3 August 2012

To: European Securities and Markets Authority

Response to ESMA Consultation Paper: *"Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories"*

The Investment Management Association (IMA) is pleased to submit its response to the European Securities and Markets Authority's consultation paper on *"Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories".*

IMA is the UK based trade association for investment managers. Our members manage investments worth more than £4 trillion for their clients, who are UCITS and other authorised funds, pension funds, insurers, sovereign wealth funds and individuals. Ultimately, much of what they manage belongs to the man in the street through their savings, insurance products and pensions. Their interest in this consultation is therefore in their role as the "buy side" of the market, accessing capital markets on behalf of their clients.

Key IMA points:

1. We thank ESMA for listening to comments made in response to the relevant discussion paper published earlier this year. We believe that the draft Technical Standards are coherent and bring clarity to many of the outstanding issues in *Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories* (EMIR).

2. We agree also with ESMA's intention to await the outcome of the Basel/IOSCO consultation on *"Margin requirements for non-centrally cleared derivatives"*, published in July 2012, before proposing further Level 2 text in this regard.

3. We have addressed points of detail in Annex A, attached. Where possible we have also sought to provide drafting as we believe this may be help to illustrate particular concerns.

4. Particular concerns relate to margin, collateral, FX, timetable and repapering.

    a. Whilst we agree that margin requirements for centrally cleared derivatives should be robust, we do not believe that a prescriptive distinction between OTC and exchange traded contracts is necessarily the best approach. For a number of reasons we therefore urge ESMA to use the confidence interval of 99% set by CPSS-IOSCO and applied in the US.

    b. Highly liquid collateral should be specified in more detail and should (as mentioned at the Open Hearing) include regulated money market funds. We also believe that it

65 Kingsway London WC2B 6TD
Tel:+44(0)20 7831 0898 Fax:+44(0)20 7831 9975
www.investmentuk.org

should not be an option for CCPs to require the delivery solely of cash for Initial Margin purposes.

c. There is a continuing and undesirable lack of clarity over the position of FX transactions which it would be helpful if ESMA could dispel. We do not believe that FX contracts are exactly comparable to other OTC derivative contracts, and note that the FX market has already found ways to mitigate settlement and other risks. We have separately emailed you a paper setting out more information on FX use generally by investment managers.

d. Members are concerned about the timing uncertainties for reporting trades. It is important that the reporting obligation has a clear timeline set by ESMA, bearing in mind that the Level 1 EMIR text brings this requirement into effect immediately, and notwithstanding the significant lack of detail yet to be decided upon.

e. We urge ESMA to consider the enormous volume of repapering that will be required across the market in order to bring participants into line with EMIR, and allow appropriate time to achieve this. Repapering will encompass: the many additional reporting requirements, not just in relation to transactions; new arrangements for managing requirements on behalf of clients and others; and setting up clearing arrangements and making adjustments to pre-existing trading relationships. It is important that all participants are given clear guidance and sensible timeframes in which to implement.

5. We also have a new, but central, point to make. The ESMA draft standards appear to be based on the premise that the current principal to principal market model will subsist in the future. In Europe it is widely (if not exclusively) used in the listed derivatives markets. However we do not agree that it is necessarily the best or should be the only model for the future, in particular having regard to the scale of business that will move from the OTC derivatives markets into central clearing. We note also that EMIR does not distinguish between market models, whether agency or principal based.

   EMIR helpfully brought in both individual client segregation and omnibus client segregation, requiring clearing houses to offer choice in both. Omnibus client segregation is used now in clearing for listed derivatives and, with pre-specified fungible contracts traded on exchange, can work well. In the much larger OTC derivatives market the proper introduction of individual client segregation is critical.

   The practical effect of individual client segregation is likely to be the introduction of gross margining into the market. If gross margining becomes the norm for individual client segregated accounts, it becomes questionable whether the use of a principal to principal legal structure should be sustained, or be the only model used. An agency model would by contrast recognise that the principals are the CCP and the client, and the role of other parties pertained to the carrying out of the transaction but not to legal ownership of the positions, assets and money.

   The concept of individual client segregation is closely connected to the concept of being able to port trades in the event of a clearing member default. A key difficulty in the principal market model is that for a CCP to be able to port client positions, assets and money, it must know the identity of the client in advance of a default, know, exactly all the positions, assets and money attributable to that client and be entirely clear on ownership and other relevant property rights in relation to the assets and money. The use of title transfer as the preferred mechanism for posting collateral to meet margin requirements sits uneasily with the concept of individual client segregation and the porting obligations.

We therefore ask ESMA to:

- make any changes necessary to the Technical Standards to ensure that there are no barriers to clearing using an agency model; and
- encourage the market and competent authorities to support the introduction of an agency model for clearing OTC derivatives, by rigorous scrutiny of the degree of investor protection offered by CCPs in relation to segregation of clients' assets, money and positions, and their ability to carry out porting.

We are, of course, very happy to discuss any of our comments with you in greater detail. Please contact Jane Lowe jlowe@investmentuk.org or Penny Froggatt pfroggatt@investmentuk.org for these purposes.

ANNEX A

ESMA Consultation Paper on Draft Technical Standards for EMIR dated 25 June 2012

IMA detailed comments on proposals:

[Please note that green text in drafting proposals denotes new wording and red text in brackets denotes text to be deleted from ESMA proposals.]

ANNEX II

Indirect Clearing – Chapter II (p.66)

We welcome the clarity provided by the proposals in relation to the provision of indirect clearing and the desire to ensure upfront that arrangements for indirect clients are well protected. We think that these proposals will help to ensure that clearing members and other financial institutions are focussed on the protection of client assets at all levels. Whilst we do not think that indirect clearing will be particularly relevant to our members or their clients at the outset, we support the proposals.

We would also support proposals which provide for the option for indirect clients to have segregated accounts at the CCP and the ability to port at this level as well.

Clearing Obligation Procedure – Chapter III (p.68)

We remain concerned about some aspects of the clearing obligation procedure, and in particular that part which will affect all contracts with a minimum remaining maturity and which are entered into from the date of a notification from a Competent Authority to ESMA. As we explained in our response to the Discussion Paper, this will create uncertainty in the market from the date of notification until the date of ESMA's determination. In addition, without a clear process for publication of the notifications from Competent Authorities there is likely to be further confusion. Uncertainty and confusion are not good for markets and will have a detrimental impact on pricing and liquidity. We were hoping that ESMA would take on board our comments in this area by providing (i) a clear indication as to how and when notifications will be published, and (ii) further guidance on the minimum remaining maturity. In relation to (ii) we believe that ESMA should ensure that a retrospective clearing requirement is only made for contracts with significant long term maturities which would not otherwise naturally move to a CCP during their lifecycle.

Notification to ESMA (p.68)

<u>Article 1(1)(e) DET (p.68)</u>

We believe that for OTC derivatives to be capable of being cleared there should be a degree of standardisation of commercial terms and that the extent to which there is standardisation of contractual documentation is largely irrelevant, especially when contractual standardisation is being considered in the context of un-cleared contracts. We therefore propose that the reference to "standardisation of contractual terms" in Article 1(1)(e) DET be amended to a reference to "standardisation of commercial and contractual terms".

The use of common master agreements and other documentation to document the terms of any OTC derivative contract should not be a significant factor in whether or not the contract should be subject to mandatory clearing, however the commercial and product focused content of such agreements would be an indicative factor.

<u>Article 1(2)(f) DET (p.68)</u>

We are concerned that Competent Authorities may not have full access to the information required to be provided under Article 1(2)(f) DET where the relevant market participants for the contract in question are dispersed across the EU. ESMA should have regard to the limitations of relying on information provided by the Competent Authority of one jurisdiction and probe this aspect of any application.

Criteria for the determination of the classes of OTC Derivative Contracts subject to the clearing obligation – Chapter IV (p.69)

<u>Article 1(2)(a) CRI (p.70)</u>

As mentioned above, we do not believe that the existence of common legal documentation is of itself relevant to the assessment of whether a contract should be subject to mandatory clearing. Instead, we believe that it is important that the contracts display common commercial terms, focused on the common features of particular product types. Documentation used in the non-cleared OTC derivatives world will be generally unsuitable for the cleared world where many of the provisions outside of the commercial terms will be set at the CCP or, where relevant, trading venue level or at the very least influenced by the rules of the CCP which has been chosen to clear the contract.

Public Register – Chapter V (p.70)

<u>Article 1(2) PR (p.70)</u>

As mentioned in our response to the Discussion Paper, we believe that the terms used in Article 1(2)(a), (b) and (c) PR lack clarity. We can only assume that ESMA will provide further guidance on these expressions once the Public Register is operative.

We also suggest that the register specify in the section detailing the contracts subject to clearing, the CCPs which are authorised to clear those contracts and in the case of the information on CCPs in Article 1(3) PR that this also includes a list of the OTC derivative contracts that the CCP in question is authorised to clear.

Liquidity Fragmentation – Chapter VI (p.71)

We agree with the approach taken by ESMA in relation to liquidity fragmentation, as set out in Article 1(2) and 1(3) LF specifically.

Risk –mitigation Techniques for OTC derivative contracts not cleared by a CCP – Chapter VIII (p.73)

We are grateful that ESMA has taken on board industry comments and relaxed these requirements. Even as currently proposed, for many counterparties, these requirements will require significant changes to documentation and processes at a time when they are also having to deal with the challenges of the introduction of the clearing and reporting obligations. We therefore encourage ESMA to find a solution with the Commission which provides for a suitable implementation period for the risk mitigation techniques specified in this consultation. A period of 12 months from the date the Technical Standards come into effect would be helpful and should apply such that only transactions executed after the end of the transition period are required to comply. [The implementation of requirements relating to the posting of margin which we understand will be dealt with later this year will need to be considered separately as they raise significant issues especially in the context of FX OTC derivatives.]

Timely Confirmation - Article 1 RM (p.73)

We are pleased that ESMA has taken on board the concerns of market participants and relaxed the requirements on confirmations. Whilst we recognise the need for timely confirmation of transactions and support the proposals set out in Article 1 RM, we believe that some flexibility is still required to allow for confirmations outside of this time period where they cannot be not performed electronically, either because of systems problems or because there is no platform available for confirming a particular class of OTC derivative. For example, complex inflation and equity derivatives are still cleared using a paper confirm. In these cases, one side to the trade will produce the paper confirmation for the other side (or their agent) to agree. If there is any delay in the production of the paper confirmation or any query over terms, this will delay the confirmation process.

Article 1(3) RM

We believe that the words "which does not allow same day confirmation" in Article 1(3) RM could be interpreted in different ways and that this phrase should be worded as follows: "such that same day confirmation is not possible".

Article 1(4) RM

A significant group of financial counterparties, including pension funds, will employ investment managers to whom this task may be delegated. Where several investment managers act for the same counterparty this information will need to be aggregated across the different investment managers. It is frequently the case that investment managers do not know the identity of the client's other appointed managers, which makes this a problematic requirement unless there is a mechanism at the Competent Authority to take information from different sources in respect of the same financial counterparties (using the LEI for example). Alternatively, financial counterparties which are themselves clients of other financial counterparties, such as banks and other derivative traders, and which are not themselves deemed to create systemic risk should be exempt from this requirement.

Portfolio Reconciliation – Article 2 RM (p.73)

Where a counterparty has delegated the management of its OTC derivative positions to a number of third parties (including fund managers), it is not clear at what level the number of derivative contracts should be counted for the purposes of Article 2(4). Should each third party consider this question separately in respect of the counterparty or will the counterparty be required to aggregate across all its third party providers?

Portfolio Compression – Article 3 RM (p.74)

Where a counterparty has delegated the management of its OTC derivative positions to a number of third parties (including fund managers), it is not clear at what level the assessment of the portfolio compression requirement should take place. It will be difficult and in many cases inappropriate for the assessment to be made across the whole of the counterparty's OTC derivative holdings. The individual portfolios delegated to fund managers will be managed against different mandates and objectives. We believe that the assessment, therefore, should be permitted at this level as an alternative.

ANNEX III

Organisational Requirements – Chapter IV (P.92)

Article 1 (p.92)

We support the requirements set out in this Article but do not think that they go far enough. We believe reference should be made explicitly to the Risk Committee of a CCP, in terms of how it should be established to comply with EMIR Level 1 requirements.

The consultation paper notes that the Risk Committee is already established under EMIR and that stakeholder arrangements should not be a mandatory element of the governance arrangements specified by ESMA. The CCP governance arrangements should reinforce the EMIR provisions regarding the composition of the Risk Committee, in particular, that clients and their representatives, who will post and manage a substantial portion, if not the majority of the collateral received by the CCP, should have meaningful representation on the Risk Committee. In addition, we would urge ESMA to require that consultation also be undertaken with a broad set of buy-side representatives to reflect the diverse nature of this segment of the market.

Article 1(5) ORG (p.92)

In addition, the requirement to consider independence and conflicts of interest should also be considered in the context of the ownership of the CCP where it is not part of a group, and where the interests of one or more of the CCP's owners could conflict with the CCP's duties and obligations. We would suggest that Article 1(5) ORG be redrafted as follows:

> "A CCP [that is part of a group] shall take into account any implications of the [group] structure and composition of its ownership for its own governance arrangements, including whether it has the necessary level of independence to meet its regulatory obligations as a distinct legal entity and whether its independence could be compromised by [the group] its ownership structure, the composition of its shareholders, or by board members also being on the board of other parts of the same group or of other shareholders. In particular, [such] a CCP shall consider specific procedures for preventing and managing conflicts of interest including with respect to outsourcing arrangements. Without prejudice to outsourcing arrangements, a CCP shall have its own dedicated human resources which are not shared with other members of the same group [entities] or another shareholder."

Article 2(6) ORG (p.94)

We suggest the addition of the following words to the end of this section:

"A CCP shall also publish the criteria by which it selects the members of its Risk Committee, with sufficient detail to ensure that meaningful representation of investor and other client interests occurs in addition to including representatives from its clearing members and independent members of the board."

Article 2(5) ORG (p.93)

The reference to remuneration policies in article 3(5) ORG should also be replicated here to make it clear that the remuneration of members of the CCP's risk function should also be such as to not compromise their objectivity.

Article 2(7) and Article 2(8) ORG (p.94)

The details of a CCP's policy on haircuts and concentration limits should be available more widely and in particular should be made available to clients of CCPs (whether or not known to the CCP), indirect clients and intermediaries acting on their behalf. We suggest redrafting these secions as follows:

Article 2(7) ORG

> "A CCP shall inform the competent authority [and], the clearing members, and clients (including indirect clients) where known to the CCP, of the applicable haircuts and of the conditions implying a modification in the applicable haircuts, including demonstrating that pro-cyclical effects are suitably limited. A CCP shall notify the competent authority, and where appropriate seek its authorisation, [and] the clearing members and clients (including indirect clients) where known to the CCP of any amendment. Clearing members will provide this information and any amendment to their clients (including indirect clients where known to the clearing member) or their representatives forthwith upon receiving it from a CCP."

Article 2(8) ORG

> "A CCP shall inform the competent authority [and], the clearing members, and clients (where known to the CCP) of the applicable concentration limits on collateral. A CCP shall notify the competent authority, [and] the clearing members and clients (where known to the CCP) of any amendment. Clearing members will provide this information and any amendment to their clients (including indirect clients where known to the clearing member) or their representatives) forthwith on receiving it from a CCP."

Article 7 ORG – Disclosure (p.98)

We support the proposals set out in this Article, however we think that the requirements to disclose information to the public and to clients and clearing members do not go far enough. In particular we believe that the details of the ownership of a CCP and links to any other businesses should be made available to the public and added to the list in Article 7(1) ORG.

As regards information to clients and clearing members in Article 7(3) ORG, this information should also be made available to indirect clients and intermediaries acting for clients and/or indirect clients.

As well as the types of information specified in Article 7(4) ORG, information on risks and on the law and rules of the CCP should cover the risks of the various account structures offered to clients, the laws under which they operate, including what happens to assets in the accounts with a CCP in the case of a clearing member or CCP default, the CCP's default rules and the extent to which porting is available and relevant timeframes.

In addition, the results of audits undertaken under Article 8 ORG should be made available, at least in summary form.

We would suggest the following drafting changes to reflect these points:

Article 7(1) ORG

Reword paragraph (a) as follows:

> "(a) its ownership structure and composition, governance arrangements, including its organisational structure as well as key objectives and strategies, material outsourcing arrangements and details of any other businesses to which the CCP has significant links by virtue of ownership or contractual arrangements;"

Article 7(2) ORG

Replace this with the following:

> "A CCP shall disclose to the public free of charge any material changes to the information set out in Article 7(2)."

Article 7(3) ORG

Redraft this as follows:

> "A CCP shall disclose to clearing members and to clients (including indirect clients) known to the CCP all relevant information on its design and operations as well as on their rights and obligations necessary to enable them to identify clearly and understand fully the risks and costs associated with using the CCP's services. Clearing members shall pass all such information as soon as reasonably practicable to their clients (including indirect clients where know to the CCP), and their representatives. [For all other clients, upon request information shall be passed to them through their clearing member.] In order to facilitate understanding of its procedures and arrangements the CCP shall offer additional documentation and training where appropriate."

Article 7(4)

We suggest that this Article be re-drafted as follows:

> "The information to be disclosed to clearing members and clients in accordance with paragraph 3 shall include, at a minimum information on the following:

(a) The structure of the CCP's model and the CCP's current clearing services, including detailed information on what it provides under each service, account options, and costs incurred when using each service;
(b) The CCP's risk management systems, techniques and performance, including information on financial resources, investment policy, haircuts, eligible collateral, price sources and models used in margin calculations;
(c) The law and the CCP's rules governing:
(i) The access to the CCP;
(ii) The contracts concluded by the CCP with clearing members and where [practicable] relevant, with clients;
(iii) The contracts that the CCP accepts for clearing;
(iv) Any interoperability arrangements;
(v) Default by a clearing member or the CCP, including the use of collateral and default fund contributions, the liquidation of positions and collateral [and], the extent to which collateral is protected against third party claims and the extent to which porting of positions is available and timeframes.
(d) Relevant business continuity information; and
(e) A summary of the results of audits undertaken in accordance with Article 8 ORG."

Record Keeping – Chapter V (p.100)

<u>Articles 2 RK</u>

Transaction records held by a CCP should also identify the client, where known to the CCP. We suggest the addition of the following paragraph in Article 2(2) RK:

"(m) the identity of the client (including any indirect client), where known to the CCP."

<u>Article 2 and 3 RK</u>

Counterparties will want to be able to check their records against those held by the CCP. We would like to see a requirement for the CCP to provide details of transactions and positions to clients and clearing members on request.

We would suggest the following be added at the end of Article 2RK as a new paragraph 4:

"4. A CCP shall on request from a clearing member and any client (including any indirect client) known to it provide, within a reasonable timeframe, to such clearing member or client any of the details of the transactions which it has recorded in accordance with Article 2(2) RK, which relate to the clearing member or client, as such clearing member or client requires."

We would suggest that the following be added at the end of Article 3RK as a new paragraph 4:

"4. A CCP shall on request from a clearing member and any client (including any indirect client) known to it provide, within a reasonable timeframe, to such clearing member or client any of the details of the positions relating to that clearing member or client which it has recorded in accordance with Article 3(2) RK as such clearing member or client requires."

Margins – Chapter VII (p.104)

Article 1 MAR – Percentage (p.105)

ESMA's paper notes that the CPSS-IOSCO Principles for Financial Market Infrastructures require at least a confidence interval of 99% and characterises OTC derivatives by specific risk characteristics such as limited liquidity, difficulty in obtaining prices, absence of a regulated market to liquidate positions and a restricted number of participants.

Whilst we firmly believe that margin requirements for centrally cleared derivatives should be robust and promote a 'defaulter pays' principle, we do not believe that a prescriptive distinction between OTC and exchange traded contracts is the best approach for a number of reasons:

1) It is inconsistent with the CPSS-IOSCO Principles and the standards established in the US under Dodd Frank based on CPSS-IOSCO, which require a confidence level of 99%. A minimum interval of 99.5% will result in significantly higher initial margin requirements for OTC derivatives irrespective of the risk profile of different product types. Material differences in initial margin calculations between the US and Europe will create a disincentive to clear through a European CCP and may also raise issues around 'equivalency' testing for third country CCPs.

2) OTC derivatives are not necessarily less liquid and more volatile than exchange traded products. A number of highly liquid and standardised OTC derivatives such as 10 year IRS exist alongside relatively illiquid exchange traded contracts, for example some commodity futures. Centrally cleared OTC products should be relatively standardised and liquid, as CCPs will target contracts they are capable of pricing with a high degree of accuracy.

3) The CP states that requiring a higher confidence interval of 99.5% for OTC derivatives does not impact end clients. We do not believe this is correct. In most cases clients will be required to post the same amount of margin to their clearing member as the clearing member posts to the CCP. Any increase in margin required of the clearing member will therefore result in a similar increase for the end client.

Taking all these points into account, we urge ESMA to consider mandating a minimum confidence interval of 99% for cleared products in line with CPSS-IOSCO principles. Of course, this should not prevent CCPs from being able to increase this level where they believe it is appropriate, for example for less liquid contracts.

Article 4 MAR – Portfolio Margining (p.106)

We assume that this Article relates to the offset of margins across different **classes** of financial instrument, as opposed to across different financial instruments of the same class, which should be allowed in any event. Please can ESMA clarify this by referring in this Article to "classes of financial instrument" as opposed to just "financial instruments".

We support margin offsets to be allowed between different instruments within a portfolio. End-users, including pension funds, use a variety of instruments to risk manage exposures. The offset that different financial instruments provide to each other is an important part of the risk management process and regulators need to recognise this in the margin calculations.

We broadly support the provision of offsets to be allowed only where there is a strong relationship between financial instruments. The use of correlation analysis to objectively determine whether a strong relationship exists between financial instruments can work in some instances. However we are concerned that there may be an over reliance on this correlation analysis to determine which instruments would fall within the same set of financial instruments. Correlation analysis is not always reliable, especially when there is not enough historical data. In fact there are many derivative instruments that do not have more than a few years of data and therefore do not have enough historical data throughout varied economic cycles.

In the first instance there needs to be a consideration made as to whether certain financial instruments have a strong fundamental, economic or structural relationship. Only when that does not exist should a correlation test be applied to determine if offsets should be allowed for margin calculations.

We consider interest rates and inflation derivatives to part of the same set of financial instruments and margin offsets should be allowed without the need for any minimum correlation test. This can be justified on the basis of a strong fundamental and economic relationship existing between interest rates and inflation. Many central banks set their interest rate and monetary policy target based on expected inflation creating a strong link between the two. There are also other fundamental and economic relationships between the two.

Furthermore, many end-users of derivatives, including pension funds, use interest rates and inflation derivatives together to create a real rate hedge to hedge its real rates exposures. This is an important risk management that pension schemes undertake to manage the financial solvency of pension schemes. Regulators should recognise the use of these instruments as two parts of the same hedge and allow margin offsets between them.

We do not know yet, based on the proposed rules, if ESMA shall consider these instruments to be falling within the same set of financial instruments (therefore not applying the correlation test) or not. Inflation derivatives have only been liquid from around 2006 and as such we are concerned that any correlation analysis will produce results that cannot be relied upon. Due to the limited historical data, any correlation analysis on these instruments would not include the full breadth of scenarios including both high inflationary as well as low inflationary environments.

It is not necessary to separate financial instruments into different portfolios for the purposes of margin calculations in order to adopt prudent risk management. By choosing an appropriately conservative confidence interval at the outset, any margin offset allowed would be prudent.

We are concerned that if ESMA requires interest rate and inflation derivatives to have a minimum negative price correlation, this could prevent offsets from being allowed between these instruments.

This is likely to have the following undesirable effects:

- members have calculated that the cost would be very high in margin terms;
- it could consequently discourage end-clients from managing risks appropriately, thereby increasing risk within the system; and
- it could also discourage clearing, as clients may seek to use existing but less liquid instruments, or other innovative instruments that would allow margin offsets (for example real rate derivatives).

We urge ESMA to specify appropriate margin offsets between products where there is a fundamental or economic relationship (such as rates and inflation derivatives) as an alternative to price correlation, to avoid the adverse effects noted and encourage as many OTC derivatives as possible into clearing.

<u>Article 4 MAR (3) (p.106)</u>

We believe that ESMA should not oppose the use of separate default funds where the risk considerations are appropriately catered for. We also oppose any requirement for separate default funds in order for portfolio margining to be allowed.

We are keen for more products to be introduced into clearing than are currently cleared by CCPs. Although we would be happy for them to be supported by the same default fund, we are concerned that CCPs may not offer clearing of some derivatives if they are not allowed to have a separate default fund for some products, for example where liquidity profiles are very different. This combined with ESMA's proposed rule in respect of default funds for portfolio margining would rule out any margin offset treatment of derivatives where CCPs require separate default funds for separate classes of financial instrument for other reasons, even when there may be a strong fundamental or economic relationship between the instruments.

Default Waterfall – Chapter X (P.111)

<u>Article 2(3) DW (p.111)</u>

The 3 month period allowed for a CCP to reinstate its own resource seems much too long bearing in mind the increased importance of CCPs in the derivatives markets and (prospectively) the volatility of world financial markets. **We would suggest a much shorter time-frame of 14 days**, but allow competent authorities to extend this up to 3 months should they believe on good grounds that the CCP has sufficient support in the meantime from a specified source to enable it to continue with its activities. Generally speaking most CCPs would expect to have capital well above the minimum and therefore have no immediate difficulty with this aspect of the default waterfall. But in the event that a CCP is poorly capitalised, it would seem unreasonable to allow them to continue in business without meeting the capital requirements for other than a very short period indeed.

Collateral – Chapter XI (P.111)

<u>Article 1(3) COL (P.112)</u>

We would like to see further guidance from ESMA regarding the types of financial instruments which ESMA consider could satisfy the "highly liquid collateral" criteria. For instance, we would suggest that in addition to highly rated government and corporate bonds, money market funds should also be specified. These are regulated in Europe and the US and are required to hold highly liquid securities.

In Europe, UCITS-compliant MMFs are structured as standalone entities. Fund investments are ring fenced from the investment manager. In the event of a solvency issue with these parties, the assets within the MMF would not be impacted. The US futures market already permits investment of collateral in MMFs by futures commission merchants (FCM)'s and derivatives clearing organisations. We see no reason why MMFs should not be included as highly liquid collateral where they are regulated, offer same day liquidity and impose no redemption restrictions.

This could be done by adding a new Article 1(4) COL as follows:

> "Without limiting the scope of Article 1(3)(b), ESMA considers that financial instruments of the following types, where they meet the criteria specified in Article 1(3)(b)COL, should be considered as highly liquid collateral for the purposes of paragraph 1 of Article 46 of Regulation (EU) No xx/xxxx [EMIR]:
>
> (i) Government bonds;
> (ii) Corporate bonds;
> (iii) Money market instruments; and
> (iv) Regulated money market funds, including those compliant with ESMA guidance."

We also believe, that in order to ensure that collateral requirements do not unduly affect the investment opportunities of clients, CCPs could be required to accept collateral other than cash in respect of initial margin.

As regards Articles 1(3)(c) and (d), we are concerned that these asset classes are not sufficiently liquid and that without appropriate concentration limits applied at the counterparty level for counterparties of a certain size, large exposures to these asset classes, in particular commercial bank guarantees, could create significant levels of systemic risk. Please see further below our comments on Article 4 COL.

Article 4 COL – Concentration Limits (p.115)

Article 4(1)

In order for concentration limits to have the desired effect as a risk mitigant, they should also be applied at the client level. We are particularly concerned that large and systemically important non-financial counterparties with large derivative positions will be able to build up significant collateral positions with their clearing member using commercial bank guarantees from one bank. Such positions may go un-monitored if concentration limits are only applied at the clearing member level. We remind ESMA of the devastation caused by the collapse of ENRON. The clearing regime should be designed to protect the market from non-financial corporate default as well as the default of financial institutions.

Where a client is known to a CCP and has opted for a segregated account, the CCP should apply its concentration policies and procedures to that client. Where clients of a clearing members have opted to use an omnibus account at the CCP, the clearing member should apply its own concentration policies and procedures to each client, which are consistent with those of the CCP's with whom it clears client contracts. The following changes could be made to Article 4(1) COL to reflect this:

> "1. A CCP shall establish and implement policies and procedure to ensure that the collateral remains sufficiently diversified to allow its liquidation within the defined holding period without a significant market impact. The CCP shall assess in particular the concentration of collateral provided in the financial instruments of an individual issuer, type of issuer in terms of economic sector, activity and geographic region, and type of asset or commercial bank guarantees. In order to avoid a high credit exposure to an individual issuer, type of issuer or type of asset, a CCP shall determine concentration limits at the level of each clearing member, at the level of each client account of each clearing

member, both omnibus and segregated, and at the level of all clearing members. In addition, clearing members shall apply similar concentration limits to those imposed by the CCP, at the individual client level in respect of each client whose collateral positions are reflected in an omnibus client clearing account with the CCP. The policies and procedures of a CCP shall determine the risk mitigation measures when the concentration limits are exceeded by a clearing member, a client of a clearing member or all clearing members in total."

Article 4(2) COL

Under Article 4(1) a CCP is required to ensure that the collateral it holds is sufficiently diversified across types of asset and commercial guarantees, amongst other things, and yet the focus of the criteria in Article 4(2) is on financial instruments.

In addition, following on from our comments in respect of Article 4(1) above, we believe that the amount and type of collateral should be considered in respect of clients as well as at the clearing member level.

We suggest that Article 4(2) COL be re-drafted as follows:

"2. Concentration limits shall be determined by the CCP in a conservative manner taking into account all relevant criteria at the clearing member and (where known to the CCP) client level, including:

(a) The amount of collateral provided [by the clearing member];
(b) The amount of collateral provided in commercial bank guarantees or by exposure to a type of asset;
(c) The amount of collateral provided in financial instruments or commercial bank guarantees issued by an individual issuer;
(d) The amount of financial instruments or commercial bank guarantees issued by issuers of the same type in terms of economic sector, activity, or geographic region;
(e) The level of credit risk of the financial instrument, commercial bank guarantee or of the issuer or guarantor based on an internal or external opinion given with a high level of confidence based on a stable and objective assessment;
(f) The liquidity and price volatility of the financial instruments."

Article 4(3)

Given the illiquid nature of commercial bank guarantees we do not think it is appropriate for a CCP to hold 50% of its collateral in these obligations. Furthermore an exposure of 25% of collateral to one commercial bank would not appear to meet the requirement of Article 4(1) and 4(2) COL.

Review of models, stress testing and back testing - Chapter XIII (p.119)

Article 5(6) and 5(7) SBT (p.120)

We support the requirements set out in these articles for CCPs to report results of stress tests to the risk committee and to clearing members and clients, where known to the CCP. This information should be made available within a reasonable time frame to ensure that it is as current as possible.

We would suggest that results in the case of Article 5(6) should be made available within 1 month of testing, unless a material gap has been identified, in which case this should be escalated to the Risk Committee as soon as practicable.

In the case of Article 5(7), the results should be made available promptly, and in any case within 2 months of testing.

Once results of tests are available this fact should be published on the CCP's website or by some other means so that clients who are not known to the CCP may request the information in a timely fashion.

Article 15(1) and 15(2) SBT (p.126)

We support the requirement for the public disclosure by a CCP of the general principles underlying its models, methodologies and tests together with a summary of test results and corrective actions. We also support the requirement to disclose key aspects of a CCP's default procedures.

Trade Repositories and Reporting

ANNEX V

First draft Regulation regarding minimum details of the data to be reported to trade repositories (p.137)

Reporting of collateral positions

We understand ESMAs desire to be able to monitor exposure on a daily basis and are not against this as an objective. However we feel that the current proposals have not been properly thought through, and will result in confusion and muddled reporting which will not be reliable. In particular this will be an issue in the non-cleared environment, where collateral between counterparties is exchanged on a net basis across a varied portfolio of financial instruments, each of which may need to be reported to a different trade repository. We set out in the Appendix an example prepared by an IMA member which highlights the issues with respect to bi-lateral trades. We therefore urge ESMA to consider the detail of this requirement further before implementing to ensure that the requirements are practicable. ESMA should also consider phasing-in implementation of this element once the base reporting arrangements are up and running.

Article 2 – Definitions (p.138)

Article 2(2)

Drafting proposal:

> "beneficiary" is the party subject to the rights and obligations arising from the contract. Where the transaction is executed by a structure, such as a trust or fund (including a sub-fund of an umbrella structure, the assets and liabilities of which are segregated from the other sub-funds of the umbrella structure, as a result of either a legal or contractual

> requirement), representing a number of beneficiaries, the beneficiary should be identified as that structure."

The additional wording is required to make it clear that a transaction executed for the specific account of a sub-fund of a structure should be reported at the sub-fund level, where the assets and liabilities of the sub-fund are segregated from those of other sub-funds in the structure, whether on a statutory or contractual basis.

Article 3(1) and (2) (P.139)

We have a number of comments on Tables 1 and 2 as follows:

Table 1

Field 12 – Trading Capacity
This field should be deleted
As the requirement to report is at the level of the counterparty, who will always be the principal to the transaction, there should be no requirement for this field.

Table 2

Field 17 – Settlement Date
The details required should be amended to read as follows: "Date of settlement of the underlying, if relevant"

Field 27
The reference to Article 11 EMIR is confusing. Is this field only relevant to non-cleared contracts?

Fields 29 and 30 and fields 32 and 33
There may be more than two types of collateral posted in respect of a single contract or a portfolio of contracts. How will this be dealt with?

Field 31
Does amount of collateral refer to number of units or value of collateral posted? Where different collateral is posted in different currencies, how should this be reflected?

Field 63
What is a post trade event for these purposes. Is it not a modification?

Article 3(3)

Drafting proposal - add the following words at the end of Article 3(3):

> "Where the counterparties have agreed who should be responsible for reporting the information in Table 2, the non-reporting counterparty shall have no further obligation in respect of the reporting of this information."

The requirement to only report the information set out in Table 2 once will mean that counterparties will need to agree up-front who is responsible for reporting this information. Where one counterparty (A) is relying on the other counterparty (B) to report this information and this has been agreed, A should not be responsible for compliance with Article 132).

We note that Article 3(5) is potentially at odds with Article 3(3) as it anticipates that he common data may be reported by both counterparties to different trade repositories, and therefore submitted more than once.

<u>Article 4 – Reporting by a third entity (P.139)</u>

<u>Article 4(1)</u>

Drafting proposal:

> "A third entity is deemed appropriate if, in the view of the delegating counterparty, following appropriate due diligence, [it guarantees] the third entity has robust processes and controls designed to ensure protection of the data and compliance with the reporting obligation under Article 9 of Regulation No (EU) No xx/2012 [EMIR].
>
> Where a counterparty has delegated to a third entity complying with this Article, and has put in place appropriate outsourcing arrangements in order to monitor the performance of the third entity, the counterparty should have no further obligations with respect to the information reported by the third entity on its behalf."

The reference in this Article to the third entity being able to "guarantee" is inappropriate given that no entity would be able to provide this assurance. The key to delegation to a third entity should be the performance of appropriate due diligence.

<u>Article 5 – Cleared Trades (p.140)</u>

We believe this article should be renamed "Novations" as it relates to novations in general, as well as to novations when a trade is submitted to clearing.

<u>Article 5(2)</u>

Drafting proposal:

> "Where a novation occurs before reporting to a trade repository, a report shall be made on the basis of the terms of the transaction before novation, and [indicating that it] where novation relates to clearing the report should also indicate that the trade has been cleared."

<u>Article 5(3)</u>

Drafting proposal:

> "The procedure described under paragraph 2 does not affect the legal effect of novation, nor, in the case of cleared trades, the qualification of a central counterparty as the counterparty in that context."

The additional wording is required to make it clear that Article 3(3) covers non-cleared trades as well.

<u>Article 5(4)</u>

Drafting proposal:

> "If a transaction is concluded in a trading venue and cleared by a CCP such that a counterparty is not aware of the identity of the other counterparty to the original derivative contract, the counterparty shall identify the CCP as its counterparty."

Article 6 (p.140)

Article 6(3)

Drafting proposal:

> "The counterparties shall report to the trade repository the specific contracts over which such collateral has been exchanged on a portfolio basis."

Second Regulation on details of the application for registration as a trade repository

Conflicts of interest - Section 6 (P.156)

Article 14 – Management of conflicts of interest – (p.156)

Examples of the types of conflicts of interest that are to be identified and managed should be specified.

We suggest that the following should be inserted at the end of paragraph (a):

> "such policies and procedures should take into account, amongst other things, any conflicts of interest arising as a result of the structure and composition of the ownership of the Trade Repository, any outsourcing arrangements, and the composition of the board of the Trade Repository."

Article 15 – Confidentiality (p.157)

We are concerned that trade repositories may decide or be persuaded to use data provided to them for commercial use. Where this is the case, Trade repositories should disclose this up-front, including a description of the types of commercial use permitted. Counterparties should have the option to prohibit use of their trade data in this way, as clearly envisaged in the Level 1 EMIR text. Trade repositories with a substantial market share in a particular product may seek to impose universal acceptance of data publication either as a condition of access or in the small print of their terms. To prevent this, we suggest ESMA add the following words in the second sentence of Article 15:

> "The latter shall include, but not be limited to, a description of how consent for commercial use is arrived at for each individual and type of counterparty, and a description of the internal procedures....."

Article 16 – Inventory and mitigation of conflicts of interest (p.157)

Article 16(2)

The inventory of conflicts of interest should include those that arise from any type ownership or material relationship, whether or not the trade repository is part of a group.

> "[Where a Trade Repository is part of a group] The inventory shall include any material conflicts of interest arising from [other undertakings within the group] the structure and composition of the ownership of the Trade Repository, any outsourcing arrangements and the composition of the board of the Trade Repository, and information on how these conflicts are being managed."

Access Rules – Section 8 (p.158)

Article 19 – Transparency about access rules

We refer to our comments with respect to Article 15. The applicant's rights to the use of data for purposes other than in accordance with EMIR should be carefully controlled in order to ensure that there is no abuse of position.

Article 21(c)

We do not understand the reference to clients and prospective clients in this Article.

ANNEX VI

The title to the regulation in this annex refers to frequency of trade reporting, but this is covered in EMIR itself and no further requirements are specified in this regulation.

Article 3 – Identification of counterparties and other entities (p.168)

Articles 3(1) and 3(2)

Drafting proposals:

"(1) A report shall use a legal entity identifier (LEI) to identify:

a. a counterparty which is a legal entity [if legal entities];
b. a broking entity;
c. a reporting entity;
d. a beneficiary which is a legal [person] entity;
e. a CCP.

(2) Where a legal entity identifier is not available, a report shall use an interim entity identifier which is compatible with the recommendations made by the Financial Stability Board."

Changes made to correct typos and make it clear that a beneficiary may not be a legal person but have a legal construct.

Annex 1 to implementing technical standard on format of the details to be reported to trade repositories Article 9 of EMIR

The scale and scope of the reporting set out is substantial and goes beyond the requirements set out in Article 9 paragraph 5. Furthermore, the prescriptive nature of the requirements and the detailed data formatting, combine to provide a significant data mapping and reporting obligation.

Our members use a wide array of systems which will capture data according to the requirements of their business models, which may not necessarily accord with the requirements set out in Annex 1. It is highly probable that other market participants, outside the asset management community will have similar issues. Additionally, repositories are not yet live for a number of classes of OTC contracts, such that the means to report, communicate and validate data are yet to be considered.

It is not clear that any consultation has taken place with the market participants to ascertain the feasibility or capability of data capture and reporting in compliance with the prescribed formats within the proposed deadlines. Nor are we aware that any impact analysis has been undertaken, considered or published. Whilst we understand the need to impose common formats to enable comparison and consolidation of reports, there needs to be a recognition of the fact that the requirements as proposed will require many firms to undertake substantial systems changes. We would strongly suggest that ESMA engagement further with market participants to ensure the Technical Standards include realistic and achievable reporting, which is accurate and complete, without imposing significant additional costs (through IT and operational expenditure) on market participants over a short timeframe.

Appendix

Collateral Reporting Example

The issue is how to report collateral on a bilateral OTC contract level when collateral is determined and managed on a portfolio basis.

Client A has a relatively simple mixed portfolio which includes credit default swaps (CDS), interest rate swaps (IRS) and total return swaps (TRS) contracts. Ten contracts with Bank X are currently not cleared and are therefore held on a bilateral basis. A breakdown on a given day shows the net exposure as Eur100 in the money. This is the summation of OTC contracts in the money (ITM) where the client has an unrealised profit on a mark to market basis (MTM) and those where the client has an unrealised loss on a MTM basis and these are out of the money (OTM).

The portfolio analysis for the bilateral OTC trades between Client A and Bank X is as follows:

Contract	**Eur MTM ITM**	**Eur MTM OTM**
CDS 1		(10)
CDS 2		(10)
CDS 3		(20)
IRS 1	35	
IRS 2	15	
IRS 3	20	
IRS 4	35	
IRS 5		(10)
TRS 1	25	
TRS 2	20	
GROSS EXPOSURE	150	(50)
NET EXPOSURE	**100**	

Collateral is determined and posted on a daily basis on the net exposure, such that Bank X will post to Client A eligible assets to value of Eur100 (assuming no minimum transfer amounts, threshold amounts or haircuts). The assets received by Client A from Bank X are:

Eligible Asset	**Eur Value**	**Currency**
Cash	22	Eur
Government Bond A	27	Eur
Government Bond B	11	Eur
Government Bond C	19	GBP
Government Bond D	21	USD
TOTAL VALUE	**100**	

Reporting issues:

CDS Contracts:

- No collateral has been posted to Bank X in respect of the CDS contracts as the OTM exposure of (40) is more than offset by the ITM exposure on the IRS and TRS contracts.
- Assets received as collateral are not directly attributable to the exposures on individual OTC contracts
- What should be reported under section 2e (page 173) for fields 27, 28, 29, 31 and 32?

IRS and TRS Contracts

- Collateral received Eur100 for OTC contracts with MTM ITM Eur150, due to offset of CDS contracts.
- Assets received as collateral are not directly attributable to the exposures on individual OTC contracts
- What should be reported under section 2e (page 173) for fields 27, 28, 29, 31 and 32?

General

- These difficulties will be significantly increased in circumstances where individual trades or OTC instrument types are required to be reported to different trade repositories whether in same or different jurisdiction. How might such reporting be achieved?
- If collateral is able to be reported on a portfolio basis (as set out in Article 6 (page 169) – for which there is little detail), how might this operate with multiple trade repository reporting requirements across multiple counterparty relationships?