



AGA/JA - n° 4167\_09/Div.

**Template for the Responses to the Discussion Paper on the Clearing Obligation under EMIR****A. Respondent**

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**Name: AFG****Country: France****Category:** please use the table below

| <b>Category</b>                             | <b>Please select</b>                |
|---|-------------------------------------|
| Audit/Legal/Individual                      |                                     |
| Banking sector                              |                                     |
| Central Counterparty                        |                                     |
| Commodity trading                           |                                     |
| Government, Regulatory and Enforcement      |                                     |
| Insurance and Pension                       |                                     |
| Investment Services                         | <b>Asset Management Association</b> |
| Non-financial counterparty subject to EMIR  |                                     |
| Regulated markets/Exchanges/Trading Systems |                                     |
| Other Financial service providers           |                                     |

**B. Introduction – General comments**

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The Association Française de la Gestion financière (AFG<sup>11</sup>) welcomes the opportunity to comment on the ESMA's Discussion Paper on the Clearing Obligation under EMIR. We thus express the French asset management's opinion on the topic.

Our members back the international and European efforts to enhance the security of OTC transactions and consider the general framework as designed under EMIR as a major step towards avoidance of systemic risk and increased confidence in financial markets.

We recall that the asset management industry is a highly and tightly regulated industry and it presents an original business model that should not be considered as part of banking. The asset management invests money of its clients in

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<sup>11</sup> The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include 425 management companies as of end January 2012. They are entrepreneurial or belong to French or foreign banking, insurance or asset management groups. AFG members manage 2,650 billion euros as of end December 2011, making the Paris Fund Industry the leader in Europe for the financial management of collective investments. In the field of collective investment, our industry includes – beside UCITS – employee savings funds, schemes and products such as regulated hedge funds/funds of hedge funds, private equity funds, real estate funds and socially responsible investment. AFG is of course an active member of the European Fund and Investment Management Association (EFAMA) and of PensionsEurope. AFG is also an active member of the International Investment Funds Association (IIFA).

a precisely defined framework. If variation margin on a daily basis is essential to market stability, the need for initial margin is questionable on OTC transactions where counterparties agree on the terms they work together.

In addition to AFG's specific responses, we would like to highlight in this section main concerns expressed by our members:

#### *Collateral restrictions established by the CCPs*

We are concerned that, when the clearing obligation will start to apply, CCPs and Clearing Brokers might enforce requirements regarding collateral quality that will be particularly hard and costly to meet and that will go beyond what is required through regulation.

As asset managers, we indeed observe that CCPs tend to excessively limit the scope of eligible collateral to only accept high quality assets – for example, by only accepting government bonds issued by a narrowed list of Member States. Clearing Brokers add a second layer of restrictions by adding limits to the CCP's collateral matrix. Those requirements are usually narrower than those set out by the European regulation.

This would generate considerable costs and tremendous constraints for Clearing Broker's clients and consequently for final unit holders, since the type of collateral influences the price of a transaction (and for certain funds it may even be lethal). It may also have consequences in terms of liquidity drain.

We strongly believe that should be taken into account in the process of CCPs authorisation the ability to accept a large class of assets as collateral without limiting the scope of eligible collateral beyond the conditions fixed by the relevant European regulation.

#### *Full segregation and counterparty risk*

The purpose of central compensation is to reduce risk and it can only be achieved under the condition that all actors have a total confidence in the solidity of CCPs that concentrate all the counterparty risk that was earlier spread on several entities; this implies on one hand that capital structure, default waterfall, access to central bank liquidity of CCPs be undisputable and on the other hand that CCPs offer to investors obliged to compensate a structure of accounts that they accept; in that respect total segregation in the books of the CCP at the level of the end client and not the member firm should be a prerequisite before any obligation to clear is decided. Our members think that regulators should be at ease with a zero counterparty risk weighting for CCPs.

#### *Legal and operational infrastructure*

In order to guaranty a smooth and successful implementation of clearing obligations under EMIR, our members are of the opinion that readiness of the CCPs, market counterparties and the availability of necessary legal and operational infrastructure are key elements to be carefully considered by ESMA before classes of OTC derivatives become mandatory for clearing.

#### *Regulatory requirements applicable to asset managers*

AFG strongly believes that any process of consideration of a new clearing obligation shall take into account the regulatory requirements applicable to asset managers. Regarding OTC products, for instance, asset managers have an obligation to be able to recall any deal through an unilateral termination right applicable at any time; this characteristic should not be overlooked by regulators when imposing a clearing obligation (CO);

#### *At least two to three CCPs*

For our members, it is essential that not only one CCP is admitted to clear a specific product but that market participants have the choice amongst different CCPs to avoid concentration of a market segment with only one CCP. Clearing should only become mandatory if there are at least two to three CCPs licensed to clear a specific derivative.

#### *Capacity of clearing members*

Also, the capacity of clearing members offering clearing services to their client base must be taken into account. Buy-side participant like asset managers wish to avoid situations where at the introduction of a clearing obligation available, clearing members cannot absorb the strong client demand. In such situations funds could be de facto

prevented from accessing certain product types necessary to implement their strategy because it was not possible to implement legal and operational set up with clearing members in due time.

#### *Sufficient time needed*

Also and without sufficient time and phase in periods given to buy-side customers, the negotiation of clearing documentation will become an empty exercise as due to time constraints buy-side customers will either have to accept unbalanced conditions imposed by clearing members in order to meet the regulatory clearing deadline or cannot trade clearable products which can have severe impact on fund management and strategies.

#### *Structured equities*

Our members are of the opinion that structured equities are not eligible for compensation since they lack standardization and liquidity (for instance: equity transactions for the specific purpose of structured funds are tailor-made).

In any case, AFG stresses the necessity of a grand-fathering provision in order to exempt from CO pre-existing structured funds as defined by the KIID regulation. The financial equilibrium of these funds would be totally impaired by CO and eventually fund holders would be adversely impacted.

#### *Key Characteristics detailed in the RTS*

If the Key Characteristics detailed in the RTS are not specific enough, every future modification will be achieved through the Register and thus without any mandatory consultation of the stakeholders. It is our view that, in order to insure that such stakeholders' concerns are heard and taken in account before any major change in the scope of the clearing obligation, Key Characteristics should include enough class and sub-classes of assets and thus be very precise. It will also help avoiding ambiguities in the practical application.

We however take into account the need for flexibility in the determination of cleared assets and are not opposed to the use of the Public Register for the more detailed and technical sub-classifications.

#### *Trade Repositories with limited scope*

Our members are concerned that the multiplication of TRs with limited scope of activities may transform the obligation to report in an operational nightmare. It would simply not serve the purpose of centralization of deals and positions in a single entry point and could prove ineffective and costly. Thus, TRs should be required to offer a service on all OTC products that have to be reported.

## **C. Comments on the discussion paper and answers to questions**

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### **1. Procedure for the determination of the classes to be subject to the clearing obligation**

#### **Comments on paragraphs 7 to 17:**

AFG believes that the Compensation Obligation (CO) should not be decided without a fair consultation period, whatever the delay that this implies. It is key to the process and a minimum period of 2 months should be granted for market participants to answer.

The question of imposing CO even if only one CCP effectively clears a product is very important to our members. AFG wants to stress that our members are highly reluctant to be obliged to clear with a CCP which they judge of poor quality.

AFG also believes that ESMA should rely to the greatest extent possible to ISDA taxonomies and ensure internationally harmonised definitions of classes of OTC derivatives.

### **2. CCP-cleared classes of OTC derivatives**

#### **Comments on paragraphs 18 to 30:**

AFG agrees with ESMA views to rely primarily on the underlying economic benefit when identifying classes (§26). It shares the pragmatic analysis that Classes should be defined on the basis of a few key characteristic defined at the RTS level (that implies the consultation process) and that other characteristics will complement the identification of each contract at the level of the Public Register (section of classes subject to CO).

As set out in Table 1 (p.11), we note that all asset classes are cleared by at least 2 CCPs. AFG would like to stress that any authorisation of clearing a new asset class may only be given if 2 CCPs' offers on that asset class are available.

## 2.1 Credit derivatives

### Comments on paragraphs 31 to 39:

We agree to the use of ISDA taxonomy for the key characteristics.

#### Question 1 (Series for Index CDS):

Please indicate your preference between the options presented. Do you believe that the possibility for a new series to exhibit low liquidity is a risk worth being considered when defining the classes of Index CDS? Under Option C, which criteria do you believe are relevant and how should they be calibrated?

#### Answer 1:

Our members expressed several arguments both in favour of options A and B.

Indeed, there are valid arguments in favour of option B. For instance, some members believe it gives certainty to users of the new series without delay (which is essential, especially if back loading is required when CO is decided) thanks to the automatic CO and provides for flexibility through the capacity to remove series from the CO a posteriori. The process for this withdrawal includes, as defined in §37, transparency on rationale and reference to criteria predefined in RTS. Effectively the risk of low liquidity of a series is real and may also lead to reconsidering the classes subject to CO if several successive series prove illiquid.

However, there are also valid arguments in favour of Option A that would permit to avoid the exclusion of names not liquid enough to the clearing but that would have benefited of liquidity through the CO. Liquidity risk is not always an appropriate criterion for clearing. In some cases, there is a risk of confusion between an asset class subject to clearing obligation and liquidity of such asset class. Indeed, we may imagine cases where if it is not considered as clearable but at the same time it could condemn its liquidity. An alternative option proposed by some of our members could be considered where we keep Option A and we mix with Option C by saying that any series of Index that has more than [7] years, where no transaction has been observed for an extended period of time (for example, 1 year), then it can be removed from clearing.

Criteria based approach may be dangerous as manipulations on some criteria (volumes for example) can push some series out and be harmful in terms of costs for final users (capital cost for non-cleared derivatives, illiquidity, cost of unwinding traders outside of a CCP...).

In any case, we are of the opinion that ESMA should monitor classes subject to CO to confirm that it is still relevant.

#### Question 2 (Index CDS):

Do you consider that the main characteristics of Index CDS are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

#### Answer 2:

Globally, our members tend to believe that the main characteristics of Index CDS are correctly captured within the proposed structure. That being said, our members point out also that currency is a direct risk when geographical exposure has no direct financial consequence.

#### Question 3 (Index CDS):

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

**Answer 3:**

Our members do not have strong views. In general, they are of the opinion that all the items of this view shall be cleared and be used to hedge systemic risk. Shall a priority list be determined, they would remove only the iTraxx Hi Vol and the CDX NA IG High Volatility which are slightly less liquid and have less systemic risk should they lose liquidity due to non-clearing.

**Comments on paragraphs 41 to 44:**

Our members perceive the geographical zone / Currency issue as broader than mentioned here. A CDS is also defined by certain Credit Event linked characteristics. Therefore the ISDA has already defined some standard for geographical zone / type of issuers, its seniority and in some cases the nature of the issuer (sovereign, insurance...).

Additional characteristics: type of set of standard (SNAC, SEUC...)

**Question 4 (Single name CDS):**

Please indicate your preference between the options presented. In relation to Option B, which geographical zones would you define, i.e. how could the currencies be grouped in geographical zones? What is the standard market practise in this respect?

**Answer 4:**

Our members tend to think that it would be more advisable to adopt option B since it appears to be the easiest one to implement and that, when dealing with Single-Name CDS, the Geographical Zone matters more than the settlement currency.

Our members would tend to stick to geographical zone as defined in standard ISDA matrix such as European Corporates, Sovereigns, Insurance. However, another suggestion could be to put together geographical zone and the sub type of product in a new characteristic called "transaction type". It would leave room to add currency as another key characteristic. Reference to the transaction type gives indications on the nature of credit events that will apply when currency points to a foreign exchange risk to which the investor will be exposed.

**Question 5 (Single name CDS):**

Please indicate your preference between the options presented. Under Option C, which criteria do you believe are relevant and how should they be calibrated?

**Answer 5:**

Our members favour option B.

This option is seen as referring to an indirect criterion, such as membership to an index, to define single names whose CDS will be subject to CO. It is far more convenient than the extremely long process of going through RTS to select a new name even if some corporate action, such as merger, could be identified and dealt with in the initial RTS. ESMA should be granted the right to add or withdraw at the level of the Register tenors that would not be actively traded. In option B this right of a posteriori withdrawal should also be granted as some names which belong to an index might not be liquid.

Although our members think that option B is the most practical option - especially as a first step for the first wave of clearing - , they also believe that additional criteria may be needed to Option B such as the size of outstanding bond issues for the relevant issuer and past liquidity. There is a risk of pushing the market on a concentrated number of Single Name CDS.

Our members understand that a *credit* that is not in an index can be anyway eligible using liquidity criteria. However this should not be the only criteria as some market participants need to use CDS for hedging purpose or to benefit from an exposure on credits that are illiquid in the cash bond market. Using only liquidity criteria may create a 2 tiers market where *credits* that are not obliged to be cleared are not proposed for clearing in any CCP and hence are penalized by bank regulatory capital costs that may reduce further their liquidity.

**Question 6 (Single name CDS):**

Do you consider that the main characteristics of Single Name CDS are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

**Answer 6:**

Our members think it would be interesting to highlight as an additional criterion the Debt ranking (Senior, Sub...), doc standard (SNAC, SEUC, SSEI, New vs old doc regarding European bail in CDS...).

Also, the current practice for Single Name CDS is to have physical settlement. If such practice is altered by the new clearing obligation and cash settlement becomes a new settlement method, we consider that a distinction should be made regarding the type of settlement (cash or physical) of the transaction.

With single names the national legal framework is very important as it may include procedures that might arguably not be considered as an event of credit or that will impact the rate of restitution or the delays for such restitution in case of default of the issuer. These elements are also important in the process of evaluating a CDS. Thus, our members would also suggest as a complement to geographical zone to add an indication of the “nationality” with reference to the law applicable in case of default.

More generally, criteria not currently relevant for central clearing might be necessary to include in the Register in the future as central clearing goes further to include new types of deals. The structure of the Register has to be flexible but its governance should be discussed at the time when draft RTS will be circulated for consultation.

**Question 7 (Single name CDS):**

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

**Answer 7:**

Our members believe that it is very important that index components are cleared if index CDS are cleared.

We think that CCP's shall offer clearing on the broader possible universe. The market will naturally select the most suitable names. If it is done the other way round (names that are not very liquid are not cleared), this may condemn the liquidity of some names that may end up never cleared, never traded.

## 2.2 Interest rate derivatives

**Comments on paragraphs 52 to 58:**

Figures evidence that interest rate derivatives are by far the most active part of OTC derivatives. Even if a total of 7 key characteristics may lead to a high number of classes, the level of granularity seems adequately defined: numerous classes but with heavy volumes in many cases and homogeneity within a given class. The introduction of such characteristics as “embedded optionality” without going further in the types of options or “currency type” to cover multi- currency deals enable a large coverage of existing transactions without multiplying classes.

**Question 8 (Interest rate derivatives):**

Do you consider that the main characteristics of the interest rate derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

**Answer 8:**

Our members wonder if the distinction made between different notional types is relevant. Indeed, if the conditional amount means that the notional amount of the swap is not a known number or a schedule of numbers but may change based on the occurrence of some future event (cf. § 53), there appears to be some type of optionality and the preceding characteristic should be sufficient to define the class.

It should be discussed whether the proposed characteristics properly define such products which are not currently cleared but could be in the future. Caps, Floors, swaptions are mentioned §54 and the possibility to include them in the proposed taxonomy must be investigated more thoroughly.

With reference to basis swaps, the assumption seems to be that the second part of the swap is the corresponding OIS rate when some basis swaps refer to Euribor with two different maturities (for example: Euribor 6 months / Euribor 3 months). Thus, a mention of the second side of the swap should be provided for, either as a specific characteristic or as part of the definition of the type of swap instead of mentioning only one floating rate index.

A maximum flexibility should be granted on the maturity and the deferred start of a swap in order to cover the largest number of transactions.

#### **Question 9 (Interest rate derivatives):**

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

#### **Answer 9:**

Our members believe that due to their amount and sensibility, LT plain vanilla IRS should be considered as a good candidate for CO. Phasing in should start with more than 10 year deals and come down to more than 3 year ones. Short term swaps should not be immediately subject to CO, because of their lower level of risk. Exemption should be considered for them, especially if other jurisdictions grant it.

Furthermore, in our members' view, the best candidates could be Fixed-To-Float, FRA and OIS rather than Basis Swaps. In the Fixed-to-floating Class, the Basis Swap Class and the FRA Class they would privilege the clearing of swaps indexed on EURIBOR or LIBOR. In the OIS Class, they would privilege swaps indexed on EONIA.

### **2.3. Equity derivatives**

#### **Comments on paragraphs 59 to 70:**

We would like to point out that Equities are far less standardized than, for example, CDS, because of the interference of the Corporate Events.

#### **Question 10 (Equity derivatives):**

Please indicate your preference between the options presented. Under Option D, which criteria do you believe are relevant and how should they be calibrated?

#### **Answer 10:**

AFG prefers Option C (MiFID list) because it is fixed between two annual reviews.

A cross reference to the list of liquid shares in MIFID gives strength and coherence to the European regulatory framework and limits the number of definitions. Criteria for the determination of the list of liquid shares converge with those specified in EMIR but they are not identical. The standardisation of derivatives can be measured at the level of the product type and availability of price depends very much on the liquidity of the underlying. However the periodical review of the list on an annual basis might be too slow and ESMA should be recognised powers to take temporary measures in case of corporate events or sudden and final absence of liquidity. A right to withdraw a posteriori one name from the list should be granted at the level of the Public Register.

Among the other options, option A which lists the names of the entities whose derivatives will be subject to CO is burdensome and lacks reactivity and flexibility, option B referring to membership to an index is not appropriate for equities where numerous indices are used, option D presents the usual drawback of a criteria-based approach in terms of delays and back loading uncertainty.

### **Question 11 (Equity derivatives):**

Please indicate your preference between the options presented.

In relation to Option B, which geographical zones would you define, i.e. how could the currencies be grouped in geographical zones? What is the standard market practise in this respect?

#### **Answer 11:**

Option A (based on currency) could be interesting as it would be the easiest one to implement.

Option C may also be recommended. In order not to create too many different classes, currency and geographical zone could be dealt with at the level of the Public Register. However, this solution gives discretion to ESMA to impose CO on contracts of the same class with different currencies without consultation. Or, our members believe that ESMA should not be entitled to impose CO if the settlement currency is not totally freely negotiable and transferable or if there is only one CCP considering this currency as an adequate basis currency and having access to the central bank in this currency.

### **Question 12 (Equity derivatives):**

Do you consider that the main characteristics of Equity OTC derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

#### **Answer 12:**

When discussing the key characteristics identified in §60, ESMA does not elaborate on the third criterion, the transaction type. Obviously CFD, swaps/forwards or options are totally different derivatives. They present highly different return profiles and cannot easily be substituted one for the other.

### **Question 13 (Equity derivatives):**

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

#### **Answer 13:**

Equities are not the best candidate for the clearing obligation and should only be included in its scope after IRS and CDS. Within equities, indexes are the best candidates since they are more liquid, standardized and that they represent an important volume of transactions. Requiring the clearing of Basket Equities might be unmanageable since they are tailor made.

Moreover, we believe that structured equities are not eligible for compensation since they lack standardization and liquidity.

## **2.4. Foreign Exchange derivatives**

### **Comments on paragraphs 75 to 78:**

Our members are convinced that it is necessary to coordinate at an international level and as far as FX is concerned to decide not to include those products that are not within the scope of DFA in the USA.

Apparently the problem of creating too many classes is not an issue for FX derivatives. It is however surprising to consider that all characteristics are considered to be key. Thus, in our members' view, the exercise of separating key from complementary characteristics has to be conducted.

**Question 14 (FX derivatives):**

Do you consider that the main characteristics of the FX derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

**Answer 14:**

The first key characteristic identified in § 76 is the type of product and it is correct to separate the derivatives according to their economic benefit. The following characteristics listed in § 78 should be split into two categories: key characteristics include notional and settlement currencies and the other two characteristics are complementary indications dealt with at the level of the Public Register: maturity and type of settlement.

**Question 15 (FX derivatives):**

Do you have preliminary views on the specific items of the presented class which would be the best candidates for the clearing obligation, in view of the criteria to be assessed by ESMA, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

**Answer 15:**

We would like to stress the fact that FX derivative transactions present less market risks than many other classes of assets. Appropriate platforms like CLS allow real-time settlement between counterparties by matching the corresponding debit and credit entries across Settlement Members. There is therefore no Settlement risk linked to those transactions.

Moreover, the counterparty risk of FX transactions with a short maturity is negligible. In our opinion, FX derivatives with a maturity < 3 months should not be subjected to the clearing obligation.

For that matter, the Dodd Frank Act did not include the FX in its mandatory clearing requirement. It is our view that discrepancies between European and US regulation would lead to market disruption and are to be avoided: it would be reasonable to converge.

Please note also that the Financial Services and Markets Act 2000 (Regulated Activities) do not consider the FX transactions with a maturity < 7 days as derivatives: those contracts could not be subject to the clearing obligation.

**2.5. Commodity derivatives**

**Comments on paragraphs 79 to 84:**

Consistence requires that the type of transaction which is first level of differentiation for FX transactions be considered as key characteristic when dealing with commodities.

The foot note to explain the biofuel case suggests that the proposed classification is not satisfactory and certainly not clear enough for non-professionals. The exact underlying asset has to be included in detail in the complementary characteristics.

**Question 16 (Commodity derivatives):**

What is in your view the best approach to specify the underlying assets within each OTC Commodity class?

**Answer 16:**

Our members ask whether the 17 category classification helps. Clearly the first level classification in 6 "Base Products" has to be introduced. Clearly the exact underlying contracts have to be identified. Intermediary granularity does not help much apparently.

**Question 17 (Commodity derivatives):**

Do you consider that the main characteristics of the Commodity derivatives are adequately captured by the proposed structure? Are there any other variables which you consider as relevant in the context of the clearing obligation?

**Answer 17:**

Our members suggest that the taxonomy include two key characteristics: product type based on the first level 6 categories on one hand and transaction type on the other. Settlement currency and settlement type are together with the exact names of contracts additional characteristics that could be dealt with at the level of the Public Register.

**Question 18 (Commodity derivatives):**

Do you have preliminary views on the specific items within those classes which would be the best candidates for the clearing obligation, taking into consideration the overarching aim of reducing systemic risk and the criteria defined in Article 5(4) of EMIR?

**Answer 18:**

No.

**3. Preliminary analysis of the readiness of asset classes vis-à-vis the clearing obligation**

**Comments on paragraphs 85 to 105:**

ESMA refers in § 88 to the obligation for signatory members of the ODRG to consult before making a derivative class subject to CO in their constituency and to consider extending that obligation to their jurisdiction. This approach is very important and constitutes a major progress in international coordination.

In 3-4 ESMA takes a shortcut to examine standardisation through the usage of electronic trading, matching or confirmation platforms. Contractual documentation and operational processes have to be investigated in depth as ESMA points out in § 104. Contracts relating to the derivative transactions have to be standardised, but they are not the only ones to be considered: relationship of an end client with the Clearing brokers members of the CCP may largely vary as well as the relationship between the end client and the CCP. These contracts must be analysed before deciding of any CO as they are capital to the general architecture of central compensation. They are currently discussed and do not seem to be largely circulated which leads to suspect large differences.

**Question 19 (readiness of the classes):**

Do you agree with this analysis?

**Answer 19:**

We broadly agree with this analysis: like successfully proven in the US interest and credit derivatives should be first in the list of clearable products. Indeed, IRS and CDS are the two classes of assets that are ready to be cleared. We would also like to stress again that equities are not ready to be cleared because they lack standardization.

Notably in the equity space ESMA should reconsider key elements and other product characteristics to evaluate the appropriateness of a clearing obligation. The large bespoke product scale in equity derivatives has to be assessed in more detail and the current approach proposed by ESMA seems too simplistic in this regard. The risk to catch up inadvertently non-clearable products because of too broadly designed RTS and Public Registers should be to the greatest extent possible eliminated.

Our members insist upon the fact that a thorough analysis of standardisation be undertaken before any CO is imposed on OTC. Contracts with clearing brokers and CCPs are far from being standardised and are not even finalised in many respects.

The usage of an electronic platform to confirm transactions does not imply that operational process is standardised enough as these platforms include some areas where specifications can be hand written. Similarly many factors are determined on a case by case basis such as eligible collateral, absence of initial margin, delays, haircut, calculation agent... and central compensation imposes a single process on these issues. It is not possible to infer from the usage of a platform the fact that operators are ready to switch to central compensation.

## 4. Determination of the phase in, and the categories of counterparties to which the CO would apply

### 4.1. Dates, phase in, categories of counterparties

#### Comments on paragraphs 106 to 115:

For our members, there is no doubt that the discussion on the possibility to impose CO even if only one CCP clears a product is not only a question of delays but of principle. Monopoly is not a favourable situation. Imposed counterparty without choice is outrageous for an investor which considers safety as essential. Our members can reject to compensate with some CCPs for instance because of: insufficient financial solidity, shareholding creating conflicts of interests, operational difficulties, inappropriate level of segregation, improper default waterfall, high dependency on a limited number of members, low quality of some of the members.

#### Question 20 (dates, phase in):

What would you consider to be the shortest delay to impose a clearing obligation to a class of OTC derivatives when there are several CCPs available? And when there is only one CCP available?

Please specify in your answer whether the cause of delay is due to operational issues (e.g. time for CCP/counterparties to be ready for the CO) and/or to market issues (e.g. time for a CCP to add a new product to its offering).

#### Answer 20:

12 months with direct access: Where several CCPs are available a minimum delay of 12 month seems in general reasonable where counterparty would access the CCP directly.

18 months for indirect access: Buy-side counterparties who do not access the CCP directly and which trade lower volumes of derivatives than major dealers should benefit from an additional time period (i.e. 6 month) to comply with the clearing obligation taken into account that they have to set up the legal and operational infrastructure with one or more clearing member(s). Indeed, the compliance with the clearing obligation will require our members to establish new processes and it would be unmanageable if they have to do so within a short delay. For entities that need to use a Clearing Member, additional documentation and operational set-up will be needed.

It does not seem reasonable to impose mandatory clearing to a class of OTC derivatives where only one CCP is available. Concentration of a clearing activity on a specific class with one CCP will increase systemic risk.

Our members consider that it is part of their fiduciary duty to their clients to undertake a full due diligence process before agreeing a CCP as well as a clearing member. They cannot pretend that ESMA's decision to impose CO exempts us from this process. On the other hand, our members cannot stop trading OTC that are beneficial to the clients and part of the strategy they accepted when selecting the fund on the basis that these products are subject to CO.

Also, our members strongly believe that the possibility to achieve full segregation (of assets and not estimated value of the assets) with a third party acting as custodian of the deposited collateral is a prerequisite before imposing CO. In that respect AFG urges ESMA to reconsider its interpretation of article 47-3 of EMIR directive as expressed in its Q & A.

#### Question 21 (dates, phase in):

What would you consider to be a reasonable delay to allow CCPs which clear the same asset class or a similar Class+ to clear a new Class+?

#### Answer 21:

We do not think that EMIR enables ESMA to impose a delay for a CCP to clear a new type of derivative, even if it belongs to the same class as another product this CCP already clears. Our understanding is that if ESMA, in a top down approach, suggests that CCPs clear a product, it can only ask for marks of interest and has no power to force a CCP to clear a derivative.

If the question relates to the time period offered to non-clearing CCPs to match the offer of other CCPs to clear a new class, then we think sensible to develop competition. The necessary delay is not for us to define. It is probably enough for a CCP to know that another CCP has been authorized by its local authority to clear a new product and that ESMA contemplates imposing CO on this product. The investigation by ESMA will take some time, the phasing in necessary before implementation of CO will add some months: a sufficient delay for a reactive CCP to build an offer and get the authorisations on time.

**Question 22 (dates, phase in):**

What should be the assumption regarding market share which the CCP would have to be able to assume? Should it be requested that each CCP be able to handle the whole volume to tackle the worst case scenario?

**Answer 22:**

AFG believes that the tests should include the buy-side and not only the sell-side in order to be more accurate.

Also, we are of the opinion that the CCP should commit itself to prepare necessary means to meet the volume that it will clear. This leaves the responsibility with the CCP and ESMA should check the reality of the commitment and the existence of technical and human capacities to deliver.

**Question 23 (dates, phase in):**

What should be the elements (e.g. number of transactions, increase in risks, number of active counterparties, new jurisdiction involved) for ESMA to investigate, after consulting the NCAs responsible for CCPs authorisation, on the ability of the relevant CCPs to handle the expected volume and to manage the risk arising from the clearing of the relevant class of OTC derivatives?

**Answer 23:**

We would like to stress again that in the process of CCPs authorisation, the ability to accept a large class of assets as collateral without limiting the scope of eligible collateral beyond the conditions fixed by the relevant European regulation should be taken in account. ESMA should thus investigate the capacity of a CCP to accept all the collateral permitted by the European regulation.

The existence of a fully segregated offer with possibility to use a third party as custodian for the collateral deposited with the CCP is also a key point before deciding of CO. The quality of the CCP itself should be checked again by ESMA as it is very different to authorise actors to use the services of a CCP or to impose them to go to a specific or a limited number of CCPs that clear a product subject to CO. Own capital, fully paid or committed, guarantee funds mechanism and real depth of the sub-fund dedicated to the considered derivative and scope of the other derivatives covered by the same sub-fund, quality and concentration of members, currencies available and access to central bank money, shareholding, risks of conflicts of interests, methodology and robustness of the model for computation of margins, cross margining policy, segregation of assets, technical equipment and human means... ESMA cannot avoid going further in depth than the local authority when investigating the ability of CCP to be eligible to CO.

**Question 24 (dates, phase in):**

Should there be a default period of [x] months whenever there is a need for a CCP to upgrade its service considering incompressible internal/external validation processes? If not, how to evaluate the time to upgrade services based on the result of the criteria assessment?

**Answer 24:**

CCPs are not ordinary commercial firms as they provide essential services under a regulation that transfers to them part of a public service. As such, they must be professional and continuously adapt to the evolution of their activities. It cannot be provided for a delay to become compliant, it is a permanent obligation. It is up to the CCP to decide which type of activities it will temporarily drop or close down.

**Comments on paragraphs 120 to 128:**

EMIR already categorises counterparties. It is not up to ESMA to introduce new sub-categories. Conversely, introducing thresholds does not add on the architecture of EMIR and is acceptable.

**Question 25 (categories of counterparties):**

Please indicate your preference between the options presented. Would you rather use an option that is not detailed here? Under Options B and C, do you agree to base the clearing access approach on the asset class to which the counterparties have access? What should be the date on which clearing access/threshold calculation should be assessed?

**Answer 25:**

We share ESMA's analysis that counterparty characteristics must be defined in a clear and unambiguous manner to allow market participants to define their status with respect to mandatory clearing and the regulatory deadline from which on they must comply with the clearing obligation.

This being said we clearly think that Option A is not adequate. Current available counterparty categories under EMIR are not appropriate in this context.

Solutions B and C seem more reasonable as they take into account either the ability to directly access clearing or the importance of counterparty's activity. Both clearing access and volume are key criteria.

From our point of view counterparty's activity in an asset class should be considered as the relevant factor and so Option C would be our preference. Indeed, option C relies on the importance of counterparty's activity. It is a simple criterion, apparently easy to implement and control and totally consistent with the risk mitigation objective of the regulation. Reference date to measure the threshold (to be calculated at the level of the asset class) could be at the date when RTS comes into force. This would allow actors to organise for a proper monitoring of the threshold and be efficient at the time of implementation. In respect of determining the volume under Option C, we could have a similar approach than the thresholds based on the aggregate month-end average notional amounts as used in the OICV-IOSCO Margin Requirements for non-centrally cleared derivatives.

**Question 26 (categories of counterparties):**

What would in your view be the appropriate timeframe for counterparties with / without access to clearing in the relevant asset class?

**Answer 26:**

Our members believe that the timeframe should be at least 18 months for buy-side counterparties who do not access the CCP directly.

**Comments on paragraphs 129 to 130:**

If a counterparty does not get access to clearing, it should stop executing new trades but should be authorised to carry the existing ones and to operate resets and other modifications of existing trades as long as they do not increase its exposure.

**Question 27 (categories of counterparties):**

Do you agree that a key factor to take into account when defining the phase in for the counterparties to comply with the clearing obligation will be the number of clearing members offering client clearing services? Is the client clearing capacity of the CCP also a relevant factor? What could be the other criteria?

**Answer 27:**

We totally agree with this analysis and are of the opinion that ESMA should pay utmost attention to the number of clearing members offering client services and the environment of this offering. The number of clearing members offering client clearing services is indeed important: if all clients choose the same clearing member, there is an operational risk of bottleneck.

Buy side customers like asset managers will access CCPs not directly but via clearing members with which they already have established clearing facilities for futures or options or PB relationships. As the circle of experienced and

operationally well-equipped clearing members is limited, we expect a strong client demand to on-board funds at the outrolling of clearing obligations and sufficiently set phase in periods are condition to handle the bulk demand in an appropriate manner without disadvantaging any group of clients.

Also the clearing documentation to be brought in place must be the result of a balanced negotiation and therefore time is of essence for counterparties who will not access CCP directly.

Capacity of a CCP to absorb client clearing demand is a well related to the number of CCP which can offer clearing of a specific asset class and therefore again the importance to have more than one CCP has to be underlined.

Another key factor looks important to us: the clearing member should be plugged to all CCPs from the beginning.

It is also essential that CCP offers full segregation to end client passing through the clearing member and third party custody.

## **4.2. Minimum remaining maturity of the OTC derivative contracts referred to in EMIR Article 4(1)(b)(ii)**

### **Question 28 (remaining maturity):**

What are your views regarding the calibration of the remaining maturity of the contracts to be subject to the CO? What criteria should ESMA take into account when defining it?

#### **Answer 28:**

We suggest a remaining maturity of 3 years for all assets.

The purpose of clearing being to reduce the counterparty risk, the risk level of a transaction could be taken into consideration. Volatility could be another key criterion: less volatile products are less risky and remaining maturity could thus be longer for such products.

AFG believes that non-significant deals in terms of notional amount (50 million) already entered into should not be reported.

AFG stresses the necessity of a grand-fathering provision in order to exempt from CO pre-existing structured funds as defined by the KIID regulation ("called "formula funds" in France) that are no longer open to public subscription and have a determined maturity. The financial equilibrium of these funds would be totally impaired by CO and eventually fund holders would be adversely impacted.

## **5. The clearing obligation in specific cases**

### **5.1. Contracts concluded with Covered Bond issuers**

#### **Comments on paragraph 136 to 138:**

The issue of covered bonds and the segregation of their cover pool is clearly stated in § 138. It is not clear however that this is a question for CCPs. It is more likely a question of legal structuring of covered bonds and different legislations may bring different answers. The questions at hand relate to the necessary steps to ensure that the cover pool is totally bankruptcy remote and segregated, the capacity for anyone to manage the pool and take decisions concerning the pool in case of bankruptcy of the promoter/sponsor/issuer of the covered bonds, the possibility to re-use assets in the pool as collateral... They are legal issues and once cleared on the legal side CCPs are able to offer an appropriate level of segregation and to understand the exact governance of the structure. A grand-fathering clause for existing pools (that do not increase their relative exposure to market risk), might be helpful while waiting for new types of structures are launched.

### **5.2. Foreign exchange OTC derivatives**

### **Comments on paragraphs 139 to 140:**

AFG strongly believes that for FX derivatives which are totally cross-border activities, a comparison with requirements of Dodd Frank Act in the USA is essential to ensure a level playing field internationally.

#### **Question 33 (FX derivatives):**

Within the foreign exchange asset class, for which type of contracts do you consider that settlement risk is the predominant risk, and what criteria or characteristics should be used by ESMA to identify those contracts?

#### **Answer 33:**

Structurally, for all FX derivatives (spot, currency swaps and forwards), the settlement risk is to be taken into consideration. The maturity of a transaction will determine the predominance of the settlement risk towards the counterparty risk.

### **5.3. Interaction of portfolio compression and the clearing obligation**

#### **Question 34 (Portfolio compression):**

Are there ways in which the imposition of the clearing obligation in the EU could hamper the effectiveness of compression services? If so, please provide evidence of the potential impact. Are there ways in which exclusions to the clearing obligation could be defined which alleviate the problem without creating opportunities for avoidance?

#### **Answer 34:**

The issue raised about compression deals relates more generally to the management of an existing exposure through partial netting or reset. If an exemption is granted to compression deals, it should apply to reset or partial netting of an existing OTC contract. The rationale and limitation for such an exemption is that it results in a diminution of the market exposure of both counterparties. CO, since imposing the CCP as necessary counterparty will diminish the number of deals available for compression and may lead to an unfortunate impossibility to reduce positions with one given counterparty. As long as the front loading period has not expired, counterparties should be granted exemption. After this period has expired, the rationale for an exemption is less evident.

### **5.4. How to withdraw a clearing obligation on a class or subset of it?**

#### **Comments on paragraphs 142 to 148:**

Our members are of the opinion that imposing CO is what ESMA is in charge of through the coming RTS, but there is an absolute necessity to be able to stop CO of certain contracts when they do not fulfil the criteria required for CO. The experience of derivative regulated markets has shown that very active contracts may become illiquid in a matter of months not to say weeks. It is sometimes difficult to explain why and how.

#### **Question 35 (Modification of a Class+):**

For which reason (other than the fact that a CCP does not clear it any longer) do you believe that the clearing obligation of a class - or subset of it - would need to be removed? Please focus on the risks which could stem from a clearing obligation on contracts which would no longer be appropriate for mandatory clearing and provide concrete examples.

#### **Answer 35:**

AFG members think that as soon as a class or subset of a class does not fulfil the criteria for CO it should be removed from the list. There is at first sight no reason why standardisation once reached would disappear. But liquidity and price availability can cease unexpectedly. Absence of prices most of the times is a signal for absence of liquidity as liquidity means transactions that must be conducted at a certain price. One could conclude that liquidity is the key

element. In fact the most important criterion is price availability which determines the level of illiquidity at which it is advisable that the CO must be removed. If very few transactions take place but that there is not much discussion about their price and if for example bid ask spread remains narrow there is no urgency to withdraw CO. But as soon as prices are questionable, removal should be decided. **The main risk in that case is to oblige CCP to compute IM and VM on the basis of questionable prices** and to discover in case of default that these prices were not realistic: the total solidity of central clearing would be challenged. Counterparties may also decide to circumvent the CCP and organise for protection through direct exchange of collateral.

**Question 36 (Modification of a Class+):**

In case a clearing obligation would need to be reviewed, how crucial would be the time needed to dis-apply the clearing obligation?

**Answer 36:**

AFG believes that when a clearing obligation is removed because a CCP has stopped clearing the product, its internal procedure must have defined how it deals with the situation and returns collateral and contracts to the clearing broker and the end client. This is widely eased if the end client has decided for total segregation and third party custody from the start. If removal is the result of a decision by ESMA, central clearing continues even if it is no longer mandatory and clients may restart a new contract outside the CCP if they prefer to turn to bilateral collateralization. Timing for dis-apply CO has to be carefully determined and should take into consideration the two cases described above. Return to bilateral relationship should be as rapid as possible, from one day to the other.

If you need any further information, please don't hesitate to contact Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr), Jérôme Abisset +33.1.44.94..96.56 (j.abisset@afg.asso.fr) at or myself at +33.1.44.94.94.29 (p.bollon@afg.asso.fr).

Sincerely Yours,

(signed)

Pierre Bollon