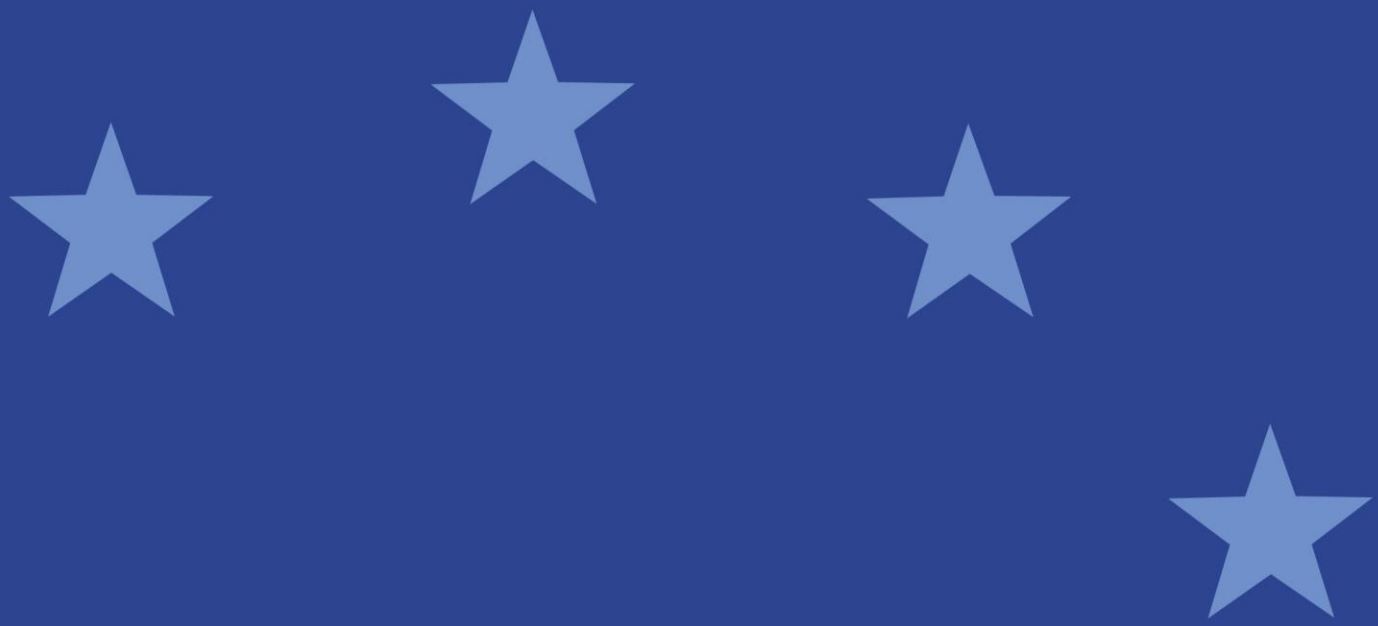
esma European Securities and Markets Authority

Reply form to the Consultation Paper on the Clearing Obligation under EMIR (no. 1)



11 July 2014|2014/799 Reply Form

European Securities and Markets Authority

Date: 11 July 2014
2014/799 Reply Form

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the questions listed in the Consultation Paper on the Clearing Obligation under EMIR (no. 1), published on ESMA's website.

Comments are most helpful if they:

- respond to the question stated;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

To help you navigate this document more easily, bookmarks are available in "Navigation Pane" for Word 2010 and in "Document Map" for Word 2007.

ESMA will consider all comments received by **18 August 2014.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

How to use this form to reply

Please note that, in order to facilitate the analysis of the responses, ESMA will be using an IT tool that does not allow processing of responses which do not follow the formatting indications described below.

Therefore, in responding you are kindly invited to proceed as follows:

- use this form to reply and send your response in Word format;
- type your response in the frame "TYPE YOUR TEXT HERE" and do not remove the tags of type <ESMA_QUESTION_1> Your response should be framed by the 2 tags corresponding to the question; and
- if you have no response to a question, do not delete the tags and leave the text "TYPE YOUR TEXT HERE" between the tags.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Legal Notice'.

Who should read this paper

All interested stakeholders are invited to respond to this consultation paper. In particular, responses are sought from financial and non-financial counterparties of OTC derivatives transactions which will be subject to the clearing obligation, as well as central counterparties (CCPs).

General information about respondent

Name of the respondent	AFG, Association Française de la Gestion financière
Are you representing an association?	Yes
Activity	Investment Services
Country/Region	France

Introduction

Please make your introductory comments below:

<ESMA_COMMENT_1>
AFG welcomes the opportunity to respond to the ESMA Consultation on the Clearing Obligation under EMIR (n°1). We deplore however the short deadline that occurs during the summer holidays period.

Our members approve the move towards enhanced financial stability and the resulting compensation obligation of standardized and liquid derivatives. We would like to highlight that the first consequence of the regulatory obligation to compensate is **an increased obligation on the regulators** to closely supervise and constantly monitor the approved CCPs in order to prevent any failure on their side that would definitely have a systemic impact.

Please see hereafter our general comments:

1. AFG members are afraid that the proposed **definition of classes submitted to mandatory compensation is too loose** and should be completed in the RTS with a specific reference to the terms of the offer of the approved CCPs. More specifically, AFG members sign IRS that are not so plain vanilla despite the fact that they are fixed/floating transactions. We query whether clauses that they use satisfy the requirement of standardisation and will not put these IRS out of the scope of the obligation to compensate. One way to answer is probably to look in detail whether CCPs (or just one of them) are practically able to supply compensation for these deals.

2. **Phase-in approach for regulated investment funds**. We agree with ESMA's proposal and **welcome the lengthy phase-in of 18 months for category 2 counterparties** (e.g. UCITS and AIFs).

3. **Front-loading requirements.**

   Our members agree with the idea that **frontloading** cannot have as a consequence to change the economical equilibrium of previous transactions and should at least be limited to the period when legal certainty has been reached, i.e. from the date of publication of RTS deciding the obligation of compensation. It is of utmost importance that **novated contracts are not caught** if they result from **'genuine amendments'** that do not circumvent the regulation but are due to usual events in the lifecycle of a contract. Otherwise, AFG members consider that the assessment of the standardisation, liquidity and prices availability of equity and other Interest rate derivatives made in **sections 6 and 7 is correct in its conclusion but arguable on many points of the analysis.**

   We welcome the proposal to effectively limit front-loading to contracts entered into during period B. **The industry is concerned, however, that the practical impact of the application of front loading to contracts with a minimum remaining maturity of 6 months, on the date of application of the clearing obligation will mean that the phase-in will be of little practical use to a large number of category 2 counterparties.**

   We therefore recommend in addition to fixing the **minimum remaining maturity for transactions that need to be compensated** to **2 years** two alternative approaches regarding the

implementation of the frontloading (remove the frontloading requirement or introduce a phase-in period for the frontloading obligation for category 2 counterparties).
<ESMA_COMMENT_1>

1 The clearing obligation procedure

Question 1: Do you have any comment on the clearing obligation procedure described in Section 1?

<ESMA_QUESTION_1>
AFG members have no extensive comments on the clearing obligation procedures described in Section 1 of the Consultation Paper. They share ESMA's view of grouping RTS by asset class and avoid consulting on each class a CCP is authorized to clear. We understand that this limits the time for the present consultation in order to fit in the 6 month delay after approval of a first CCP.
However, we feel that a more thorough analysis of the **exact clearing possibilities of each CCP** is necessary and should be included in the RTS on IRS, as it is on equity and other interest rate derivatives.
<ESMA_QUESTION_1>

2 Structure of the interest rate derivatives classes

2.1 Characteristics to be used for interest rate derivative classes

Question 2: Do you consider that the proposed structure defined here for the interest rate OTC derivative classes enables counterparties to identify which contracts fall under the clearing obligation as well as allows international convergence? Please explain.

<ESMA_QUESTION_2>
AFG would generally agree with the proposed structure of the interest rate OTC derivatives classes.

However, AFG members believe that the proposed classification is not clear enough to provide **legal certainty**. If we agree that the classification according to 7 characteristics mentioned in §§ 16 and 17 correspond to a current taxonomy in the industry, we stress that there are other criteria that might be relevant to better adjust the classification as mentioned in §§ 20 and 24. More generally, we think that for that type of bottom up approach, **a thorough study of clearing offers by the various CCPs is a pre-requisite** that is missing in the proposed RTS in order to more precisely define the limits of the clearing obligation. As it stands, our members understand that all transactions on IRS that are listed in the tables 1 to 4 attached to the RTS will be subject to mandatory clearing, provided that there is at least one of the approved CCPs that can clear it. If it is the case, it imposes on actors to analyse on their own the offer of the CCPs with more detail than what appears on the central register published by ESMA. We stress that it should be for ESMA to exactly define those contracts that are eligible for clearing at the date of the RTS and will be mandatorily cleared. It should be noted that our members regularly trade IRS that are not commonly cleared because of specific payment or reset frequencies or day count fraction methods…

Furthermore, the proposed RTS could be interpreted as meaning that if one CCP introduces a new flexibility enabling it to clear selected IRS with a character which made it 'unclearable' before, it might lead to an immediate obligation to clear without regulatory analysis and announcement. We strongly oppose that view and require the RTS to confirm that within a class, new contracts will not be subject to clearing obligation without a prior consultation and a new RTS defining the extension of the clearing obligation and fixing the date for the implementation as well as the conditions for a potential front loading.
These concerns are of great importance to our members because their practical impact is of consequence in their daily activities. As mentioned, they trade IRS with characteristics that limit their ability to be centrally cleared. Just as a matter of illustration, please see hereafter some concrete examples given by AFG members:

- Close out clause: UCITS must be in a position to close any OTC transaction they entered in at any time; this is not easy to organize with a CCP except if we traded at first with the clearing broker we use; it looks like UCITS will have to breach either UCITS rules or EMIR rules; we urge ESMA to express a clear position on this point already raised several times;
- Zero coupon IRS swap does not fit in the proposed categories as it implies a kind of third leg in the swap with the payment of an amount in order to compensate the difference between the nominal and the market value of the underlying asset; we consider it out of scope even if one day a CCP might propose some kind of clearing for them;
- Currently, CCPs seem to accept day count fractions on one end of the swap but not on both and our members use that type of swap to optimize the hedging of some portfolios; they do not want to be under the obligation to clear straight away without advance notice with the CCP that first organizes for the clearing of these swaps; the more so if for instance it is a CCP that our member does not want to work with;
- For cross currency swaps where the two legs are expressed in different currencies; we understand that they are excluded from the present RTS and belong to another class because they differ on one of the relevant criteria: settlement currency type.

Our members feel that in all these examples there is a legal uncertainty resulting from the absence of a precise definition of the extension of the clearing obligation. We urge ESMA to clarify this and suggest that it could be done through a more detailed analysis of the limits imposed by CCPs on the types of clauses they can accept in a centrally cleared transaction.

Concerns are also expressed that the draft RTS would not adequately reflect the proposed structure as outlined in the consultation paper (CP). Indeed, the CP (paragraph 22) states that derivative contracts that are (1) supported by CCPs and (2) have their seven characteristics meeting the scope of classes defined in section 3.2.4 (also in Annex I of the draft RTS) will need to be cleared. However the RTS only refers to the second part of the test. We suggest that ESMA includes an explicit reference to the first part of the 'two-step test' that either appropriately reflects the detailed terms that CCPs use to determine whether a contract can be cleared OR require the RTS to state that a particular contract will only be subject to the clearing obligation if it meets the seven characteristics outlined in Annex 1 of the RTS and an authorised or recognised CCP will actually clear the contract on its terms. This will minimise the burden on counterparties having to undertake their own analysis (on a trade-by-trade basis) of whether an authorised or recognised CCP is able to clear a particular contract.
<ESMA_QUESTION_2>

2.2 Additional Characteristics needed to cover Covered Bonds derivatives

Question 3: Do you consider that the proposed approach on covered bonds derivatives ensures that the special characteristics of those contracts are adequately taken into account in the context of the clearing obligation? Please explain why and possible alternatives.

Stakeholders (CCPs and covered bond derivatives users, in particular) are invited to provide detailed feedback on paragraph 38 above. In particular: what is the nature of the impediments (e.g. legal, technical) that CCPs are facing in this respect, if any? Has there been further discussions between CCPs and covered bond derivatives users and any progress resulting thereof?

<ESMA_QUESTION_3>
AFG agrees with ESMA's approach to identify derivative transactions made to hedge covered bonds as specific transactions not included in the standardized definition of the class submitted to the obligation to compensate. We have no particular comments on this question apart from the fact that the same question may be raised when considering the obligation for UCITS to benefit from a close out provision for any OTC derivative they conclude.
<ESMA_QUESTION_3>

2.3 Public Register

Question 4: Do you have any comment on the public register described in Section 2.3?

<ESMA_QUESTION_4>
AFG agrees on the principle of a public register available on ESMA's website. Such register will indeed enable all market participants (including investment fund management companies) to access in a timely manner all relevant data belonging to a class of OTC derivative contracts which is subject to clearing obligation. This will also help reducing research costs incurred by market participants who will no longer have to conduct their own research for each authorized or registered CCP.

AFG expresses some concerns regarding the practical implications of the public register process in cases where derivative classes should be removed from the register. Indeed, AFG thinks that ESMA should be able to remove quickly a clearing obligation in case of unexpected market circumstances, in particular in instances where the CCPs may impose extremely high margin requirements.

In this context we would like to take the opportunity to reiterate that UCITS may have substantial difficulties to provide cash collateral in cases of centrally and bilaterally cleared OTC derivative transactions under EMIR. The ESMA Guidelines on ETFs and other UCITS (published on 25 July 2012, (ESMA/2012/832EN)) restrict the re-use of cash obtained from UCITS repo transactions for such purpose. We fear that paragraph 42 of ESMAs Guidelines on ETFs and other UCITS issues hampers UCITS accessing CCP clearing. The mentioned guideline prohibits to post cash received in a repo transaction as collateral to a CCP respectively the clearing member. Since funds' borrowing is limited to 10% of the net asset value (NAV), it is obvious that UCITS will be hampered to use OTC derivatives subject to a clearing obligation. ESMA also needs to amend the Guidelines in order to allow the investment fund industry to continue to participate in the derivative markets by allowing sufficient cash from repo transaction to fulfill the collateral requirement under the EMIR regime.

Even though we understand the legal constraints highlighted by ESMA in terms of amending existing RTS, and the proposal to review the removal process as part of the overall 2015 EMIR review, we urge ESMA to consider alternatives to a full consultation process, which is not expressly prescribed by the Level 1 text of EMIR. In our view, the removal of a clearing obligation need not be treated in the same manner as the imposition of a clearing obligation, and the absence of a full consultation process in that case would not be detrimental to those who wish to continue to clear such contracts.
<ESMA_QUESTION_4>

3 Determination of the OTC interest rate classes to be subject to the clearing obligation

Question 5: In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to interest rate OTC derivatives? Please include relevant data or information where applicable.

Please include relevant data or information where applicable.

<ESMA_QUESTION_5>
We generally agree with the proposed criteria described in section 3 of the Consultation Paper.
<ESMA_QUESTION_5>

4 Determination of the dates on which the obligation applies and the categories of counterparties

4.1 Analysis of the criteria relevant for the determination of the dates

Question 6: Do you have any comment on the analysis presented in Section 4.1?

<ESMA_QUESTION_6>
We generally agree with the analysis presented in Section 4.1.

Section 4.1 includes analysis of the criteria relevant for the determination of the dates for the clearing obligation to apply. We support the criteria that ESMA proposes taking into consideration, which include: a) the expected volume of the relevant class of OTC derivatives; b) whether more than one CCP already clear the same class; and c) the ability of the CCP to handle the expected volume. We especially note the importance of criterion b). Where there is only one CCP available, ESMA should assess the potential impact that this has on access generally and the options available to market participants and increase the timeframe where they consider that this will result in more CCPs offering to clear the class of derivatives in question. The same argument should also apply to the number of clearing members that have access to the authorised CCP(s). Other related factors which ESMA may consider, include what jurisdictions the CCPs operate, the extent to which the CCP has market share across the OTC clearing market generally and the range of clearing account options (and pricing structures) made available for client clearing. When discussing the number of CCPs, ESMA rejects the idea that the text implies that there must be some competition between several CCPs before deciding obligation to compensate and takes it as an element when fixing the date from which the clearing obligation would apply; we strongly oppose this view that may lead to a monopoly or, even worst, to the necessity to clear through a CCP which might not meet the standards we expect; We insist, ESMA should always verify the existence of at least 2 CCPs offering total segregation service and their quality before deciding a clearing obligation; figures in table 13 and §§154-155 evidence the adequacy of the clearing possibility for IRS both in terms of number of CCPs and variety of clearing members.

ESMA seems to overlook in §137 the criterion about the ability of CCPs to handle the expected volume. It is justified when considering the volumes effectively cleared on IRS by some of the largest CCPs involved in that business; however the supplementary reason that the scalability of the CCPs was validated during the re-authorization process is only relevant because this process took place very recently. AFG believes that ESMA should not as a policy decide not to re-assess what has been approved by NCAs.
<ESMA_QUESTION_6>

4.2 Determination of the categories of counterparties (Criteria (d) to (f))

Question 7: Do you consider that the classification of counterparties presented in Section 4.2 ensures a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

<ESMA_QUESTION_7>
AFG generally supports ESMA's proposed categorisation of counterparties.
<ESMA_QUESTION_7>

4.3 Determination of the dates from which the clearing obligation takes effect

Question 8: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

<ESMA_QUESTION_8>
We strongly agree with ESMA's proposal and highly **welcome the appropriately lengthy phase-in of 18 months** for category 2 counterparties (e.g. UCITS and AIFs), as this gives our members sufficient time to prepare for clearing. However, our members have **serious concerns with the impact of the proposed front-loading requirements** for our members as category 2 counterparties.

We want to stress, in front of the suggestion that 6 months phase-in delay between two categories actors might be unnecessary in the future, that the current 12 month period between the first two categories (6

months for CM and 18 months for category 2) is far from excessive knowing that legal teams active on EMIR contracts are totally overworked on both sides of the negotiating counterparties. Today it is clear that we are far from the day 'when most counterparties already have an access to clearing'.

Regulated investment funds need sufficient time to put in place new legal and operational arrangements with the clearing members and the CCPs. For instance, the implementation of the segregation requirements for regulated funds takes additional time given that fund management companies have to conduct an analysis of the various complex framework agreements with the CCP in order to determine if such agreements are in compliance with the European investment fund law. The terms "individual client segregation" and "omnibus client segregation" are not clearly defined which leads to the consequence that each CCP develop, interpret and offer its own segregation model to the financial industry.
<ESMA_QUESTION_8>

5 Remaining maturity and frontloading

Question 9: Do you consider that the proposed approach on frontloading and the minimum remaining maturity ensures that the uncertainty related to this requirement is sufficiently mitigated, while allowing a meaningful set of contracts to be captured? If not, please explain why and provide possible alternatives compatible with EMIR.

<ESMA_QUESTION_9>
Novation

We strongly believe that **the definition of 'novation' should be clarified**. It is of vital importance that until the publication of RTS all contracts that would totally alter the economical equilibrium of the initial transaction are exempt from clearing obligation. Article 4 (1) of the proposed RTS includes in the scope of clearing obligation 'OTC derivative contracts entered into or novated on or after the date of the RTS publication'. The point of legal certainty and economical equilibrium of OTC derivatives would be totally missed if novation were to be misinterpreted. Novation in that circumstance should not include simple change of parameter such as diminution of the notional amount traded, the modification of a date or the give up of the deal... We would like at least recital 11 to refer to BCBS/IOSCO definition of "genuine amendments" in order to give a clear understanding of what novation means. (See, BCBS /IOSCO final report on Margin requirement for non- centrally cleared OTC derivatives, September 2013, page 24 and specially foot note 20 that reads: *Genuine amendments to existing derivatives contracts do not qualify as a new derivatives contract. Any amendment that is intended to extend an existing derivatives contract for the purpose of avoiding margin requirements will be considered a new derivatives contract*. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf).

Frontloading

We welcome the proposal to effectively limit front-loading to contracts entered into during period B.
We are concerned, however, that the practical impact of the application of the front-loading requirements to contracts with a minimum remaining maturity of 6 months, on the date of application of the clearing obligation will mean that the phase-in will be of little use.

Some of our members' clients execute long-dated OTC contracts (longer than 6 months), often to hedge long-dated liabilities. A minimum remaining maturity of 6 months will mean that the vast majority of OTC contracts subject to mandatory clearing which are executed during the phase-in period will become subject to front-loading requirements. In addition to the often mentioned pricing impact of front-loading, such a large front loading requirement would have a substantial operational impact on clients, clearing members and CCPs, and would require significant time and resources to be effectively implemented.
In order to complete the front loading process by the end of the phase-in period, the process would have to be initiated well in advance of the deadline. The structures for client clearing (including operational procedures and legal documentation) would have to be in place before starting the front loading process**. In practical terms, this would significantly reduce the phase-in period for many category 2 counterparties**.

Furthermore, market participants will also have to put in place an appropriate process for moving open contracts into clearing. One must remember that the experience of implementing the back-loading requirement in respect of trade reporting had a huge operational impact in terms of imposing retrospective requirements on market participants; and the front-loading of non-cleared contracts into a cleared environment is much more complex than trade reporting!

When considering systemic risk, it is probably too conservative to fix the **minimum remaining maturity for transactions that need to be compensated** to 6 months. A minimum maturity of **2**

years would not create a risk to miss deals of systemic importance. On the other side it would reduce the burden of front loading considerably and prevent a bottleneck effect due to front loading.

For these reasons, we encourage ESMA to consider alternative approaches to the front-loading and phase-in proposals set out in the Consultation Paper. Our members would recommend, in particular, examining the following options:

- **Option 1:** remove the front-loading obligation for category 2 counterparties.
- **Option 2**: implement a phase-in front loading for category 2 counterparties, so that the front-loading period only starts 12 months after the start of the phase-in period for category 1 counterparties. This would give market participants sufficient time to put in place the necessary processes, procedures and documentation to ensure compliance with the clearing obligation, before having to consider also front-loading.

Whatever the option retained by ESMA, we urge ESMA to interpret rules in the same manner in all its jurisdictions.

Lastly, we also suggest that the effective date for front-loading (i.e. the start of period B) should be the date of entry into force of the regulatory technical standards[1], rather than the date of publication in the Official journal. Indeed, it is unlikely that the date of publication in the OJCE will be announced in advance to market participants, which means that they would not be in a position to anticipate with precision the exact start date of front-loading requirements. To the contrary, if the effective start date for front loading is the date of entry into force of the RTS, this will give market participants a 20 days advance notice.

Non-financial counterparties and front-loading
Under the current proposals, front-loading is not applicable to contracts for which at least one of the counterparties is a non-financial counterparty. However it is not clear what the process is for a counterparty that shifts from non-financial counterparty to financial counterparty during a front-loading window. For example, if an AIFM becomes authorised or registered under AIFMD, any AIFs managed by that AIFM would become financial counterparties and so be subject to front-loading. We suggest that ESMA make it clear (either through a recital in the draft regulatory technical standards or in future Q&A) that the front-loading obligation is only applicable to contracts which would, in the absence of a phase-in period, be subject to the clearing obligation at the time the contract was entered into. For example, when an AIFM becomes authorised or registered under AIFMD (and so becomes a financial counterparty), any contracts entered prior to that point would not be subject to front-loading, even if the change in counterparty status occurred in the middle of a front-loading window that would generally require financial counterparties to front-load during that entire window.
<ESMA_QUESTION_9>

6 OTC equity derivative classes that are proposed not to be subject to the clearing obligation

Question 10: Do you have any comment on the analysis on the Equity OTC derivative classes presented in Section 6?

[1] As stated in the Letter from ESMA to the European Commission dated of 8 May 2014: http://www.esma.europa.eu/system/files/2014-483_letter_to_european_commission_re_frontloading_requirement_under_emir.pdf

<ESMA_QUESTION_10>
We support ESMA's proposal not to submit any equity OTC derivatives classes to the clearing obligation.

We cannot follow ESMA in § 292 when it starts with the confession that there is no evidence of OTC non-cleared equivalent contracts and concludes that the level of standardisation is satisfactory.
<ESMA_QUESTION_10>

7 OTC Interest rate future and option classes that are proposed not to be subject to the clearing obligation

Question 11: Do you have any comment on the analysis on the OTC Interest rate future and options derivative classes presented in Section 7?

<ESMA_QUESTION_11>
We support ESMA's proposal not to subject the OTC interest rate future and option classes to the clearing obligation at this stage.
<ESMA_QUESTION_11>

Annex I - Commission mandate to develop technical standards

Annex II - Draft Regulatory Technical Standards on the Clearing Obligation

Question 12: Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA_QUESTION_12>
We have no additional comments to make on the draft RTS.
<ESMA_QUESTION_12>

Annex III - Impact assessment

Question 13: Please indicate your comments on the CBA.

<ESMA_QUESTION_13>
AFG members believe that the assessment made when defining classes of IR OTC derivatives should be complemented by further discussion on the way to take into consideration specificities of some contracts.
Our members wonder why there is no assessment of the proposed periods for the phasing in and the remaining maturity to determine the front loading obligation. As we agree with the proposed phasing–in for the CO but put the suggestion that 2 years would be more appropriate for the minimum remaining period for frontloading, we think that an impact assessment on this latter period should be conducted.
<ESMA_QUESTION_13>