookalike as well as an OSA lookalike. In light of the challenges above, delivering an ISA-like protection at indirect client level presents legal and risk challenges that are extremely difficult. OSA-like protections should be more achievable but serious questions would remain as to the nature of any porting mechanism that clearing members are required to make available in such circumstances.

ISDA and its members have spent extensive efforts looking to develop models which are (i) legally robust, particularly in a cross-border scenario and based on the EMIR requirements and (ii) commercially viable – i.e. capable of being provided at a cost and with regard to the capital costs of clearing members. Despite those efforts, there continue to be material obstacles to designing a model which satisfies all of these elements.

ISDA therefore welcomes the fact that these issues appear to have been well understood and taken into account by ESMA when contemplating the design of indirect clearing for exchange-traded derivative under MiFIR (the **ETD Proposal**) – in particular with regard to the removal of porting requirements and an ISA lookalike element from the ETD Proposal.

Whilst encouraged by the ETD Proposal, and supportive of industry responses refining that proposal, ISDA and its members consider it essential that revisions to the EMIR regime give appropriate recognition to the differences in scope of the EMIR clearing obligation which require specific consideration. In particular:

A. Industry responses to the ETD Proposal have advocated clarification that proposed rules under MiFIR for ETD indirect clearing arrangements include a territorial limitation such that the requirements apply only in relation to EU-incorporated EMIR-authorised CCPs – which has the important effect of allowing existing structures for the provision of access to non-EU markets to continue in accordance with existing practices. In the context of EMIR, however, simply excluding certain arrangements with non-EU EMIR-recognised CCPs when setting out provisions regarding "compliant" indirect clearing is not an obvious solution to the challenges of catering for non-EU regimes, unless it is made clear that such indirect arrangements may continue to be used by an indirect client in order to satisfy its EMIR clearing obligation.

   Any other approach would risk the effect of making EMIR-recognised CCPs largely if not entirely unavailable to indirect clients. While it is recognised that permitting indirect clearing through EMIR-recognised CCPs might not fully deliver protections equivalent to Article 39 EMIR, such an approach is a necessary element of acknowledging the differences in applicable regimes and the client choice that should remain available to indirect clients wishing to use those EMIR-recognised CCPs.

B. Similarly, industry responses to the ETD Proposal have advocated that the prescribed form of indirect clearing should only be applicable in relation to EU-based indirect clients – which reduces materially the potential existence of cross-border insolvency challenges to successful indirect clearing structures and the level of related diligence that clearing members and indirect clearers would need to undertake. By contrast, the EMIR clearing obligation can apply equally to entities inside and outside the EU. Any "compliant" indirect clearing structure therefore needs to take account of a potentially far wider range of clearing member, indirect clearer and indirect client jurisdictions inside and outside the EU (and their applicable insolvency regimes).

We would argue therefore that in any revision of indirect clearing under the EMIR Review there must be appropriate acknowledgement of potential complications regarding applicable insolvency regimes, and regulatory regimes, where an indirect clearer and / or clearing member is based in a non-EU jurisdiction and services are provided to an indirect client who may not be established in the EU but is still subject to the EMIR clearing obligation.

Indirect clearing rules – key objectives

Therefore, we believe that the indirect clearing rules need to be redesigned in order to achieve the following critical objectives:

Jurisdictional scope

1. *Ensure that indirect clients are able to choose to use recognised CCPs (and not just authorised CCPs) in order to satisfy EMIR clearing obligation.*

ESMA has acknowledged that EU clearing members of non-EU CCPs are not required to comply with Article 39 when offering client clearing to direct clients (ESMA Q&A CCP 8(j)). The recognition process in Article 25 of EMIR, which looks at segregation amongst other things, is the comfort provided for regarding client protection

This approach was essential in order to allow the EMIR recognition regime to work, since it is acknowledged that non-EU CCPs will provide services in accordance with their home state regime – there is (rightly) no attempt to export specific EMIR requirements to recognised CCPs or to those who provide access to them.

We consider the same must remain true for indirect clearing. Any requirement for indirect clearing which relies on the way in which the CCP itself structures its service cannot be applied for recognised CCPs since EMIR does not apply to them. Consequent expectations on clearing members and indirect clearers in offering indirect clearing need to be varied accordingly.

Failure to introduce a pragmatic approach will effectively deny ICs the ability to clear on recognised CCPs. We would propose amending Article 4(3) EMIR to allow a more flexible approach in relation to the use of indirect clearing on recognised third country CCPs, with the DC making appropriate disclosures to ICs.

Such an approach is important because: (i) a non-EU CCP will most likely not have any special arrangements for indirect clearing, and (ii) the clearing member may well be non-EU (given local law requirements, and EU licensing issues which suggest that indirect clearing will be commonly used where a non-EU clearing member finds it difficult to provide services directly to EU clients). Whilst non-EU CCP services which look comparable to some form of gross omnibus arrangement might exist, the detailed functioning which would be required to meet the terms of a "compliant" indirect clearing structure (in line with the ETD Proposal or otherwise) may simply not be available. In any event, an obligation upon the clearing member and/or the indirect clearer to demonstrate comparability of function would be onerous and should not be required, on the basis that the jurisdiction in which that non-EU CCP is operating has been determined to be equivalent as part of the process of recognising the CCP under Article 25 EMIR.

We propose that indirect client clearing arrangements should be permitted in satisfaction of the EMIR clearing obligation provided:

a) there has been appropriate disclosure to the indirect client by the indirect clearer; and

b) if possible, an alternative arrangement is also offered to the indirect client by the indirect clearer which does provide "equivalent" protections.

In respect of (a), the nature of the disclosure should be limited to making the indirect client aware: (i) of the protections that EMIR provides to an indirect client if an authorised CCP, EU clearing member and EU indirect clearer are used, (ii) that recognised CCPs are not subject to the same detailed client protection requirements of EMIR and (iii) that, by choosing to satisfy the EMIR clearing obligation by way of an indirect clearing arrangement through a recognised CCP, the indirect client will not receive those protections. This disclosure obligation should be imposed at the indirect clearer level on the basis the indirect clearer will

have the customer relationship with the indirect client and will also have a choice as to which CCP(s) and which clearing member(s) it will use to facilitate its services to indirect clients.

In respect of (b), the alternative the indirect clearer would need to offer to the indirect client would need to be considered further but could entail the indirect clearer advising the indirect client of the possibility of using a different CCP – where available for that asset class (i.e. one which is an authorised CCP, for which indirect client protections would apply), or advising the indirect client of the possibility instead of becoming a direct client of an EU clearing member of the non-EU CCP which is willing and able to provide direct client access (i.e. not using indirect clearing at all - again, where available and subject to licensing / regulatory issues).

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

Clearing members (wherever located) of EU CCPs may be subject to Article 39 EMIR when providing clearing services to direct clients. However, ESMA's Q&A CCP 8(i) provides that where the insolvency regime of a non-EU clearing member could interfere with the provisions of omnibus client segregation or individual client segregation, the clearing member should: (a) offer its clients alternative possibilities that ensure those clients receive such a choice of protections – e.g. clearing solutions provided by an affiliate or other clearing member of the CCP; and (b) where, notwithstanding the alternatives offered, the client chooses to use the non-EU clearing member, disclose the risks to the client at the outset of the relationship.

This approach was essential in order to recognise that non-EU clearing members subjected to the requirements of EMIR could not be expected to act outside the scope or possibilities of the legal and regulatory regimes within which they operated. The result is that entities satisfying their EMIR clearing obligation as a direct client might do so in a manner which does not in fact entail "full" satisfaction of Article 39/48 EMIR requirements. Instead, a regime of offering alternatives and appropriate disclosure provides the direct client with the tools to choose the level of protection it requires.

We consider that the same issues arise in relation to indirect clearing, and indeed are likely to be more prevalent in practice since there will be two intermediaries (clearing member and indirect clearer) whose positions need to be taken into account. Taking any other approach in the context of indirect clearing would potentially add significant geographical limitations on the entities capable of acting as clearing members and/or indirect clearers. A solution which retains the features of alternatives, client choice and appropriate disclosure should be extended for circumstances where the clearing member and/or indirect clearer involved in providing indirect clearing access to an authorised CCP is non-EU.

That is, where the insolvency regime of a non-EU clearing member or non-EU indirect clearer could interfere with the provisions of relevant indirect client segregation options, the indirect clearer should: (a) offer indirect clients or suggest indirect clients may wish to seek alternative possibilities that ensure those clients receive such a choice of protections – e.g. clearing solutions provided by an EU clearing member of the CCP or by another clearing member/indirect clearer arrangement; and (b) where, notwithstanding the alternatives offered,

the client chooses to use the non-EU clearing member/non-EU indirect clearer arrangement, make appropriate disclosure to the indirect client at the outset of the relationship.

The same approach to disclosure in respect of recognised CCPs (as discussed in the preceding section 1 of this Response) should apply here. Any obligation to make appropriate disclosure in respect of the non-EU clearing member or indirect clearer should only require the indirect clearer to make the indirect client aware: (i) of the protections that EMIR provides to an indirect client if an authorised CCP, EU clearing member and EU indirect clearer are used, (ii) that choosing to satisfy the EMIR clearing obligation by way of an indirect clearing arrangement via a non-EU clearing member and/or indirect clearer (as applicable) may mean that these protections may be affected by a non-EU insolvency regime and (iii) that, by choosing to satisfy the EMIR clearing obligation by way of an indirect clearing arrangement via a non-EU clearing member and/or indirect clearer (as applicable), the indirect client acknowledges that it may not receive those protections.

Finally, with regard to the position of non-EU entities who are caught by the EMIR clearing obligation, we would argue that it is appropriate to introduce additional flexibility so that such entity can elect to use a "non-compliant" means of indirect clearing access to an authorised or recognised CCP but should be given the rights, vis a vis the indirect clearer, to "opt-up" to an EMIR-compliant indirect clearing arrangement if it so elects (subject still to the variations argued for elsewhere in this Response and without prejudice to a clearing member's ability to decide not to facilitate an EMIR-compliant indirect clearing service if it so chooses).

Compliant indirect clearing arrangements

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

   As mentioned, we do not believe that Regulation 149/2013 has the effect of overriding national insolvency regimes. Article 4(5) requires that the clearing member ensures that its procedures allow for the prompt liquidation of the assets and positions of indirect clients and the clearing member to pay all monies due to the indirect client following the default of the indirect clearer. But this so-called 'leapfrog' payment may conflict with or be incompatible with the insolvency regime of the indirect clearer, or otherwise involve contentious actions, and thus be subject to challenge. For example, in the event of a shortfall in the assets available for return to indirect clients, any assessment by the clearing member as to the allocation of such shortfall amongst indirect clients is potentially complex and would invite challenge. These challenges can occur both with respect to third countries and possibly within the EU and the clearing member does not benefit from any legislative or other protections which allow it to act without risk or assess applicable risks before deciding whether to facilitate such payments.

   As to the risk of insolvency challenge within the EU at least, we believe that Article 4 of EMIR should be amended to include an operative provision as below:

> The requirements laid down in the technical standards adopted pursuant to paragraph 4 on the segregation [and portability] of the positions and assets of counterparties establishing indirect clearing arrangements with a clearing member and the default procedures with respect to those assets and positions shall prevail over any conflicting insolvency and other laws, regulations and administrative provisions of a Member State that would otherwise prevent any person from fulfilling them.

Even with such an amendment however, we have noted above the risks that may still reside with clearing members in acting to make a leapfrog payment and would urge ESMA to consider appropriate conditionality to such an obligation so that clearing members are not force to take on additional unreasonable or unmanageable risks. We would argue that, in complex circumstances, the prompt return of such assets by the clearing member to the insolvency official of the indirect clearer, together with appropriate identification of assets and entitled indirect clients (as last notified by the indirect clearer to the clearing member) would still allow the insolvency official to take prompt action to return assets and minimise detriment to indirect clients without exposing clearing members to additional risk.

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

   Article 4(4) of 149/2013 states that "a clearing member shall establish robust procedures to manage the default of a client that provides indirect clearing services. These procedures shall include a credible mechanism for transferring the positions and assets to an alternative DC or CM, subject to the agreement of the indirect clients affected". As explained above, any arrangement which anticipates or has the effect that clearing members take on additional risk for any period of time, in order to facilitate porting, fundamentally undermines the CM ability to protect itself (and its other clients).

   We would urge ESMA to remove this requirement, in line with its approach under the draft MiFIR RTS.

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

   Under the draft MiFIR RTS, ESMA has included in the proposal the choice of both gross omnibus segregated accounts (GOSA) and NOSA for indirect clients in relation to exchange-traded derivatives. This is not entirely appropriate for OTC client clearing in all cases so we would not propose replicating this approach in relation to OTC derivatives.

   Under the ETD Proposal, the GOSA is the novel element which has been introduced to offer the indirect client a higher level of protection than that which would be available under the currently prevailing approach for indirect clearing of ETD which generally reflects a NOSA basis. In that sense, the availability of the GOSA option is the incremental regulatory protection, with the NOSA being available also as a continuation of the status quo for those indirect clients who are happy with this.

   By contrast to ETD, a number of EMIR-compliant OTC client clearing services which exist today include an ISA service and a gross omnibus service (without a net omnibus option), in a manner sufficient to meet the requirements of Article 39 EMIR. EMIR does not require that an authorised CCP offer both net and gross omnibus services. While net omnibus account

structures do also exist at certain CCPs for certain OTC clearing services, these are much less widely used and there is currently little market demand for such accounts in the OTC context. Prescribing that clearing members and indirect clearers must always facilitate the choice of NOSAs in addition to GOSAs under an indirect clearing arrangement for OTC derivative clearing would potentially be incompatible with the arrangements of an authorised CCP which does not currently facilitate net omnibus arrangements for OTC derivatives clearing.

We would therefore recommend that the requirement for indirect clearing arrangements under EMIR be varied so that the indirect clearer offers to the indirect client in all cases:

a) at least, a GOSA service; and

b) an alternative omnibus client account structure, but only where the relevant authorised CCP and clearing member offer such an alternative omnibus client account structure without all the features of the GOSA (which could be a NOSA service or some other client omnibus arrangement).

Such an approach ensures that the indirect client is always offered a GOSA but may also be provided the choice of an alternative omnibus client account offering in circumstances where both the CCP service and clearing member facilitates it doing so.

Basel Leverage Ratio should recognize the exposure-reducing effect and segregated initial margin

ISDA believes that capital levels should be appropriate to the level of risk of a given financial activity, in order to ensure that potential exposures arising from such activities are properly aligned and calibrated with the capital supporting them. However, under the current BCBS Leverage Ratio rules, for the purposes of calculating derivatives exposures in the denominator of the ratio, segregated margin received from clients is not allowed to offset the potential future exposure (PFE) associated with such off-balance sheet exposures – the policy rationale being that such margin can increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself. However, we believe that margin that is segregated may not be leveraged by a bank to fund its operations, and that such segregated margin solely functions as a risk mitigant in reducing exposures with respect to a bank's cleared derivatives exposures. Failure to recognise the exposure-reducing effect of such margin acts as a significant disincentive to central clearing, as margin will substantially increase a clearing firm's total leverage exposure, leading to an increase in the amount of capital required to support client clearing activities, which will:

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

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

(b)(i) Are there any other significant ongoing impediments or unintended consequences with respect to preparing to meet clearing obligations generally in accordance with Article 4 of EMIR?

Yes. In particular:

- The frontloading requirement should be removed for all future classes of derivatives deemed subject to the clearing obligation;
- ESMA should be given the ability to terminate or suspend the clearing obligation as a matter of urgency;
- A mechanism for the liquidation of contracts at a CCP that has lost its authorisation/recognition needs to be created;
- Treatment of trades that result from systemically risk-reducing processes should be exempted from the clearing mandate and rules governing the margining non-cleared derivatives;
- Trades entered into by securitisation vehicles or other structured finance SPVs should not be subject to the clearing obligation or margin requirements for non-cleared derivatives;
- Trades resulting from group restructurings should be exempted from clearing and margining requirements;
- At least two CCPs should clear a given class of derivative before a mandatory obligation can be imposed; and
- Product suitability assessments for central clearing should be more granular and take into account risk characteristics.

(b)(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

The frontloading requirement should be removed for all future classes of derivatives deemed subject to the clearing obligation

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

Pricing issues, systemic risk and undermining phase-in periods

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

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

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

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

- Both the hybrid pricing approach and the price to clear approach are likely to result in less efficient pricing. This issue is likely to be compounded where a bilateral trade can be cleared at more than one CCP, since the pricing for clearing at each eligible CCP may differ. The parties to a frontloadable trade may therefore need to pre-agree the CCP where they intend to clear the trade, even though the counterparty does not have clearing arrangements in place with the CCP at the point of execution.

- While the hybrid pricing approach is typically employed by dealers when 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.

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

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

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

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

- Concurrently, the risk that some counterparties may have been unable to put clearing arrangements in place (at the agreed CCP) by the end of the frontloading period, in combination with pricing and valuation uncertainty, could force very large numbers of contracts to be terminated or assigned. This requirement would arise simultaneously at the clearing obligation application date for all trades remaining uncleared, causing major disruption and having a detrimental effect on the stability of financial markets. Parties who wish to rely on frontloading will need to have negotiated bilateral amendments to their ISDA agreements with all their trading counterparties, to incorporate the necessary termination rights. The legal and operational process surrounding a mass termination exercise would also be considerable, with dealers being requested to provide potentially thousands of independent valuations, and would be exacerbated by the feedback loop from pricing uncertainty which would introduce an element of contention into the calculation of close-out amounts.

- For the reasons summarised above, the frontloading obligation has presented the market with significant implementation challenges. To the extent it is expected that allowing a frontloading period will reduce disruption in the market upon the introduction of the clearing

mandate, we note that the market suffered little, if any, disruption in the US where mandatory clearing obligations were implemented without frontloading.

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

Documentation burden

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

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

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

Frontloading and non-recognised CCPs

Another major concern arises if firms clear OTC derivatives traded during the frontloading window at CCPs that have not yet been authorised or recognised by the time the clearing obligation enters into effect. If firms clear OTC derivatives traded during the FL window at CCPs that have not yet been authorised/recognised by the time the clearing obligation enters into effect, those firms will have to extinguish their positions and re-open them on EMIR authorised/recognised CCPs, which will cause significant market disruption (especially as some firms may not have clearing arrangements in place with other CCPs). In some cases it may not even be possible to extinguish the exact position and thus trades will be in regulatory breach. Firms will be required to flatten their positions by booking a new

exactly offsetting swap and compressing the position (by recognising offsetting cashflows). But if a firm had a range of positions with equivalent cashflows in a non recognised CCP, some subject to FL and some not, and booked a new offsetting swap intended to offset and then compress those cashflows subject to FL, there would be no way to ensure the CCP would use the offsetting swap to offset and compress the cashflows subject to rather than those predating FL. In which case post-FL cashflows could remain intact and in regulatory breach.

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

- European end user firms (Category 2 firms) will be required to set up costly alternative clearing arrangements with another EMIR authorised or recognised CCP prior to the start of the FL window, and be forced to maintain two separate pools of derivative exposures, thus splitting netting sets, and forcing such firms to post extra margin (an additional funding cost). The establishment of new clearing arrangements is not a straightforward process and can take up to three months, and may be further complicated if a swathe of participants are required to set up arrangements for the same class of derivatives at the same time.

- European firms will be unable to trade with US persons who choose to clear on US DCOs and have to comply with the EMIR clearing obligation, thus fragmenting markets. This will likely result in increased trading costs as a result of liquidity fragmentation and loss of market efficiencies.

- Firms intending to clear their trades at US DCOs, will price the trade according to the CCP in which it will be cleared. If firms are eventually forced to then clear the trade at another CCP at the end of the FL period, the trade will have been mispriced given the pricing differences which currently exist in relation to certain trades executed on different CCPs.

ESMA should be granted the ability to terminate or suspend the clearing obligation as a matter of urgency

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

Specifically, in such cases and in the absence of a termination or suspension of the clearing obligation, CCPs may find themselves clearing more risk in a contract or product than there would be market capacity to manage upon a member default, or the default of another CCP. A CCP may therefore have no option but to encourage participants to reduce these cleared positions by increasing margin requirements to levels at which it is uneconomic to hold the positions, and thus force the risk to be closed out. Participants would not then be able to replace the closed out cleared contracts with uncleared contracts, as the clearing obligation would still apply in respect of those contracts, leaving

hedgers exposed and potentially forcing them to contract their businesses. In contrast, if the clearing obligation were terminated, firms would be afforded the option to de-clear the product and maintain their positions on an uncleared basis.

We also believe that if a CCP 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 instruments to continue to be subject to mandatory clearing.

ESMA has recognised that the current RTS amendment procedure is ill-suited to this task (paragraph 67 of consultation paper no.1), and has itself stated that during the 2015 review of EMIR it "will flag that the clearing obligation process may need to be reviewed to take into account the fact that the classes that had been deemed subject to the clearing obligation in the past may no longer satisfy the necessary conditions in the future, and that the time of the procedure to amend the RTS is unsuited to the level of urgency that such a modification may require."

It is also worth noting the European Systemic Risk Board (ESRB), in its EMIR Review response[1], has similarly recommended that the EMIR provisions should include the possibility of, and the conditions to be fulfilled, for a swift removal or suspension of the clearing obligation for certain classes of derivatives if the relevant market situation so requires. According to the ESRB, from a macro-prudential standpoint, the mandatory use of CCPs for contracts that no longer have the characteristics qualifying for compulsory central clearing can lead to unintended consequences in terms of CCP exposures on potentially illiquid financial instruments and significant changes in margin requirements, possibly leading to procyclical implications.

A mechanism for the liquidation of contracts at a CCP that has lost its authorisation/recognition needs to be created

The proposed structure of the clearing obligation, for all the RTSs so far proposed by ESMA, currently gives no ability for firms to liquidate the risk that sits at a CCP that had been clearing mandatorily clearable contracts but then subsequently had its authorisation or recognition revoked and where the clearing obligation still remains because another CCP clears those contracts. In such cases, any requirement for firms to move outstanding contracts to another CCP may be impractical and in some cases may negatively impact financial stability.

In our view, it should be ensured that:

a) to the extent a clearing obligation is still in force, a firm may either liquidate its positions on the de-authorised or de-recognised CCP or, 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.

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

b) if a CCP is de-authorised and therefore ceases to provide clearing services, members should be provided with sufficient time, in order to mitigate the impact on the markets, to transfer and/or liquidate their positions and should not be required to do so immediately. In particular, 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 the Capital Requirements Regulation 575/2013, which provides for a period of time in which clearing members may continue to calculate their exposure with beneficial qualifying-CCP capital treatment even following revocation of CCP status.

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

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

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

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

(iii) introduce new pricing risks for market participants.

Typically, there are two types of compression mechanisms: the replacement swap method and the amended swap method. Under the former, a compression cycle will result in the termination of existing derivatives which will be replaced with new derivatives, with the effect of reducing notional exposure between counterparties. Under the amended swap method, the notional value between counterparties is reduced by amending the original derivatives. In both cases, if the new or amended derivatives were to become subject to the clearing obligation, market participants would be presented with significant pricing risks.

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

- Derivatives traded bilaterally will have been priced taking into account their associated underlying collateral agreements. Contracts traded bilaterally are typically priced as a

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

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

- Even if a common pricing approach could be developed and agreed by all participants, a possible outcome may be that compression cycles are run in future to only include either 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 and the margining of uncleared derivatives any replacement trades and amendments to trades (which could include notional increases or decreases) that result from portfolio compression and other post-trade risk reduction exercises. As a starting point, ESMA could define 'portfolio compression' as contained in Article 2(47) of MIFIR, which states:

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

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

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

- the transaction is designed to be overall market risk neutral for each participant;
- the participants of the transaction do not submit bids and offers to enter into a specific position;
- the transaction is cycle-based and multilateral (e.g. including at least two participants), and must be accepted in full by all participants or it will not be effected; and
- the transaction is designed to reduce secondary risks emerging from existing derivatives transactions, such as counterparty credit risk, operational risk and/or basis risk.

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

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

- According to Recital 27 of MIFIR, the obligation to conclude transactions in derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation on a regulated market, multilateral trading facility, organised trading facility or third country trading venue should not apply to the components of non-price forming post-trade risk reduction services which reduce non-market risks in derivatives portfolios including existing

OTC derivatives portfolios in accordance with EMIR without changing the market risk of the portfolios;

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

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

  The answer stated:

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

EMIR objective to reduce systemic risk

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.

Trades entered into by securitisation vehicles or other structured finance SPVs should not be subject to the clearing obligation or margin requirements for non-cleared derivatives

Securitisation and other structured finance SPVs should not be required to clear derivative transactions that they enter into, nor be subject to rules governing the margining of non-cleared derivatives. 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.

Trades resulting from group restructurings should be exempted from clearing and margining requirements

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 and rules governing the margining of non-cleared derivatives 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.

At least two CCPs should clear a given class of derivative before a mandatory obligation can be imposed

ESMA in its consultation paper on the clearing obligation for the G4 interest rate derivatives (in paragraph 145) stated it had no legal basis on which to refuse to launch a clearing obligation procedure solely on the grounds that a class of derivatives is cleared by a single CCP. 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**")). [See – A mechanism for the liquidation of contracts at a CCP that has lost its authorisation/recognition needs to be created]

- 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.

Therefore, we believe that EMIR be amended so that a clearing obligation may only be imposed if a minimum of two authorised/recognised CCPs clear a given class of product.

Product suitability assessments for central clearing should be more granular and take into account risk characteristics

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

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

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

QUESTION 2.3: TRADE REPORTING

(i) Are there any significant ongoing impediments or unintended consequences with respect to meeting trade reporting obligations in accordance with Article 9 of EMIR?

Yes. In particular:

- Dual-sided reporting (DSR) has fallen short of providing regulators with accurate data thus undermining the ability of regulators to effectively assess systemic risk. ISDA believes that the adoption of a single-sided reporting (SSR) regime will significantly reduce the operational complexity of the current framework, and the burden for less sophisticated derivatives to report, which will lead to a vast improvement in the availability of accurate data to regulators; and

- The requirement to backload dead trades is operationally complex, and of limited value, and should be removed.

(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Single-Sided Reporting – A blueprint for increased data quality to better enable the assessment of systemic risk

The primary objective[2] of the EMIR reporting requirement is to provide regulators with increased transparency in OTC derivatives markets in order to better enable the monitoring and assessment of risks that pose a threat to the stability of the financial system. However, recent experience has shown that the EMIR dual-sided reporting (DSR) requirement has fallen well short of providing regulators with an accurate set of data that allows effective monitoring of systemic risk, thus undermining a key part of the G20 objectives for the reform of OTC derivatives markets. As a result of the operational complexity of the current regime, the on-going complications with implementation and the burden placed on less sophisticated counterparties, significant trade data gaps exist today.

ISDA believes that these problems can in large part be addressed by the adoption of a single-sided reporting (SSR) regime, which we believe will significantly simplify the operational complexity associated with the current reporting requirements by removing the DSR requirement to match trades (both legal entity identifiers (LEIs) and unique trade identifiers (UTIs)), lower costs, and in most cases remove the reporting burden for less sophisticated derivatives users. We believe the simplification of operational complexities associated with DSR will lead to a vast improvement in the availability of quality data for regulators.

To this end, we have designed an initial blueprint, including suggested Level 1 changes, for a European SSR framework for consideration by the Commission (see Annex). The blueprint is the

[2] EMIR Recital 43: In order to allow for a comprehensive overview of the market and for assessing systemic risk, both CCP-cleared and non-CCP- cleared derivative contracts should be reported to trade repositories.

result of a collaborative industry effort comprising both sell- and buy-side trade associations and their members[3].

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

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

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

DSR has resulted in deficient data quality and is operationally burdensome for all market participants (including buy-side and end-users)

Under a DSR regime, trades need to be matched. This doubles the number of trade records, which amplifies the challenges on aggregation, consistency, and implementation and operational costs for the industry. The matching process across counterparties and repositories, especially when a large number of transactions are executed on the same day, is operationally intense and has proved challenging and open to interpretation. Overall current matching rates at trade repositories is around 60%, whereas current confirmation rates for most asset classes are at or above 90%. This means that while counterparties in most cases agree on the economic terms of the trade, it is the extra fields required in DSR, such as UTIs and LEIs that lead to inconsistencies and poor matching rates. This compounded by the fact that there are multiple trade repositories, participants report trades using different trade representations and reporting formats.

[3] Alternative Investment Management Association (AIMA), British Banking Association (BBA), FIA Europe, Global Financial Markets Association (GFMA), Investment Association (IA), Managed Funds Association (MFA).

Many buy-side firms lack the ability to self-report and rely on the dealer community to report on their behalf – a process known as delegated reporting. However, inconsistent dealer delegated reporting contracts and offerings make it difficult for buy-side firms to reconcile across multiple sources, creates a challenging operational environment and increases the data quality issues. Delegation under DSR may in some cases lead to entities informally delegating 'their obligation' and failing to check the accuracy of their trade data. Delegation under DSR results in the same trade being reported twice (flipped), therefore the end result is the same as SSR but with added operational complexity.

We believe that SSR would remove the dependency between counterparties to report the trade consistently to achieve match rates, and significantly reduce the operational burden for buy-side firms, which lack resources to reconcile across multiple sources. We believe data quality will improve if the focus shifted away from addressing DSR matching rates and towards improving economic and counterparty data under SSR, which we believe will yield a vast improvement in the availability of accurate data to regulators. An example of poor data quality can be evidenced from the Dec 2014 MIFID II consultation paper. There were many issues with data extracted from the trade repositories and used by the regulator to draw conclusions and make recommendations. This provides further evidence that the regulators are unable to rely on the existing data reported under DSR.

Switching to a SSR regime will be more cost effective for the industry

ISDA believes that switching to a SSR regime will, rather than being a significant cost to the industry, in the long run, be a much more cost effective reporting framework. We also believe that the initial switch over from a DSR framework should not result in undue costs being placed on market participants. For this reason we propose a simple SSR hierarchy, which would need to be implemented. For this reason ISDA does not propose making changes to reporting timeframes or to reportable data attributes beyond what is necessary to support SSR.

Under the current DSR framework, firms can either self-report or delegate reporting to another firm. While those firms (particularly buyside firms) that have chosen to delegate reporting to their dealer counterparts that are better placed to report on their behalf, discharge the burden of reporting the trade, supporting such a model is no light undertaking. Apart from having to maintain and reconcile across multiple delegated reporting agreements, firms also face significant on-going costs in fulfilling the obligation to check that trades have been correctly reported on their behalf to the trade repository, and reconciling such data if an inconsistency is found. We believe the additional burden placed on the buyside is unnecessary given there are other reconciliation processes under EMIR. The effort deployed here could be better spent ensuring those other reconciliation processes are achieved.

Under a SSR regime that is designed to ensure that the obligation to report trades lies with sophisticated parties (ie large derivatives dealers – see Blueprint in ANNEX I), the costs of supporting dual-sided delegated reporting will be significantly reduced and the associated costs with the operational overhang of ensuring both sides of the trade have been reported to a trade repository will cease to exist. A further cost that will be allayed is the on-going cost for those firms offering delegated reporting, which can be significant – this includes providing operational support, legal contractual costs, technology costs and trade repository costs.

Some ISDA buyside member firms who have chosen to self report, and have already invested in systems and building connectivity to trade repositories, believe that treating such existing builds as a 'sunk cost' and shutting down systems is an easier low cost solution than continuing to maintain systems, investing in new builds and upgrades for DSR, and support operational processes to ensure

they meet their obligation. Other buy-side firms with more complex portfolios believe that they will still need to maintain the ability to self-report a significant number of OTC bilateral trades between NFCs even under the proposed SSR regime. The main fabric of their existing reporting solutions should therefore be capable of being preserved. .

DSR should not be used as a dispute resolution tool

ISDA understands that alongside the objective of monitoring the build up of systemic risk, regulators also believe a DSR framework can serve as a form of dispute resolution. However, we believe that there already exist market mechanisms and specific EMIR requirements designed to improve data quality between counterparties and resolve disputes, and thus using DSR as a form of dispute resolution is in fact duplicative and may actually result in both sides of the trade not being reported. For example, under Article 11 of EMIR, there are specific requirements that already require market participants to have trade confirmations processes in place (Article 11(1)), conduct portfolio reconciliations on a regular basis (Article 11(1)), adhere to a dispute resolution procedures should a disputes arise (Article 11(1)), and conduct daily valuations of portfolios (Article 11(2)).

A SSR for EMIR would establish a reporting model that can be exported across to reporting regimes in other regulations

Reporting regimes for financial instruments across different sets of regulations should be aligned. There is already movement in other regulations to explore the efficacy of SSR. For example, in the Securities Financing Transactions Regulation (SFTR), ESMA is required to present an annual report to the European Parliament, the Council and the Commission on the efficiency of reporting, taking into account the appropriateness of single-sided reporting, in particular in terms of reporting coverage and quality as well as reduction of reports to trade repositories, and on significant developments in market practices with a focus on transactions having an equivalent objective or effect to a securities financing transaction. Therefore the adoption of a SSR regime in EMIR can serve as the basis for a model than can be exported to other regulations, such as the SFTR.

Requirement to backload dead trades should be removed

According to Article 9(1) of EMIR, the reporting obligation extends to all trades that were both outstanding on or entered into after August 16, 2012. This means all trades that were outstanding, but that had expired before the reporting start date (RSD) of February 12, 2014, will have to be reported to a trade repository. According to implementing regulation EU 1247/2012, those derivative contracts which were both outstanding on or entered into after 16 August 2012, that are not outstanding on or after the reporting start date shall be reported to a trade repository within 3 years of the RSD for a particular derivative class.

The backloading of historical dead trades, which expired before February 2014 remains a task that many firms have not completed yet. Because backloading is performed using the same data fields/format as is used for the reporting of new trades, trade repositories apply similar validation rules for both backloaded as for new reports. As a result, ISDA believes that such a requirement requires significant effort for firms to retrieve and source such data, the value of which will be of little use as many trades will be unmatched as they will be reported without UTIs, which were not used at the time of trade execution. Moreover, trades must also be identified using valid legal entity identifiers, however, many reports will be single-sided, as the counterparty to the trade may no longer exist (for example a fund that has closed down). Furthermore, the reporting and storage of the

backloadable data is costly, but the use of this data and the added value it brings to the monitoring of systemic risk is questionable and disproportionate compared to the cost. ESMA data validation exercises add to the challenge to report this data population correctly. Thus, ISDA believes that such a requirement should be removed from EMIR If contemplated changes to the EMIR level 1 text are only expected to enter into force beyond February 2017, we believe Implementing Technical Standard 1247/2012 should be revised to extend the deadline for the backloading of those trades to allow for sufficient time for the level 1 text to be amended.

QUESTION 2.4: RISK MITIGATION TECHNIQUES

(i) Are there any significant ongoing impediments or unintended consequences with respect to meeting risk mitigation obligations in accordance with Articles 11(1) and (2) of EMIR?

Yes. In particular:

- Trade confirmation deadlines are too strict for trades with NFCs and trades not confirmed electronically.

(ii) If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

Timely Confirmations

ISDA is concerned that although the Commission has confirmed via FAQs that the rules are not hard deadlines to be complied with on a case-by-case basis, hard deadlines remain in the RTS, and it is not clear how firms can confidently deem themselves compliant. We believe the rules should be amended such that trades facing NFCs have a deadline to despatch confirmations (rather than to reach formal agreement), allowing firms to have policies and procedures in place designed to achieve two-way agreement by T+2.

What is more, certain structured trades (and indeed some asset classes) are not supported by electronic platforms and must be confirmed on paper. This process takes significantly longer than electronic confirms. In many cases such structured or customised trades need careful review, which in some cases results in revisions being made. Thus, sufficient time to promote the accuracy and agreement of such trades should be given, and therefore, the deadlines should be amended to take into account trades that need to be confirmed on paper.

QUESTION 2.5: EXCHANGE OF COLLATERAL

(i) Are there any significant ongoing impediments or unintended consequences anticipated with respect to meeting obligations to exchange collateral in accordance with Article 11(3) under EMIR?

Yes.

(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Application of margin rules to third-country entity NFC minuses - technical amendment to Article 11

While we welcome the interpretation taken by the European Supervisory Agencies (ESAs) in the second consultation paper on the margining of non-cleared derivatives with regards to the treatment of third country entity (TCE) non-financial counterparty minuses (NFC-s), by leaving the decision of whether or not collateral should be exchanged to the risk management assessment of the firm in scope of the EU obligation, we believe that for the avoidance of doubt, it would be beneficial if a technical amendment to the Level 1 text could be made so as to ensure that the treatment of TCEs is harmonised with the treatment of TCEs for the purposes of the clearing obligation.

Thus, we recommend that the Level 1 text be amended to ensure that the obligation would only apply to "an entity established in a third country that would be subject to the obligation if it were established in the Union".

Application of margin rules to non-netting jurisdictions – technical amendment to Article 11

Under the second consultation paper on the margining of non-cleared derivatives, the ESAs require that when an EU counterparty trades with a third country entity (that would be subject to the requirements of the RTS if established in the EU) initial and variation margin should be exchanged in both directions. On top of that, the EU counterparty also has the obligation to assess, at least on an annual basis, the legal enforceability of such bilateral netting arrangements and the effectiveness of segregation agreements. But when those assessments highlight non-compliance with the RTS, EU counterparties are required to identify alternative processes to post collateral, such as relying on third-party banks or custodians domiciled in jurisdictions where those requirements can be guaranteed.

However, a party in a Non-Netting Jurisdiction (a "**Non-Netting Party**") may be subject to local insolvency proceedings and such proceedings may affect the treatment of margin posted by or held (directly or indirectly) by the Non-Netting Party. Use of a third-party custodian in a different jurisdiction may not remedy issues with the legal enforceability of collateral.

Imposing the margin requirements on OTC derivatives with Non-Netting Parties will severely limit such OTC derivatives. Such a limitation will cause significant disruptions in financial markets and prevent hedging and financial flows between the EU and Non-Netting Jurisdictions. Moreover, requiring collateral posting may prevent parties from using more effective alternative

mitigations such as using limits to contain exposures, re-pricing trades, selling options and using short dated trades.

In addition, while these OTC derivatives are important for individual Non-Netting Parties and Non-Netting Jurisdictions, the overall volume of such OTC derivatives is relatively small compared to the total volume of OTC derivatives entered into by EU counterparties.

Implementation challenges of rules governing margining of non-cleared derivatives

While we appreciate that the current draft RTS on non-cleared margin rules are out of scope for the purposes of this consultation, we wanted to highlight to the Commission the numerous implementation challenges that firms will face as they prepare to come into compliance with the rules (http://www2.isda.org/attachment/Nzc1OQ==/ISDA%20Response%20to%202nd%20Consult%20Paper.pdf).:

We also believe that it is crucial that in the regulatory approval stages of the Standard Initial Margin Model (SIMM) – a common initial margin (IM) methodology that can be used by market participants globally – the levels of margin need to be taken into consideration and carefully managed so as to prevent a situation in which levels of margin are set a level where liquidity becomes unmanageable.

QUESTION 2.6: CROSS-BORDER ACTIVITY IN THE OTC DERIVATIVES MARKETS

(a)(i) With respect to activities involving counterparties established in third country jurisdictions; are there any provisions or definitions within EMIR that pose challenges for EU entities when transacting on a cross-border basis?

Yes. We believe that the following points should be addressed:

- Article 13 Equivalence assessments;
- Article 25 Equivalence assessments;
- Categorisation of non-EU counterparties;
- Indirect clearing arrangements with non-EU counterparties;
- Treatment of non-EU exchange-traded derivatives; and
- Transactions between two third country entities.

(a)(ii) If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

Article 13 Equivalence – Mechanism to avoid duplicative or conflicting rules

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

Therefore, ISDA believes that it is essential the Commission work closely with other regulators in third countries to develop plans for equivalence and further clarify the practical application mechanics of equivalence. Given EU firms and some of their EU or non-EU counterparties are active in most major markets across Africa, the Asia-Pacific region, the Middle East, Latin America, Switzerland and the US, we are particularly concerned that the absence of such equivalence decisions could have significant negative impacts on the provision of financial services in, and effective functioning of, those markets to local players, EU firms, their EU and non-EU counterparties, and also to European clients looking to access overseas markets.

Practical application of Article 13 equivalence

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

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

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

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

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

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

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

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

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

Article 25 Equivalence – Recognition of third country CCPs

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

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

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

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

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

- From a clearing perspective:

  o For clearing of derivatives subject to the EMIR Clearing Obligation, EU counterparties may be unable to clear OTC derivatives contracts through non-EU CCPs that have not been recognised under EMIR by the time the Clearing Obligation comes into effect in mid-2016, even if clearing via a local clearing member (see frontloading concerns under Question 2.2).

  o For clearing of derivatives cleared on a voluntary basis (not subject to the clearing obligation), Article 25 EMIR only allows non-EU CCPs (which have failed to apply for recognition with ESMA by 15 September 2013) to provide clearing services to EU clearing members if the non-EU CCP applies for and receives recognition under EMIR (although the non-EU CCP can provide clearing services, in this instance, via a local unaffiliated clearing member or local subsidiary).

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

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

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

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

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

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

Categorisation of non-EU counterparties

There are a number of difficulties in categorising non-EU counterparties, including:

- Non-EU FCs: in order to assess whether or not a non-EU incorporated entity would have been an FC if it had been established in the EU, it is necessary to assess whether its activities are the type of activities covered by the relevant legislation and to determine whether or not any exemption would have been available. FCs and NFCs are unlikely to have access to sufficient information about unrelated non-EU counterparties in order to make this assessment themselves, and the non-EU counterparty is also unlikely to know whether or not it would have been required to seek authorisation if it had been established in the EU.

  We would propose introducing a definition of "third country financial counterparty" modelled on the definition of "third country financial institution" in Article 2(1)(41) MiFIR which reads as follows:
  'third-country financial institution' means an entity, the head office of which is established in a third country, that is authorised or licensed under the law of that third country to carry out any of the services or activities listed in Directive 2013/36/EU, Directive 2014/65/EU; Directive 2009/138/EC of the European Parliament and of the Council (21), Directive 2009/65/EC of the European Parliament and of the Council (22), Directive 2003/41/EC of the European Parliament and of the Council (23) or Directive 2011/61/EU of the European Parliament and of the Council (24);

  This would need to be expanded to cover regulated third country pension schemes and funds. There would need to be corresponding definitions of "third country non-financial counterparty" and "third country counterparty" (and appropriate transitional provisions).

  There would also need to be consideration to an appropriate definition of "established" (for example, a definition similar to that used in the proposed Securities Financing Transactions Regulation could be used).

- Non-EU NFCs: Non-EU counterparties often do not have systems in place for monitoring group-wide OTC derivatives positions (or if they do, these systems comply with local law requirements rather than tracking positions of "OTC derivatives" across the "group" as defined under EMIR). As a result, it is difficult for FCs and NFCs to determine whether a non-EU counterparty which would have been an NFC if established in the EU should be treated as an NFC+ or an NFC-. We would propose introducing a definition of "third country non-financial counterparty" that does not require non-EU counterparties to assess their group positions against the clearing threshold.

  In addition, as mentioned above in our response to question 2.6(a)(ii) in relation to Article 13 equivalence determinations, it will be important for the Article 13 equivalence relief to be available where a counterparty is subject to equivalent obligations in a non-EU jurisdiction (not just where that counterparty is established in that jurisdiction).

- Non-EU AIFs: Under EMIR, AIFs which are managed by authorised AIFMs are FCs. When the AIFMD passport is extended to non-EU AIFMs, it will become possible for non-EU AIFMs to become authorised under the AIFMD. At this point, every AIF it manages will become an FC. It may be difficult for a non-EU AIF, managed by a non-EU AIFM, to comply

with EU rules as well any applicable home state rules (which may be conflicting or duplicative). The treatment of non-EU AIFMs may be something that can be dealt with under Article 13 of EMIR.

- Application of the exemptions to non-EU counterparties: we would welcome extension of the exemptions from clearing and margining to cover equivalent non-EU counterparties (e.g., non-EU pension schemes).

Indirect clearing arrangements with non-EU clearing members, clients or indirect clients

As discussed in our response to Question 2.2, there are a number of significant concerns regarding the application of the indirect clearing requirements in relation to transactions involving non-EU parties. Please see our response to Question 2.2.

Non-EU exchange-traded derivatives

Currently the definition of "OTC derivative" captures derivatives traded on third country exchanges. This raises a number of concerns, including:

- NFCs must include third country ETDs when calculating whether they exceed the clearing threshold;
- It is unclear when ESMA and the Commission will complete the equivalence determinations in relation to relevant non-EU trading venues that would mean that these instruments are no longer considered to be "OTC derivatives".

Transactions between two third country entities

We would propose simplifying the rules covering transactions between two third country entities. It is not clear which entity would be required to comply with the obligations under EMIR: as currently drafted, the obligations apply directly to the non-EU counterparties. However, there are significant difficulties in applying these obligations to non-EU entities, not least identifying which EU competent authority should be responsible for enforcement.

There are other ways of addressing any risks posed by these transactions. For example, any risk posed to EU markets by transactions where one counterparty benefits from a guarantee provided by an EU FC are already addressed through capital requirements and can also be addressed through resolution planning obligations.

In addition, it is unclear how the exemptions under EMIR would apply to these transactions. For example, the availability and application of the intragroup exemption to these transactions should be clarified.

(b)(i) Are there any provisions within EMIR that create a disadvantage for EU counterparties over non-EU entities?

See answer to (a)(i) & (ii).

(b)(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

See answer to (a)(i) & (ii).

QUESTION 2.7: TRANSPARENCY

(i) Have any significant ongoing impediments arisen to ensuring that national competent authorities, international regulators and the public have the envisaged access to data reported to trade repositories?

(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

QUESTION 2.8: REQUIREMENTS FOR CCPs

(a)(i) Are there any significant ongoing impediments or unintended consequences with respect to CCPs' ability to meet requirements in accordance with Titles IV and V of EMIR?

(a)(ii) If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

(b)(i) Are the requirements of Titles IV and V sufficiently robust to ensure appropriate levels of risk management and client asset protection with respect to EU CCPs and their participants?

(b)(ii) If your answer to i. is no, for what reasons? How could they be improved?

(c)(i) Are there any requirements for CCPs which would benefit from further precision in order to achieve a more consistent application by authorities across the Union?

Yes.

(c)(ii) If your answer to i. is yes, which requirements and how could they be better defined?

A. CCP Risk Committees

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

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

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

- The role of an RC representative should be that of an expert that provides an independent opinion on a CCP's risk management strategy (including any proposed changes) and its impact on CCP stability, market integrity, as well as impact on users. RC representatives should be encouraged to provide their own views as experts, and these views may differ from membership views expressed by others at their respective employing entity.

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

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

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

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

- A CCPs default fund framework should be approved by the RC.

We also believe that EMIR Article 27(2), which requires clients of clearing members to be invited to CCP board meetings for matters related to transparency and segregation (Articles 38 and 39 of EMIR) should be extended to representatives of clearing members.

B. CCP Capital Requirements

Regulations governing capital requirements at CCPs should be revisited to appropriately capture risks assumed by CCPs. At present, it captures capital on credit and market risks net of available financial resources available leading to low capitalisation levels. The current minimum capital requirement of €7.5 million for authorised CCPs is, in absolute terms, low. CCP capital requirements should be commensurate with the risk profile of a CCP driven by factors like riskiness of products cleared, member concentration risk, credit profile of members etc. While it might be difficult to establish an absolute level of minimum capital required for all CCPs to be authorised, other financial metrics, for example, a customised leverage ratio for CCPs, should be considered instead of absolute capital levels to ensure CCPs have minimum sufficient capital.

C. CCP Default Funds

a. Stress testing total financial resources to ensure "Cover 2" [EMIR Articles 42 & 43, and Article 53 of 153/2013]

EMIR requires a CCP's margins and default fund (DF) be sized to cover at least the default of the largest member to which it has the largest exposures or of the default of the second and third largest members. Total financial resources are required to cover defaults of at least two largest clearing members. We suggest that CCPs should determine Cover N based on the distribution of risk (concentrated vs. uniform distribution) exposures across members. CCPs should publicly disclose the risk distribution based on uncovered stress losses and initial margin to justify the coverage being adopted. As a minimum, we believe a Cover 2 requirement should be adopted.

In addition, CCPs should also account for idiosyncratic economic scenarios which may lead to multiple clearing member defaults and this should be factored in sizing of the DF. Member coverage should also be driven by correlation between members and the ability of members to withstand calls for additional resources should also be taken into account[4].

b. Minimum size of default fund should always be funded [EMIR Article 42(1)]; Requirement to replenish CCP resources at the monthly interval at a minimum [Article 36(3) of 153/2013]

CCPs, as required by Article 36(3), are required to reinstate dedicated own resources at least within one month if such resources fall below the amount in Article 35 of 153/2013. However, EMIR Article 42(1) requires that a CCP shall maintain a pre-funded default fund in order to limit its credit exposures to its clearing members. This gives CCPs the ability to call on members to replenish the default fund following the resolution of a clearing member default. In the event of multiple defaults within a short time period, clearing members are liable to replenish the default fund at intervals much shorter than a CCP is required to replenish its own resources in the default waterfall – an asymmetry we believe should be removed. We believe there should be consistency in the time interval at which replenishment is to be made by CCPs and members- in normal and default scenarios. We believe CMs should also only be required to replenish their contribution to the default fund within one month if such resources have been depleted, and that CCPs should be required to replenish each time CMs are asked to replenish the default fund. This ensures (i) consistency across CCPs (ii) uniform approach across jurisdictions for replenishment horizon, and (iii) ensures that member liability is capped.

c. Identifying extreme but plausible market conditions [Article 30(2) of 153/2013]

According to Article 30(2) of 153/2013, when determining the framework for the determination of the size of the default fund, a CCP is required to specify a range of historical scenarios, including periods of extreme market movements observed over the past 30 years or as long as reliable data has been available. We believe that if "as long as reliable data have been available" is insufficient or if it is less than 30 years of data, we recommend that CCPs should be required to extrapolate to 30 years based on similar products and generate hypothetical scenarios[5]. A CCP should also scale historical prices to reflect current market prices and volatility. Moreover, in determining which stress loss to apply in sizing the DF, the most conservative approach that a CCP may take is to look to the maximum historical loss rather than the loss at any specific confidence interval.

d. Material changes to stress scenarios [Article 31 of 153/2013]

Article 31 of 153/2013 requires that the set of hypothetical and historical scenarios used by a CCP to identify extreme but plausible market conditions shall be reviewed by the CCP, in consultation with the risk committee, at least annually. Any material changes to the framework need to be reported to the board. We believe that the CCP, in addition to consulting the risk committee, should also consult clearing members before making any material changes to the framework.

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[4] http://www2.isda.org/attachment/NzcxNQ==/ISDA-Letter_to_CPMI-IOSCO_on_CCP_Stress_Testing_Transparency_Governance_and_Best_Practices-FINAL.pdf

[5] Ibid

D. Clearing Member exposure should be limited to CCPs [EMIR Article 43(3)]

As aforementioned in paragraph C(b), the minimum funded default fund requirement as per Article 42(1) means members are exposed to sizeable liabilities in the event of multiple clearing member defaults in a short time period. For example, some CCPs require default fund replenishment up to a floor during cooling off period, where such replenished default fund is available to be used to cure future defaults that may occur during the cooling off period. Since this requirement to replenish is repetitive, members are liable for extremely large liabilities in prolonged stress events. As such, even though theoretically members can estimate the liability, they won't be able to manage liability in stress event. We believe that such liability should be limited. If CM liability is extremely large, albeit quantifiable, it does not limit members' risk towards CCPs and in practice, effectively is equivalent to being uncapped for members. Aligning the time horizon of a member replenishment requirement with the CCP replenishment requirement to reinstate dedicated own resources at least within one month should address this concern. For an interim period, a pre-defined or limited assessment irrespective of the number of member defaults can be used to ensure availability of resources.

However, we also believe that no replenishment of default fund should be required from members to fund the minimum default fund while the default management process is ongoing. In other words, the requirement to have a minimum funded default fund should be suspended while default management process is ongoing. Furthermore, default fund liability should not be capped by withdrawal only. The default fund liability should be limited for all clearing members - continuing as well as exiting members – so that stress events do not encourage members to exit, which would result in heightened market stress.

E. CCP Liquidity requirements [EMIR Article 44(1)]

According to EMIR Article 44(1), a clearing member, parent undertaking or subsidiary of that clearing member shall not provide more than 25% of the credit lines needed by the CCP. We believe that a threshold up to which a CCP can rely on credit lines from all members when considered in aggregate (as a proportion to total liquid resources) should also be imposed.

Where a CCP relies on resources of one clearing service to meet liquidity requirement of another clearing service, the CCP should be required to formally incorporate such arrangement in its rules. This would enable members to evaluate risks arising from membership of the CCP. Further, such CCP should be made fully responsible for replacing collateral which has been used to meet liquidity shortfall at another clearing service. CCPs should have responsibility of returning cash collateral to members and should be made liable for any market risk involved in transformation of non-cash collateral back into cash collateral. We re-iterate that access to central bank liquidity would be the safest way for CCPs to ensure liquidity, albeit CCPs should have the possibility to use different arrangements as long as they are in line with the requirements for CCP investment policy and appropriate collateralisation (Article 43 and 45(2) of 153/2013).

F. CCP Skin in the Game [EMIR Article 45(4); Article 35(2) of 153/2013]

According to Article 35(2) of 153/2013, a CCP shall calculate the minimum amount it shall keep of dedicated own resources in the default waterfall, by multiplying the minimum capital, including retained earnings and reserves, held in accordance with EMIR Article 16 and Commission Delegated Regulation 152/2013 by 25%. However, we believe such sizing of CCP own resources to be used in

the default waterfall – skin in the game (SITG) – is not adequate given that current regulatory capital is not designed to cover credit and market risk from cleared portfolios given the capital calculation nets all financial resources from cleared exposures.

We recommend that CCP skin in the game is risk-based and scales with the level of activity. We believe further work is needed in determining appropriate CCP SITG, and urge the Commission to explore alternative measures such as a percentage of DF, percentage of stressed losses or CCP profits etc. Various industry participants – including a number of ISDA members - have expressed their views on the topic and we remain at the disposal of the Commission to provide input into developing alternative measures.

Meanwhile, EMIR Article 45(4) provides that non-defaulting clearing members' margin should not be used to cover losses arising from another clearing member's default. We believe that member initial margin should not be used in CCP Recovery & Resolution phase situations either.

G. Investment Policy [EMIR Article 47(5)]:

We believe that CCPs should have sufficient capital and/or insurance to cover all non-default losses, and that clearing members should not have any responsibility for these losses as only the CCP is able to quantify and manage these risks. Thus we recommend that:

- A CCP's investment policy should be made publicly available.
- CCPs should be able to invest at a central bank to minimise credit risk faced when investing at commercial banks.
- Transfer of non-cash collateral should only be by way of pledge and not title transfer
- Rehypothecation or re-use of non-cash collateral posted by defaulting clearing members to CCPs should not be permitted other than to access central bank liquidity in the limited circumstances of clearing member default.
- CCPs should be required to provide reasoned legal opinions to the effect that margin and guarantee fund contributions would not be included in their insolvent estates.

Furthermore, Article 45(2) of 153/2013 requires that when cash is maintained overnight in highly secured arrangements that at least 95% of cash held is deposited through arrangements that ensure the collateralisation of the cash with highly liquid financial instruments. However, we believe that if 95% of cash necessarily has to be deposited through arrangements that ensure collateralisation, investment losses are possible. We believe that, as per Question 1.1, CCPs should be permitted to hold cash at the central banks to significantly reduce credit and operational risk arising from exposure to commercial banks.

H. Independent validation of models [EMIR Article 49]

i. Frequency of independent validation

According to Article 47(1) of 153/2013, a CCP before effecting any changes to its margin model must first seek an independent validation. We believe that independent validation of margin models should be undertaken on a regular basis (e.g. annual) and not just before a change to the model is being

contemplated. Further, independent validation should be performed by an external party and cannot include an internal party with independent reporting

ii. Backtesting [Article 49 of 153/2013]

According to Article 49 of 153/2013, a CCP shall assess its margin coverage by performing an ex-post comparison of observed outcomes with expected outcomes derived from the use of margin models. However, we also believe that such backtesting should also involve static portfolio back testing. This implies evaluating margin requirements on today's portfolio would be sufficient to cover all economic conditions that existed over the previous year. The range of historical time horizons to be considered by a CCP should include, at minimum, the most recent year or as long as a CCP has been clearing the relevant financial instrument if that is less than a year.

iii. Risk factors to stress test [Article 52 of 153/2013]

According to Article 52 of 153/2013, a CCP is required to develop an adequate method for measuring relevant risk factors specific to the contracts it clears that could affect its losses. We recommend CCPs should take into account additional risk factors for stress testing including:

- "Stress period of risk" should be longer than "margin period of risk"
  Rationale: Unwinding portfolios in stress conditions should be assumed to take longer than that assumed for a default of a member under normal market conditions

- Liquidity risks arising from closing out positions in "extreme but plausible" market conditions
  Rationale: Stress scenarios are derived from "mid-to-mid" but positions will have to be closed out on a "mid-to-bid" basis.

- Collateral valuation
  Rationale: stress scenarios should be consistently applied across collateral and positions.

I. Highly secure arrangements for the deposit of assets received as collateral and default fund contribution [EMIR Article 47(3) and Article 44 of 153/2013]

CCPs should have the option to either deposit assets received as collateral and DF contributions within a direct account at a securities settlement system (SSS), or use a highly secured arrangement, such as depositing the said assets at an SSS via a securities account operated in the name of the CCP.

First, there is no difference from the point of view of asset protection whether the assets are deposited directly by the CCP in a direct access account or in a segregated account operated at the SSS for the CCP by a custodian bank. In both cases, the assets deposited by the CCP are clearly segregated, protected from any third party claims, and benefit from the protections under the Settlement Finality Directive, primarily the irrevocability of transfers.

Second, the duty for a CCP to use exclusively a direct account at an SSS actually results in additional risks and adds complexities to the process of transfer and management of collateral:

a) posting collateral to the CCP still requires the involvement of a transfer agent and a transfer account at the level of that particular SSS that the CCP has selected. This impedes the

immediacy of transfer and the efficiency of substitution, and results in higher transaction risks and operational costs for derivatives users; and

b) similar to problems faced by users to post collateral, CCPs cannot renounce to the use of global custodians: no single (European or other) SSS can ensure universal access of a CCP to collateral deposited worldwide. In practical result, CCP have to use global custodians to manage collateral transfers between multiple CCP direct accounts at various locations. This practical consequence effectively defies the presumed objective that CCP should manage to rely only on own direct custody account. At the same time, the lack of harmonisation in the settlement practices between various SSS makes the use of global custodians essential in order to ensure collateral liquidity.

QUESTION 2.9: REQUIREMENTS FOR TRADE REPOSITORIES

(i) Are there any significant ongoing impediments or unintended consequences with respect to requirements for trade repositories that have arisen during implementation of Titles VI and VII of EMIR, including Annex II?

(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

QUESTION 2.10: ADDITIONAL STAKEHOLDER FEEDBACK

(i) Are there any significant ongoing impediments or unintended consequences with respect to any requirements or provisions under EMIR and not referenced in the preceding questions that have arisen during implementation?

(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

ANNEX I - SSR FRAMEWORK BLUEPRINT

The driving principles behind the development of the SSR blueprint below are to (i) significantly improve the quality of data available to regulators for the purposes of monitoring systemic risk, (ii) reduce the operational complexity of the current DSR framework, (iii) lower costs/redeploy effort for all market participants, and (iv) remove the reporting obligation for less sophisticated derivatives users, such as buyside firms and NFCs.

In order to achieve the above objectives, we believe that a SSR framework should be designed as follows (see also attached Entity Decision Logic & Asset Tiebreaker Logic):

I. Scope of the reporting obligation

i. The reporting obligation should not apply to Non-financial counterparties (NFCs) that do not meet the conditions referred to in EMIR Article 10(1)(b) – ie NFC minuses.

ii. The reporting obligation should not apply to intragroup transactions for all non-financial counterparties, including those NFCs that do meet the conditions referred to in EMIR Article 10(1)(b). Large companies with numerous operating affiliates generally employ a model whereby the hedging transactions of affiliates are executed with a centralized treasury unit (CTU) which will then aggregate exposures (and net where appropriate). The CTU will then enter into a smaller number of street facing transactions. The CTU is a proven model that actually reduces systemic risk and complexity. The requirement to report such transactions do not represent any real external risk and add no value to reporting. In order for a SSR to work, intragroup trades (at least for non-financial counterparties) should be excluded from the reporting obligation. If an NFC is not required to report its external facing trades but is required to report internal trades, this would negate the intent of a SSR framework for many multinational companies.

iii. Exchange traded derivatives – derivatives which are not defined as OTC derivative as per EMIR Article 2(7) – should be exempted from the reporting obligation or should be subject to single-sided reporting, which should be done on a position rather than trade-by-trade basis [insert cross reference to FIA Europe's response];

II. Determining the reporting counterparty:

a. Cleared trades: we believe that CCPs should report cleared trades and have all the necessary trade information to report on-going valuation and collateral data. Therefore, we believe that:

- A CCP should report trades between itself and a CM
- CMs would be responsible for reporting trades between itself and its clients for which it is providing access to clearing.
- If an EU CM faces a third-country CCP (on which the obligation does not fall and does have the capability to report) the CM will either have to delegate the obligation to a third party or report the trade itself. Similarly, if an EU client clears via a third-country CM (on which the obligation to report does not fall and does not have the capability to report) the obligation to report will fall on the client, which will have to either delegate the obligation or report the trade itself.

b. Non-cleared trades: For all other non-cleared trades, the determination of which counterparty should report the trade should adhere to the following logic (see in conjunction with Entity Decision Logic):

Step One: A determination must be made if one of the counterparties to the trade is a third country entity. If the answer is yes, the reporting obligation will fall on the EU counterparty;

Step Two: If both counterparties are EU entities, a determination needs to be made as to whether there exists an agreement between both counterparties as to who will report the trade. If both counterparties had previously contractually agreed one party would be the reporting counterparty, that counterparty would then assume the obligation to report the trade;

Step Three: If no agreement exists between the two counterparties, a defined hierarchy (which is designed to impose the reporting obligation on the more sophisticated counterparty – ie the higher-level counterparty) should be used to determine the reporting counterparty. The higher-level counterparty would then report the trade [See Entity Decision logic below];

Step Four: If both counterparties belong to the same level in the hierarchy, then a tie-breaker logic convention should be used to determine the reporting counterparty. Such a convention (which differs depending on the asset class of the swap) has already been designed by ISDA (see attached) for use in other jurisdictions that employ a SSR framework (we request that ESMA endorse the tiebreaker logic to ensure consistency across the industry).

Any reporting party should continue to be able to delegate reporting of its trades.

LEVEL 1 TEXT CHANGES

In order to aid the Commission in designing a workable SSR framework, we have outlined below suggested Level 1 text changes to incorporate the above logic and suggested entity decision logic for determining reporting counterparties, which should be included in associated regulatory technical standards.

Amendment to EMIR Article 9(1) – replace existing text with:

1. Financial counterparties, non-financial counterparties (that meet the conditions referred to in EMIR Article 10(1)(b) – ie NFC+s) and CCPs shall ensure that the details of any derivative contract they have concluded and of any modification or termination of the contract are reported to a trade repository registered in accordance with Article 55 or recognised in accordance with Article 77. The details shall be reported no later than the working day following the conclusion, modification or termination of the contract.

There shall only be one reporting party in relation to a derivative contract. The reporting counterparty shall be:

a) If a CCP authorised in accordance with Article 14 is a counterparty, that CCP;
b) If only one counterparty is an FC or NFC, the FC or NFC;
c) If one counterparty is an FC, that FC;

d) <u>If both counterparties are FCs, or if both counterparties are NFCs, the reporting counterparty shall be specified in technical standards</u>

The reporting obligation shall apply to derivative contracts which:

2. were entered into after 16 August 2012 and remain outstanding on the **reporting start date** detailed in the regulatory technical standards;
3. are entered into on or after the **reporting start date**[6].

<u>A **reporting party**</u> may delegate the reporting of the details of the derivative contract.

<u>The **reporting party** shall ensure that the details of the derivative contracts they report</u> are reported without duplication.

<u>Amendment to EMIR Article 9 – add new Article 9(7):</u>

7. In order to ensure consistent application of this Article, ESMA shall develop draft regulatory technical standards specifying the counterparty which will be the **reporting party**.

ESMA shall submit those draft regulatory technical standards to the Commission by [*].

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No. 1095/2010.

ENTITY DECISION LOGIC

ISDA has considered three potential approaches to devising a reporting party logic for inclusion in an associated regulatory technical standard. The guiding principle behind the entity decision logic is to place the reporting obligation on the more sophisticated counterparty to the trade. We would welcome the opportunity to work with the Commission and ESMA to agree on consensual approach. The three approaches are detailed as follows:

1. EMIR Definitional Taxonomy;
2. EMIR Definitional Taxonomy + ESMA Clearing Categorisation;
3. EMIR Definitional Taxonomy + WGMR Non-cleared margin thresholds; and

For simplicity and ease of use we would encourage the Commission and ESMA to opt for Option 1.

Option 1: EMIR Definitional Taxonomy (see attached Entity Decision Logic Diagram)

The principle behind this approach is to ensure the reporting obligation falls on more sophisticated counterparties.

Where one party is an EMIR-defined financial counterparty (FC), and the other is an EMIR-defined non-financial counterparty (NFC+) then the FC shall be determined the reporting party. Where both parties are FCs, then the following determination logic applies:

[6] The effective date of EMIR Review changes – ie entry into force of amendments to the Level 1 text. Previously reported transactions should remain reported as they are.

- Where one party is classified as either as an "Investment firm" (IF) or a "Credit Institution" (CI), and the other is not, then the classified firm will be the reporting party.
- If both firms are classified as a CI or IF, where one firm is a clearing member (as maintained in a register of CMs maintained by ESMA as of the entry into force of the G4 Rates Clearing Obligation RTS).
- If both firms are classified as CMs, then the ISDA tiebreaker logic applies (see attached Asset Class Tiebreaker Logic)

Where both parties are NFC+s, then ISDA tiebreaker logic applies.

In most cases, under this approach, the reporting obligation will not fall on end users including corporates, investment and pension funds, UCITs and AIFs, but instead will be borne by the broker/dealer (if such entity is an EU entity). Note that in scenarios where an end-user also qualifies as a CI or IF, for example where the trade is executed on behalf of a CI/IF by an entity providing a portfolio management service to the CI/IF, the obligation should fall on the dealer.

Option 2: EMIR Definitional Taxonomy + ESMA Clearing Categorisation

The determination logic explained in Option 1 can be extended to include all four clearing category thresholds[7]. However, we believe that such an approach while more nuanced than Option 1, adds unnecessary complexity and may be difficult for firms (including buyside) to maintain in their systems.

Option 3: EMIR Definitional Taxonomy + WGMR Non-cleared margin thresholds

Another option is to extend the determination logic in option with the notional thresholds contained in the European Supervisory Agencies (ESAs) proposed rules governing the margining of non-cleared derivatives[8]. However, we believe that this will approach will be computationally burdensome and also adds unnecessary complexity and will be prohibitive for firms (particularly those in the lower aggregate notional bands, who would have to establish whether their counterparties are above them, the same level or below them).

[7] Category 1, comprising counterparties 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 set out in Annex I, of at least one of the CCPs authorised or recognised before that date to clear at least one of those classes

Category 2, comprising counterparties not belonging to Category 1 which belong to a group whose aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives for *[three months after the publication of the RTS in the OJ excluding the month of publication]* is above EUR 8 billion and which are any of the following:
(i) financial counterparties;
(ii) alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU that are non-financial counterparties.

Category 3, comprising counterparties not belonging to Category 1 or Category 2 which are any of the following:
(i) financial counterparties;
(ii) alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU that are non-financial counterparties.

Category 4, comprising non-financial counterparties that do not belong to Category 1, Category 2 or Category 3.

[8] Aggregate average notional amount of non-centrally cleared derivatives is above EUR 3.0 trillion (3trn entity); EUR 2.25 trillion (2.25trn entity); EUR 1.5 trillion (1.5trn entity); EUR 0.75 trillion (0.75trn entity); EUR 8 billion (8bn entity), Below EUR 8 billion (sub-8bn entity) as of a set date (e.g. Date X).