ISDA. Safe, Efficient Markets

***ISDA Commentary on EMIR RTS on Portfolio Reconciliation, Dispute Resolution and Compressions (in European Commission Delegated Regulation C92012) 9593 final (19 December 2012))***

14th February 2013

A. Introduction

We welcome the opportunity to comment on the final Regulatory Technical Standards (RTS) on EMIR, covering OTC derivatives, CCPs and Trade Repositories, endorsed by the European Commission on 19 December 2012. In this note we comment specifically on the RTS on portfolio reconciliation, dispute resolution and compression.

ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

ISDA recognizes the importance of the RTS and strongly supports initiatives that enhance market efficiency and soundness. We further recognise the tireless work of the EC and ESMA towards delivery of G20 objectives and deadlines.

B. Detailed Concerns

Clarifications, Concerns about other Non-Margin Risk Mitigation Requirements

**1. Approach to identification of FCs, NFC+ and NFCs**

The uniform identification of counterparties as FCs, NFC+ or NFCs is central to the consistent cross-market implementation of individual firms' policies and procedures designed to meet the reconciliation requirements established under EMIR. In the absence of industry sources or a requirement to make counterparty representation mandatorily available, firms will need to rely on counterparty representation and internal reference data which could lead to inconsistent treatment of firms, particularly as it relates to the distinction between NFC and NFC+ where the reconciliation threshold and frequency are quite different, depending upon counterparty categorization. It would be extremely beneficial if ESMA (to whom the relevant report by an NFC breaching the clearing threshold is made, in the first instance) could make this information centrally available to the industry in a way that the information can be relied upon and give certainty to those dealing with firms as to how they should be categorised. It should also be noted that the CFTC makes registered firm classifications available to the public via the National Futures Association (NFA) website.

## 2. Reconciliation Frequency and Threshold Requirement Inclusive of Legacy Swaps

Do the frequency and threshold reconciliation requirements relate only to trades dealt post the Article 12 compliance date or all trades in the portfolio (both pre and post compliance date)? Clarification on the EMIR approach would be helpful.

It is worth noting that the CFTC, in their reconciliation frequency and threshold requirements, include all derivative contracts that are outstanding at the relevant time.

## 3. Clarification of FC's responsibilities in the circumstance where the counterparty does not provide data for reconciliation

We would welcome clarification of the scope of the reconciliation requirements where a counterparty does not provide its data for reconciliation. We anticipate that this would typically be a concern in respect of smaller NFC counterparties. We would suggest that (in a similar manner to which the CFTC provides for the possibility of a single party reviewing the trade information and valuations delivered by the other party and either affirming or objecting to such trade information and valuations) a negative affirmation process could efficiently be used when dealing with such circumstances. If the counterparty returns a portfolio, the reconciliation will be carried out, but if the counterparty does not return a portfolio (within a suitable timeframe), it will be deemed to have agreed with the data sent to it for the purposes of the reconciliation. Such arrangements would of course have to be subject to an appropriate contractual framework between the parties.

## 4. Reconciliation of contracts relating to discretionary investment management business

In respect of discretionary investment management business, we consider that trades entered into with clients by the discretionary investment manager in different capacities (i.e. both as counterparty and as discretionary investment manager acting for the client), should be dealt with separately. In particular, it should not be a requirement to involve the client in a reconciliation of discretionary investment management trades (including FX hedging trades, to the extent covered by EMIR) as the client would not have directly participated in the decision to book the trade. Such trades are entered into under the general discretionary investment management mandate with the client (in some cases for hedging purposes in relation to the client's portfolio). We would suggest that the terms of the discretionary investment management agreement between the parties could in such circumstances provide that such trades should not be reconciled, but believe the position should be clarified.

## 5. Clarification regarding exclusion of types of trades from reconciliation exercises

We understand that physically settled FX spot contracts are not subject to EMIR or CFTC portfolio reconciliation rules. However, non-physically settled FX spot transactions would not appear to be excluded from the EMIR reconciliation requirement. ISDA suggests that ESMA consider the exclusion of non-physically settled FX spot transactions as settlement risk is the main risk for FX spot trades, and the risk mitigation provided by margining is not the most appropriate mechanism for addressing such risk. It follows that such trades should be exempted from reconciliation requirements. Moreover, it is essential that a consistent treatment is applied globally, avoiding differential treatment by individual jurisdictions. For example, when considering the case to reconcile an FX spot trade – If an FX spot trade is booked on T, it is reconciled on T+1. The trade settles T+2 and is immediately dropped from the reconciliaton process. Therefore this one day reconciliation process is effectively duplicative of the trade confirmation and settlement process.

**6. Clarification regarding exclusion of types of trades from compression exercises**

ESMA's commentary in its Final Report to the Commission on the draft RTS is helpful to the understanding that portfolio compression may not be 'appropriate' in all circumstances. For example some trade types can be compressed (i.e. vanilla IRS, FRA and OIS) and others are not eligible (i.e. cross currency swaps and exotic interest rate swaps). However, we read the reference to there being no justification to a priori exclude some categories to mean that ESMA was not proposing to hard wire this in the RTS; however, we believe that it is possible to reasonably conclude based on analysis properly conducted that compression would not be appropriate for a particular type of trade, in which case all such trades could be excluded from compression without the need for a trade-by-trade analysis. Dealers would work on a best efforts basis where possible to perform compression but we would welcome ESMA's clarification on this point.

**7. Clarification of the meaning of "valid explanation"**

We note that Recitals 97 and 98 of the Final Report acknowledge that compression might not always be a suitable risk mitigation tool and that ESMA has acknowledged that it may not be appropriate to compress certain portfolios. However, Article 13 of the RTS requires a "valid explanation" as to why portfolio compression should not be conducted which suggests that there are both valid and invalid explanations. In such a case it would be helpful if ESMA could clarify what is intended by the term "valid explanation" and what criteria might be used to judge whether an explanation is valid or not.

**8. Clarification on how frequently the 500 transactions requirement needs to be ascertained?**

ISDA take the view that it should be clear how often it is necessary to determine whether there are 500 compression eligible transactions outstanding since this is a pre-requisite to the obligation to analyse the possibility to conduct the portfolio compression exercise. ISDA seeks clarity on whether is it sufficient under Article 13 of the draft RTS to check at a snapshot point every six months whether there are 500 outstanding transactions and then if there are more than 500 outstanding then the procedures will apply to analyse the possibility of conducting a portfolio compression exercise

**9. Recognition of efficiencies of organised multilateral compression cycles**

ISDA supports the requirement to analyse the possibility to conduct a portfolio compression cycle at least twice a year, but requests that the use of organised multilateral compression cycles be acknowledged as an acceptable method to achieve this (which would make the process less time consuming and more efficient). Although nothing should preclude bilateral compressions between two counterparties, the requirement to assess every relationship in excess of 500 transactions could represent a significant hindrance to the efficiency of both parties.

**10. Guidance on the interpretation of certain dispute resolution requirements would be welcome**

There are a number of uncertainties in relation to Article 14 on Dispute Resolution:

- The RTS (addressing Dispute Resolution) says that 'When concluding OTC derivative contracts with each other, FCs and NFCs shall have agreed detailed procedures and processes in relation to:
    a) the identification, recording, and monitoring of disputes relating to the recognition or valuation of the contract and to the exchange of collateral between counterparties.

Those procedures shall at least record the length of time for which the dispute remains outstanding, the counterparty and the amount which is disputed;

b) the resolution of disputes in a timely manner with a specific process for those disputes that are not resolved within five business days.

- It is not absolutely clear whether such detailed policies and procedures referenced above refer to valuation differences at the trade (or contract) level or margin disputes which occur at the portfolio level. Our assumption is that since the portfolio reconciliation requirement includes both collateralised and non-collateralised trades the word 'dispute' here refers to valuation differences observed in the reconciliation process.

- Furthermore, Article 14.2 states that 'financial counterparties shall report to the competent authority…any disputes between counterparties relating to an OTC derivative contract, its valuation or the exchange of collateral for an amount or a value higher than EUR 15 million and outstanding for at least 15 business days.' It is not clear whether such reporting would need to be at the trade level or portfolio level. The use of the words 'valuation [of the contract]' and 'exchange of collateral' (which occurs at the portfolio level) in the same sentence, are the source of confusion. Though the dispute reporting requirement addressed in Article 14.2 refers to 'an OTC derivative contract' (which points towards the valuation, and hence the threshold being applied, at trade level), collateral is typically exchanged based on assessment undertaken by counterparties at portfolio level and incorporates other data points (e.g. credit support document calculation requirement, independent amount, collateral positions and values), which are not addressed in the RTS. Our view is that, based on the foregoing, such Article 14 reporting can only be focused on trade level valuation differences that breach the EUR 15 million threshold.

- The frequency of the reporting to a competent authority under Article 14 needs to be clarified (e.g. monthly, quarterly?).

- Do the Dispute Resolution Requirements relate only to trades dealt post compliance date or all trades in the portfolio (both pre and post compliance date)?

We would be supportive of careful alignment of application of these standards with the equivalent CFTC rules, in order to enable consistency and comparability in reports to competent authorities.

**11. Confirmations rules and the reporting of disputes**

Did ESMA intend Dispute Resolution rules to apply to trade Confirmations? ISDA doesn't believe that it was the intention, however the RTS can be interpreted as such due to Paragraph 102 of ESMA's explanation of the RTS (addressing Dispute Resolution) published as part of the 'final report' - including draft RTS - on 27 September 2012, which says that the proposals are 'in order to identify and resolve any dispute'. Instead it is expected that Dispute Resolution rules should only apply to Valuation breaks over EUR 15 million.

C. Conclusion

ISDA members want to be able to comply with the requirements of the RTS on portfolio reconciliation, dispute resolution and compression. We hope that this paper will assist ESMA's understanding of our key concerns in this context, and help industry and regulators to focus discussions on interpretation of the RTS in the coming weeks. We look forward to discussing the

issues addressed in this paper with ESMA, and would be happy to respond to any queries from ESMA on the views and questions set out.

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