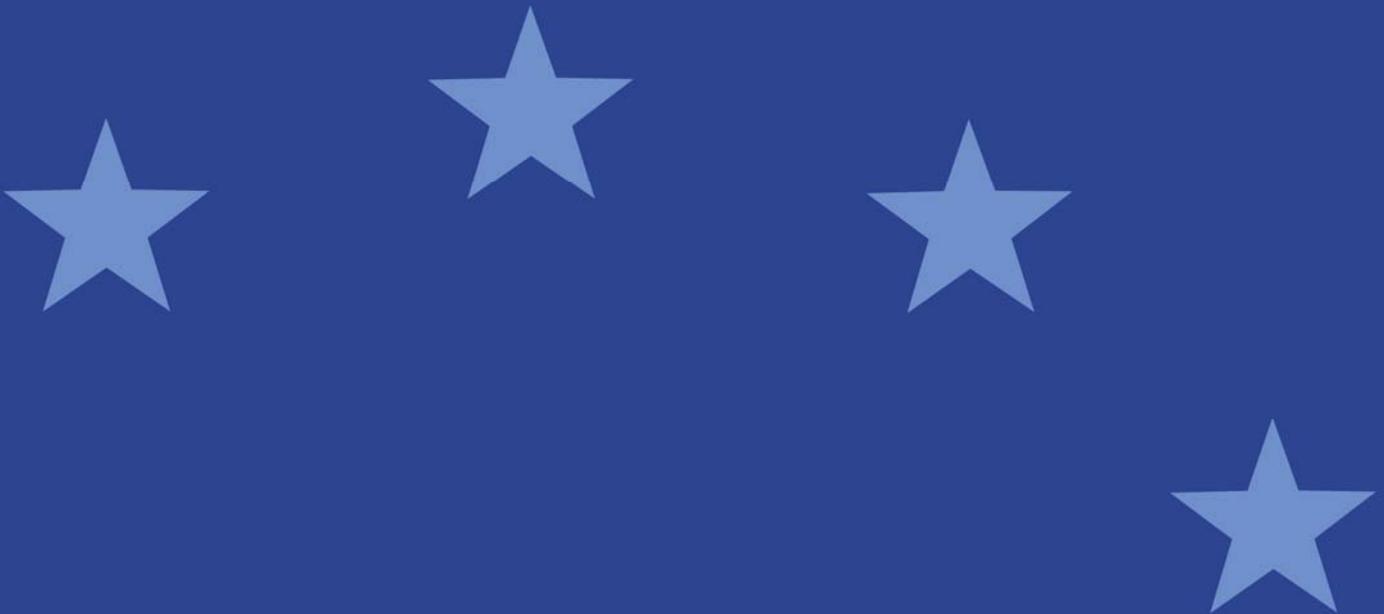




European Securities and
Markets Authority

Reply form to the Consultation Paper on the Clearing Obligation under EMIR (no. 2)



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. 2), 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 September 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 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°2).

We would like to remind that 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. 2 CCPs at least

Before declaring an obligation to centrally clear a contract, ESMA should make sure that at least 2 CCPs offer a possibility to clear that contract and that they both offer real full segregation as required in EMIR level1.

2. Phase-in approach for regulated investment funds.

We agree with ESMA's proposal and **welcome a phase-in period of at least 18 months for category 2 counterparties** (e.g. UCITS and AIFs). It should not be reduced.

3. Novation and compression

The obligation to compensate should not apply to modifications applied to a previous contract that do not amount to a total novation; in that respect "genuine amendments" should be specifically excluded from the scope of the obligation; transactions entered into with a view to compress an existing contract that is not subject to clearing obligation should also not be obliged to clear with a CCP but kept available for bilateral compression.

4. UCITS specific regulatory regime : close-out clause and cash settlement clause

AFG would like to recall that funds that its members manage are strictly regulated and AFG feels that there are two clauses that should be taken by CCPs in their operational rules in order to enable UCITS to contract CDS: the close out clause and the cash settlement clause allowing funds not to receive loans in case of an event of credit.

5. Admitted collateral

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.

6. Front-loading requirements.

As already expresses in our response to the first consultation, we strongly 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 for CDS clearing two alternative approaches regarding the implementation of the frontloading



(either remove the frontloading requirement or introduce a phase-in period for the frontloading obligation for category 2 counterparties).

7. Convergence

Regarding international convergence, we support the approach of ESMA to allow international convergence, however, the European context must be analysed locally as we are in presence of different market practices. The EU should not align to foreign practices for the mere reason of simplification and put at risk those local market practices that prove to work well.

8. Status change for bilateral derivatives under the two components of EMIR

We would like to draw regulators' attention to the dates that are retained for the clearing obligation's and frontloading's application in relation to the non-compensated IM+VM ESMA's requirements. One should pay attention to the risk of mismatch that would ask us to onboard to CCPs trades that were previously been submitted to the VM+IM requirements.

<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 share ESMA's view of grouping RTS by asset class and avoid consulting on each class a CCP is authorized to clear. However, we feel it is difficult to engage in a thorough analysis on CDS before full authorization of ICE Clear Europe, the second CCP ready to clear CDSs.

In general, AFG considers that the authorisation of clearing a new asset class may be given only if 2 CCPs have offers available on that asset class. Before declaring an obligation to centrally clear a contract, ESMA should make sure that at least **2 CCPs** offer a possibility to clear that contract and that they both offer real full segregation as required in EMIR level1. Indeed, our members are of the opinion that any authorisation of clearing a new asset class may only be given if 2 CCPs' offers on that asset class are available to avoid concentration of a market segment with only one CCP and so that portability is possible and competition is offered on the EU market.

Moreover, the capacity of clearing members offering clearing services to their client base must be taken into account. We wish to avoid situations where at the introduction of a clearing obligation available, clearing members cannot absorb the strong client demand.

<ESMA_QUESTION_1>

2. Structure of the credit derivatives classes

Question 2: Do you consider that the proposed structure for the untranching index CDS classes enables counterparties to identify which contracts are subject to the clearing obligation as well as allows international convergence? Please explain.

<ESMA_QUESTION_2>

AFG members consider that ESMA's definition of the untranching index classes is rather clear and enables counterparties to reasonably identify which contracts are subject to the clearing obligation..

Our members share the view that, as a principle, new series should be immediately included in the obligation to compensate, provided that ESMA would be empowered to suspend, temporarily or definitely, this obligation whenever the criteria of standardization, liquidity and availability of prices disappear.



However, AFG urges ESMA to take into account **UCITS requirements** when they enter into credit derivatives transactions.

Indeed, **UCITS must be in a position to close any OTC transaction they entered in at any time (close-out clause)**; 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.

Also, as per article 8.2 of Directive 2017-16 in application article 50 of Directive 2009-65, UCITS¹ are not allowed to acquire loans (as loans are not an eligible asset). The credit derivatives transaction's confirmation includes provisions detailing the procedure applicable in case of default of one of the counterparties. Or, in this procedure, if a transaction is in default and if it cannot be settled in securities, the fallback settlement method of most credit derivatives is the physical settlement method which may lead to the consequence that loans are the only deliverable obligations. In such situations UCITS could be subject to a contractual obligation either to accept or deliver loans. Consequently and to circumvent this issue, ISDA has developed so-called "Additional Provisions for Credit Derivatives" and prior to their first transaction, UCITS must enter into a bilateral arrangement with their counterparties and execute these Provisions. This ensures that, in case of default of the counterparty of the fund, cash settlement prevails on a physical settlement. Therefore, **we urge ESMA to recognise this situation and to ensure that the clearing obligation only takes place to Untranched CDS if at minimum one CCP is able to offer clearing of this product that includes those dedicated provisions.**

Regarding **international convergence**, we support the approach of ESMA to allow international convergence. However, regulators should take due note that we are in presence of different market practices (different clearing models, different approaches by instrument, different trading platforms between EMIR and Dodd-Franck regulations). Ideally, a global approach would be very desirable, but in practice there are a lot of structural difficulties. CCPs mutual recognition is far from taken for granted. The objective is to get closer so as to facilitate day to day operations and avoid case by case side letter writing for counterparties for instance, but convergence should in no case mean abandoning European counterparties' characteristics that work well. The EU should not align to foreign practices for the mere reason of simplification; we consider that the European context must be analysed locally and urge ESMA not to consider equivalence for CCPs which do not offer perfect safety and total segregation, meaning the possibility for the end client to be known from the CCP that would open an account for him and individualise his holdings even if they are administered by a clearing member.

<ESMA_QUESTION_2>

3. Determination of the classes of OTC derivatives to be subject to the clearing obligation

Question 3: 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 credit OTC derivatives?

Given the systemic risk associated to single name CDS, would you argue that they should be a priority for the first determination as well? Please include relevant data or information where applicable.

<ESMA_QUESTION_3>

AFG members agree with the proposed criteria described in section 3 of the Consultation Paper.

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

¹ This applies to UCITS and equivalent AIFs under local regulation as it is the case in France for *Fonds d'Investissement à Vocation Générale* as per article R 214-32-26 of COMOFI.



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.

We would however recall the fact that UCITS using a CDS contract are not allowed to receive a loan as payment in a case of a credit event for which no Additional Provision had been executed (see also our reply to question 2).

We thus urge ESMA to ensure that CCPs clearing CDS contracts develop an offer including the required special settlement terms that are UCITS compliant.

Some of our members challenge the idea to start from series 11 to impose mandatory clearing and strongly recommend that mandatory compensation apply to series 17 onwards. The more so, that on the application date there will be 2 or 3 more series.

<ESMA_QUESTION_3>

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

<ESMA_QUESTION_4>

We generally agree with the analysis presented in Section 4.1. We insist however on the fact that **ESMA should always verify the existence of at least 2 CCPs offering total segregation service and their quality before deciding a clearing obligation.**

This section includes analysis of the criteria relevant for the determination of the dates for the clearing obligation to apply. As we have already mentioned for the 1st consultation, 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 worse, to the necessity to clear through a CCP which might not meet the standards we expect. Indeed, our members could 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.

In §41 to 46, ESMA takes as a guarantee of complete standardization the fact that most CDS trades are confirmed through electronic platforms. In fact the process for CDS is less automated than for IRS. Counterparties must consult the documentation to check the terms of specifications that vary from one master confirmation or one side letter to the other; for example, the “partial cash settlement” clause is not standardized and is always specified when an asset manager trades for the account of a fund; we conclude that phasing in of the obligation to clear CDS must be long enough.

<ESMA_QUESTION_4>

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

Question 5: Do you agree with the proposal to keep the same definition of the categories of counterparties for the credit and the interest rate asset classes? Please explain why and possible alternatives.

<ESMA_QUESTION_5>

We agree that definition of counterparties for credit and interest rate asset classes should be the same.

<ESMA_QUESTION_5>

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

Question 6: 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_6>

We consider that the final adopted dates for asset managers should ensure a smooth implementation of the clearing obligation as far as they take into account the delay of the onboarding process with the direct clearing members (DCM), in order to avoid bottleneck. DCMs has also to finalize as soon as possible their models.

We agree with ESMA's proposal and welcome **a phase-in period that runs for at least 18 months**. In any case, it should not be less as currently proposed 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.

Regulated investment funds need sufficient time to set up new legal and operational arrangements with the clearing members and the CCPs. For example, the assessment and the implementation of the segregation requirements for regulated investment funds take additional time for the investment fund management companies as they have to analyse the complex and different clearing framework agreements by the CCPs knowing if the agreements comply 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 develops, interprets and offers its own segregation model to the financial industry.

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 for the collateral deposited with the CCP is also a key point before deciding of clearing obligation. 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 clearing obligation.

We consider that the clearing obligation shall be effective before the obligations applicable to the collateral requirement (initial and variation margins).

<ESMA_QUESTION_6>

5. Remaining maturity and frontloading

Question 7: Do you consider that the proposed approach on frontloading ensures that the uncertainty related to this requirement is sufficiently mitigated, while allowing a meaningful set of contracts to be captured? Please explain why and possible alternatives compatible with EMIR.

<ESMA_QUESTION_7>

Novation and compression

As we have already stated for the first CO n°1 consultation, 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>).

Furthermore, **trades entered into with a view to compress preexisting trades** that were not within the scope of the obligation to compensate **should be exempted** as well; otherwise the result would be an increase of open positions and risk instead of the intended reduction. Indeed, our members believe that any trade that is reducing a pre-existing position under a bilateral trade, and which is intended to be compressed (and is compressed) with the original trade so that the position is partially or fully terminated should not be subject to the clearing obligation. Compression is not possible between a cleared and bilateral contract and novating the bilateral trade to a CCP before compressing, is both problematic and inefficient.

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 for these more long dated contracts.

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 category 2 counterparties that execute more long dated contracts.**



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!

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 standards², 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.

<ESMA_QUESTION_7>

Annex I - Commission mandate to develop technical standards

Annex II - Draft Regulatory Technical Standards on the Clearing Obligation

Question 8: Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA_QUESTION_8>

Status change for bilateral derivatives under the two components of EMIR

We would like to draw regulators' attention to the dates that are retained for the clearing obligation's and frontloading's application in relation to the non-compensated IM+VM ESMA's requirements. One should pay attention to the risk of mismatch that would ask us to onboard to CCPs trades that were previously been submitted to the VM+IM requirements.

<ESMA_QUESTION_8>

Annex III - Impact assessment

² 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



Question 9: Please indicate your comments on the Impact Assessment.

<ESMA_QUESTION_9>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_9>