Securities and Markets Stakeholder Group

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ADVICE TO ESMA

Securities and Markets Stakeholder Group –

Advice on EMIR Draft (Regulatory) Technical Standards

I. Executive summary

The objective of this paper is to provide advice to ESMA on the refinement of Technical Standards for the Regulation on OTC Derivatives, Central Counter Parties (CCPs) and Trade Repositories and to contribute to achieving the original goals of the financial reforms envisioned by the G20 mandate and the EMIR (European Market Infrastructure Regulation) legislation.

The SMSG very much welcomes ESMA's efforts to allow for two rounds of market consultation in the process of defining Level 2 Regulation for EMIR despite the tight timeline given by the legislation. Still, the SMSG is concerned that the time pressure, which ESMA has been put under, does not allow for a careful consideration of the cost-benefit impact of the Technical Standards. This concern is even heightened by the fact that ESMA has decided in many areas to propose standards deviating from or exceeding the approaches taken in CPSS-IOSCO or in comparable rule-making in the US.

The key messages the SMSG would like to highlight towards ESMA for consideration in their work going forward regarding finalizing EMIR Technical Standards, in addition to the points provided in April, are:

- Deviations from International Standards will increase the cost of clearing in Europe and create a competitive disadvantage for European market participants as well as a higher administrative burden for non-financial end users such as SMEs

- Recognition of Third Country CCPs without an ESMA assessment may harm Investor Protection in Europe and creates room for regulatory arbitrage

- Prescriptive and inflexible standards for risk management deviate from international standards and can hamper further development of state-of-the-art approaches

II. Introduction

1. On July 27 th, 2012 the Regulation on OTC derivative transactions, central counterparties and trade repositories ("EMIR") was published in the Official Journal of the European Union. The legislation calls ESMA to propose Technical Standards by September 30, 2012 on various topics regarding the clearing obligation, CCP requirements and trade repositories. ESMA published a first discussion paper on February 16, 2012 inviting comments on several aspects of the draft Technical Standards. A further consultation paper was published on June 25th, 2012.

2. The substantial delays in the legislative process put ESMA under undue time pressure to finalize its work in only 8 weeks between publication of the legislation and the delivery date defined in EMIR. Given the significance of these standards for the financial industry in Europe and their impact for market infrastructure providers and market participants, also end-users including small and medium enterprises (SMEs) and retail investors, the SMSG is highly concerned about the rushed process of such an important piece of Level 2 legislation. All the more, the SMSG highly welcomes the efforts made by ESMA to commence work early and to allow for two rounds of public consultation in the process.

3. In particular, the SMSG believes that the rushed process of Level 2 legislation does not allow for a proper impact analysis of the standards suggested. A careful consideration of the cost-benefit impact of the Technical Standards is of paramount importance to avoid harm to the macroeconomic function of the financial system and ensure the global competitiveness of the European financial markets. This concern is even increased, since ESMA has decided in many areas to propose standards that deviate from or exceed the approaches taken in CPSS-IOSCO or in comparable rule-making in the US. This may also make it difficult to come to equivalence rulings with non-EU countries, which could potentially impact markets and increase compliance costs.

4. The SMSG would argue for a level playing field both globally and among small and large participants across EU member states and a need for harmonization where this is still lacking, in order to facilitate the continued development of an internal market and to stay globally competitive.

5. The objective of this paper is to provide advice to ESMA on the definition of Technical Standards and to contribute to achieving the original goals of the financial reforms envisioned by the G20 mandate and the EMIR legislation.

6. This paper is organized as follows: Section III recalls the SMSG recommendations on the February 2012 ESMA Technical Standards discussion paper. Section IV introduces some general remarks the SMSG would like to make. Section V highlights important aspects for consideration in refining technical standards and meeting the EMIR mandate as well as the G20 goals. The aspects are outlined along the structure of the June ESMA Technical Standards consultation paper. The last Section VI reflects other important issues that the SMSG would like to raise and are mostly directly linked to a specific Technical Standard.

III. SMSG recommendation on previous Advice Paper

7. Key messages the SMSG has highlighted towards ESMA for consideration in their work going forward regarding drafting EMIR (regulatory) Technical Standards:

   - Technical Standards should be criteria-based and leave flexibility for market-driven approaches
   - New requirements should be phased-in to reduce impact and implementation effort for market participants
   - Clearing obligation for OTC derivatives has to be based on clear definitions to ensure legal certainty
   - Information requirements for clearing requirements are disproportionate and not inline with CFTC approach
   - Harmonize requirements for CCPs in Europe
   - Ensure international consistency based on CPSS IOSCO principles and mutual recognition of European Standards by foreign regulators Standards
   - CCP Access Criteria for participation should be further strengthened
   - Default procedures for CCPs require harmonization of National Insolvency Regimes

The SMSG still considers the aspects above to be of critical importance for meeting the G20 mandate and feels that they could have been better reflected in the now discussed Technical Standards.

IV. General remarks

8. The SMSG welcomes the opportunity to provide further comments based on the draft Technical Standards published in the consultation paper on June 25th, 2012. As explained in the introduction, specific aspects of the ESMA Technical Standards proposals will be discussed in the next section V in more detail, at this stage the SMSG would like to provide a comprehensive overview on some general observations and concerns.

Deviations from International Standards will increase Cost of Clearing

9. The Technical Standards proposed by ESMA reflect requirements over and above those of CPSS-IOSCO and deviate in many aspects from comparable rulemaking by US regulators such as the Commodity Futures Trading Commission (CFTC). In this regard the SMSG would like to recall Recital 90 of EMIR as the guideline for ESMA's work, which states:

10. *"It is important to ensure international convergence of requirements for CCPs and trade repositories. This Regulation follows the existing recommendations developed by the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) noting that the CPSS-IOSCO principles for financial market infrastructure, including CCPs, were established on 16 April 2012. It creates a Union framework in which CCPs can operate safely. ESMA should consider these existing standards and their future developments when drawing up or pro-*

posing to revise the regulatory Technical Standards as well as the guidelines and recommendations foreseen in this Regulation."

11. There are a number of examples where ESMA has not followed this guideline as explained in more detail in Section V. These include the requirement for higher confidence levels in margining OTC derivatives than required in CPSS-IOSCO and EMIR[1], a longer liquidation period for calculating initial margin beyond current practices and US rules for listed derivatives[2], a substantial capital exposure of 50% for CCPs before being able to use further lines of defense such as the mutual guarantee fund[3] or the treatment of non-financial counterparty limits.

12. In addition, ESMA does not sufficiently recognize that non-financial end-users are not driving financial sector systemic risk; and the resources, especially IT systems, available to these non-financial end-users (especially SMEs and individuals) are not sufficient to handle regulatory requirements drafted from the perspective of the financial sector. This is reflected in particular in the unreasonable administrative burden being imposed in respect of information that will not impact on regulators' ability to monitor and control systemic risk and support the stability of the financial system. So, it is important that the quantitative thresholds remain high.

13. The SMSG also suggests that ESMA and the ESAs should always bear in mind that an increase in capital, whilst increasing systemic resilience and thereby being of benefit to investors and other market users, will undoubtedly result in additional costs and these additional costs will inevitably be passed on to users. The means that there must always be an appropriate balance maintained between the desire to seek to completely eliminate risk for market users and investors and the need to allow markets to function effectively and economically. This balance should always inform any policy decisions around the level of capital required and its consequent cost/benefit.

14. This same balance also has a bearing on the ability of issuers, particularly small caps, to raise funds in the market; if the overall costs of clearing are so high as to act as a disincentive for investors and market participants to engage in the trading that is required to provide liquidity that keeps the cost of capital lower, then such issuers will find it harder to raise the much needed capital for stimulating growth and rebuilding the European economy at this difficult time.

15. Taken together, the additional requirements will mean a substantial increase in the cost of central clearing for users of CCPs in the European Union and will be detrimental to the attractiveness of central clearing in the EU. In addition, it could lead to business shifting outside the European Union either directly by using Third Country CCPs recognized in Europe or indirectly by transactions being executed outside the European Union. The SMSG believes that any deviation from CPSS-IOSCO or the US rulemaking requires a careful analysis of the costs and benefits including quantification and a clear justification. The consultation document does not deliver such quantitative analysis or justification.

Non-assessment of Third Country CCPs could harm Investor Protection in Europe

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[1] See EMIR Art. 41 (1)
[2] CFTC regulation 39.13(g)(2)(ii) requires 1 day for futures
[3] No such requirement exists in the US or in CPSS-IOSCO.

16. In relation to the recognition procedure, ESMA proposes not to conduct an individual assessment for Third Country CCPs whether they comply with home market regulation, EMIR and the relevant technical standards.[4] The SMSG does not agree with this approach and believes this approach is not in line with ESMA's regulatory mandate as defined in EMIR and its supervisory responsibilities. EMIR Article 25 (3) directly refers to such an assessment being conducted by ESMA.

17. Also for purposes of investor protection in Europe, the SMSG believes that ESMA has the responsibility to ensure that Third Country CCPs comply with EMIR and Technical Standards in Europe such as Client Asset Segregation and their legal enforceability as is required for European CCPs. Otherwise European investors using a recognized Third Country CCP could not rely on important aspects of the legislation such as protection of client funds for Third Country CCPs being enforceable although such Third Country CCPs have been recognized by ESMA to offer their services in the European Union.

18. In addition, the SMSG is very concerned that rules are established creating a preferential framework for Third Country CCPs to the disadvantage of European CCPs, facilitating regulatory arbitrage and putting investors trust in EMIR rules at risk.

19. Information requirements in Article 1 3C (1) should for example include important criteria such as Client Asset Segregation and its legal enforceability to be provided by Third Country CCPs. As this is an area that directly touches the interests of Investor Protection in the European Union.

Standards for risk management are prescriptive and inflexible

20. Despite SMSG's advice to ESMA in April, some of the Technical Standards proposed are very prescriptive such as standards on Margining, Investment policy or Liquidity controls.

21. ESMA should strive to allow for flexibility avoiding a too prescriptive and too detailed guidelines/technical standards (e.g. for risk management which need to be tailor made and reflective of actual risk) which hamper development and do not provide room for new developments, practices, instruments, participants etc.

22. In particular, the Technical Standards on Margining seem to have been designed for traditional instrument-based and rule-based margining methodologies such as SPAN or TIMS, but do not reflect state-of-the-art risk modeling approaches. CCPs increasingly apply risk factor-based and portfolio-driven Value at Risk models, which can be more precise and forward-looking and therefore are better suited in particular for OTC derivatives. Thus, the SMSG is concerned that the standards as currently defined are too narrow and could impact innovation in risk management. The SMSG would suggest explicitly allowing for alternative model approaches in the Technical Standards.

23. The SMSG disagrees with the rough approach chosen to use the classification of OTC and non-OTC financial instruments as a relevant differentiation for risk management in areas such as confidence interval or liquidation period. Margining should be based on the risk factors of the specific product.

24. The SMSG also does not support to require a higher confidence level of 99.5% for OTC instruments. The current and proven industry standard is to cover a 99.0% confidence level for margins and 99.9% for the guarantee fund. Deviating from this standard has significant cost implications, but does not

[4] See ESMA Consultation Paper - Recognition of third country CCPs - Policy options, p. 205.

automatically translate into a higher protection level if other statistical assumptions are not defined. It also reduces the weight of the mutualized component in comparison to the individual component of the lines of defense.

25. The SMSG is concerned that EMSA has chosen to weaken the role of the guarantee fund as the mutualized component of the lines of defense of the CCP compared to the current industry standard and CPSS-IOSCO requirements by the higher confidence level and the requirement for a CCP to first use 50% of its own capital. This policy on the one hand leads to a cost increase for the entire industry, since the guarantee fund is much more cost efficient way to cover extreme tail risks, on the other hand it reduces the incentive for clearing members to participate and assist in the default management process to avoid losses to the mutual resources of the CCP.

26. As ESMA links the own resources/skin in the game calculation to the capital requirements established by the EBA, the overall impact of the two consultations must be considered; regulators must take account of other proposals when making their own.

27. Given the significance of ESMA's policy decisions for CCP risk management proposed in the EMIR standards and the deviation from CPSS-IOSCO and US standards, the SMSG would call ESMA to conduct a careful impact analysis of these changes and when in doubt rather stay with CPSS-IOSCO principles. This impact analysis should also include a view on proportionality of costs and benefits to e. g. investors.

V. Detailed Comments on Draft Technical Standards

28. In the following, the SMSG outlines detailed recommendation to various articles of the ESMA Technical Standards, along the structure of the consultation paper.

Draft Technical Standards on OTC derivatives

Annex II – Chapter 2: Indirect clearing arrangements

29. The SMSG supports in general that some attempt has been made to ensure the continued availability of indirect clearing arrangements; however significant concerns remain from a legal, operational and cost perspective. To explain:

    a. Clearing members should have the option but not the obligation to offer indirect clearing when it is consistent with their business model and risk tolerances - yet some of the current drafting appears to suggest this is a mandatory obligation on all CMs. Yet level 1 text does not require a CM to offer direct client clearing, so it would seem anomalous to require CMs to offer indirect clearing. CMs will offer it when appropriate (e.g. supportive national structures, regulation is available) and many will voluntarily choose to do so, but for others it may not be an appropriate environment and compelling them to provide it may act as a commercial disincentive - obtaining the additional investment and specialist expertise, and conducting the additional KYC and anti-money laundering checks, and bearing the additional risks, becomes prohibitive for them. This may then limit eligible clearing members to a few global institutions who have the operational capability and scale to make it a viable part of their business. Such a result would increase concentration of counterparty risk- and this would in turn increase systemic risk, reduce competition and drive up clearing costs; and the counter side of this argument is that CMs who are not best placed to offer indirect clearing, do so anyway, thus creating new and unnecessary risks to the system and the need for greater regulatory supervision/intervention.

b. The requirement that when a CM's client fails, the CM is expected to support indirect clients for a period of 30 days and the significant insolvency law implications have not been properly addressed by this proposal. Absent of a supportive legal environment in relevant jurisdictions, it is hard to see how CMs can offer indirect clients the same degree of 'default management protection' that a CCP is required to offer to direct clients of an insolvent CM. CCPs by virtue of their status get special treatment in many jurisdictions e.g. Part VII CA in the UK effectively says that a CCPs default rules (segregation and porting) trump any contrary provisions of insolvency law. CMs on the other hand do not benefit from such special status, so insolvency of indirect clearing members in such a situation would be very problematic for CMs from a legal/risk perspective and much more so than for CCPs. The end consequence would be to create an uneven playing field between CMs and CCPs, and unreasonably put more legal risk/liability onto CMs when compared to CCPs.

Annex II – Chapter 3: Clearing obligation procedure

30. The SMSG notes that the information requirements under the clearing obligation procedure are still disproportionate and significantly exceed information requirements for instance documented in the CFTC rules. The SMSG has already in its previous advice commented that a more flexible and realistic approach should be implemented. ESMA itself acknowledges that many data will not be available but still insists on its approach. The quality of data provided will have to be poor for OTC derivatives or solely based on assumptions or not available at all such as bid-ask-spreads for OTC Derivatives. The information requirements of the procedure that exceed the more realistic criteria of the CFTC will lead to an unnecessary administrative burden to the industry with little added value.

Annex II – Chapter 4: Criteria for determination of the classes of OTC derivative contracts subject to the clearing obligation

31. Current Technical Standards should provide for a set period of time by which the clearing obligation becomes effective, i.e. effective date should not be determined by ESMA on an ad hoc basis. In general, ESMA should give clear signals on its willingness to phase-in clearing and margining obligations. Not only is this needed for operational reasons (the industry caters for tens of thousands of clients), but also to ensure foreign jurisdictions are given time to be equivalent and for their CCPs to be authorized to provide services in the EU. Otherwise the rules will de facto not allow competition in the first phase of clearing.

Annex II – Chapter 5: Public register

32. In relation to the public register the parameters are adequately set. However, the term "settlement conditions" referred to in article 1PR par. 2 (h) requires clarification. It is not clear what exactly is meant by this term.

Annex II – Chapter 6: Liquidity fragmentation

33. The SMSG advice in April recommended that EMIR should not block fair and open access between trading venues and CCPs for OTC derivatives. In this context ESMA is required to draft a Technical

Standard to define the notion of liquidity fragmentation where a CCP seeks to compete with an incumbent CCP and requests access to a trading venue. In its proposed approach, ESMA rightly acknowledges that it is only considering liquidity fragmentation within a single venue and identifies the clearing arrangements needed to avoid this.

34. The SMSG would like to highlight that the proposed technical standard by ESMA does not fully capture the notion of liquidity fragmentation in OTC derivatives. Reference is made to EMIR Article 8 (4): "Access of the CCP to the trading venue shall be granted only where such access would not require interoperability or threaten the smooth and orderly functioning of markets in particular due to liquidity fragmentation and the trading venue has put in place adequate mechanisms to prevent such fragmentation."

35. In its Technical Standards, ESMA states that "Liquidity fragmentation refers to a situation in which the participants in a trading venue are unable to conclude a transaction with one or more other participants in that venue because of the absence of clearing arrangements to which all participants have access". This definition by ESMA falls short to prevent fragmentation of liquidity since it only captures the aspect of participants' access to clearing but ignores liquidity itself by neither defining it nor stating when fragmentation of liquidity would be detrimental to market quality.

36. ESMA's approach would limit the notion of liquidity fragmentation to a single extreme scenario in which a transaction is prevented from happening, ignoring situations in which a transaction has been or could be effected, but where it would be impaired in terms of the quality of the execution (i.e. through price slippage) or the timeliness or efficiency of execution as a result of multiple CCPs serving a single trading venue. This potential price slippage and execution delays would be key indicators of liquidity fragmentation in such a situation and increase costs for market participants. Both would be damaging to the interests of end users. As such, the fact that "... there is one CCP which is common to all participants in the trading venue ..." does not appear as sufficient to prevent against the risk of liquidity fragmentation unless all transactions were cleared through the common CCP and no transactions were cleared through the other CCPs which have access to the trading venue. Thus a broader, alternative definition has to be developed.

37. Since liquidity pools develop on the trading and clearing layer due to network effects, the approach needs to consider both trading liquidity fragmentation and clearing liquidity fragmentation. Liquidity fragmentation on the trading layer has to consider the impact for the implied transaction cost for market participants. Clearing liquidity pool fragmentation is a situation where the connectivity between CCPs would create additional systemic risk (resulting from the split of liquidity between the CCPs). The case would arise for instance where the linkage of two CCPs would end up in a net long position of one CCP and a net short position of the other CCP, and where the CCPs do not provide margins for cross CCP risk positions. It is required, that inter-CCP risk positions need to be collateralized (i.e. secured by margins) at a third party. In addition, the trading venue needs to ensure the availability of an orderly post-trade process for instance in terms of default management. However, any requirement should only relate to the obligations of the trading venue, as required by EMIR.

38. With regard to clearing arrangements, ESMA explicitly gives a green light to interoperability arrangements for OTC derivatives clearing ("Clearing arrangements ... may ... take the form of interoperability arrangements ...", Art. 1 LF (6)) subject to regulatory approval. This is in contrast to the Level 1 text. EMIR Article 8 (4) requires that access to trading venues (OTC derivatives but not exchange traded derivatives) should not lead to interoperability and a process is outlined in Recital 73, where ESMA needs to produce a report first by September 2014, before an extension of interoperability ar-

rangements can be considered for asset classes other than transferable instruments. The SMSG believes interoperability in OTC derivatives clearing can fundamentally increase systemic risk and questions to take such a significant decision without any reasonable impact assessment and even before defining requirements for interoperability according to Title V of EMIR. However, the SMSG supports fair and open access among infrastructures, and a minority view of the SMSG feels the systemic risk created by interoperability arrangements can be properly addressed by national regulators, especially since the number of interoperable CCPs should remain limited.

Annex II – Chapter 7: Non-financial counterparties

39. Non-financial counterparties (NFC) use OTC derivatives to protect themselves against commercial risks directly linked to their commercial activities or treasury financing. In its consultation paper ESMA has suggested different thresholds for 5 different classes of derivatives that a NFC would need to aggregate across the group it forms part of. In terms of calculation against the threshold amounts, NFCs are permitted to exclude transactions entered into for hedging or treasury financing purposes. However, in circumstances where any one of these thresholds is breached all classes of derivatives of those NFC and the group will need to be cleared, whether or not they are entered into for hedging or treasury financing. The below comments primarily relate to the wording of the consultation paper potentially leading to definition problems.

40. There is relatively little rationale presented by ESMA why a certain level of threshold has been chosen. In addition the SMSG would like to invite ESMA to further develop its motivation why it is in line with the Level 1 text that a breach of a clearing threshold in one class of instruments would dis-apply exemptive treatment across all classes of derivatives, including derivatives used for hedging and treasury financing purposes outside the class of derivatives in which the relevant clearing threshold was exceeded. In effect, exceeding the threshold for one asset class will lead to a 'contamination' of all other asset classes. The Level 1 text does not prohibit a distinction between asset classes; it just says that "where a non-financial counterparty takes positions in OTC derivative contracts and those positions exceed the clearing threshold" they should be cleared.[5] Introducing a distinction between asset classes almost necessitates a distinction in the consequences of exceeding a threshold. This contrasts with the US approach, which provides a safe-harbor for all the hedging activities of NFCs, irrespective of the level of non-hedging activities of a non-financial corporate. In addition under this US approach exceeding the threshold for one of the two individual categories ("rate" swaps and others) would result in only that respective class of instruments becoming subject to collateralization requirements. ESMA's proposals are more onerous than equivalent US rules.

41. In addition the SMSG questions the use of notional amounts to determine the level of thresholds. Although notional amounts are an easy way of determining exposure they do not necessarily give a good insight into the actual exposure due to e.g. different tenors or payoff formulae. On the other hand the market value of derivatives actually provides a better measure, taking into account actual risk exposure and showing the actual relevance of participant for systemic risk. Finally, it should also be noted that this requirement appears to be more onerous than that of the equivalent US rules and also in light of this reconsideration may be appropriate.

42. According to the consultation paper derivatives entered into for "the purpose that is in the nature of speculation, investing or trading" will in any event not be seen as risk reducing and therefore counted

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[5] See EMIR Art. 10.

towards the thresholds (Art 1 (2) NFC). However, in practice this could potentially lead to a lot of debate since not necessarily all investing or trading is speculative. Generally speaking in financial regulation (see e.g. the IORP directive for pension funds) in the treatment of derivatives risk reduction is at times contrasted with speculation and not with investing or trading. Introducing the concepts of investing or trading will lead to definition problems, whilst the focus in the consultation paper should be on non-risk reducing, i.e. speculative, trades. Changing this for instance to "a purpose that is in the nature of speculation" would prevent definition problems and still address the policy intention of ESMA.

43. It is not clear how compliance with the requirement "objectively measurable as reducing risks" should practically be determined. This could for instance be achieved through customer assertion, since it will be difficult to always objectively show that a derivative reduces risk. In any event it could lead to a significant operational burden and NFCs potentially having to disclose confidential information as evidence to counterparties. Also in this case having counterparties of NFCs rely on representations regarding the nature of derivative trades seems to make sense.

44. There is no clarity on who will be responsible for monitoring compliance with the clearing threshold and bears the burden of proof. This should not be the responsibility of the financial counterparties when they are not sure whether their counterparty is over the clearing threshold as they would require the full picture of the relevant NFC's activities, and this would introduce an unrealistic expectation and burdensome requirement. Market participants would benefit from having more clarity on how this process should work. Furthermore, there is no clarification of who bears the burden of proof in cases non-financial counterparties fail to meet any of the criteria or the thresholds set out in Articles 1 and 2 NFC. Also, ESMA should consider introducing a standard rule (i.e. that there will be a "deemed" confirmation by the lapse of certain time) in case the recipient of the confirmation fails to affirm by that time.

Annex II – Chapter 8: Risk-mitigation techniques for OTC derivative contracts not cleared by a CCP

45. In Article 2 (4) RM the suggested thresholds for mandatory portfolio reconciliations are too high with regard to smaller financial counterparties with a limited range of derivative exposure. To recognize the fact that smaller institutions have often just a single-digit number of OTC derivative contracts with low amounts the following 'de-minimis'-threshold should be added to Article 2 RM (4) lit. b.: "iii. Once per year for a portfolio between 1 and X (e.g. 50, to be cleared by ESMA) OTC derivative contracts outstanding with a counterparty."

46. Regarding notification details defined in Article 7 (1) ESMA's reading that intragroup transactions within a Member State and without any impediments for the transfer of funds are not to be notified to the competent authority are shared, because they are exempted from the need of notification in general in the Level 1 text EMIR Art. 4 (2) subpara. 1. EMIR releases a general exemption whereas subpara. 2 lit. a and b refer to the cases of cross border transactions within and without the EU. The provisions of Article 7 RM for the notification procedure should be complemented by a possibility to have a general notification to exempt all intragroup transactions instead of a case-by-case basis.

Draft Technical Standards on CCP Requirements

Annex III – Chapter 3: Recognition of third country CCPs

47. The SMSG fully supports Annex III, Recital 13, that it is "important to ensure that recognized third country CCPs do not disrupt the orderly functioning of European markets or have competitive advantage to authorized CCPs…" as a guideline for the recognition of third country CCPs.

48. In its Impact Assessment, ESMA has considered two policy options[6]: Policy option 1 being to request evidence from the third country CCP if it complies with home market regulation, EMIR and the relevant technical standards. In Policy option 2, ESMA intends not to assess whether the third country CCPs comply with home market regulation, EMIR and the relevant technical standards. ESMA has decided for option 2 i.e. not to assess compliance of third country CCPs. The SMSG does not agree with this approach and believes this approach is not inline with ESMA's regulatory mandate as defined in EMIR and its supervisory responsibilities.

49. ESMA within its mandate should pay particular focus on investor protection issues in the European Union. The segregation requirements are a key aspect in the regulation for clearing members and clients alike. Therefore, the SMSG believes it is of critical importance that ESMA should request information on segregation services and legal enforceability within the European Union for Clearing Members and Clients. Segregation and portability (customer protection arrangements) services of the third country CCP and the legal soundness of those services should be added as a letter (k) to the list of information requirements in Article 1 3C (1).

50. In general, as stated in its previous advice paper, the SMSG is very concerned about the unequal approach adopted by the EU compared to other jurisdictions like the US for Third Country Access. A mutual recognition approach is not adopted in the US. While US legislation does permit US regulators such as the Commodity Futures Trading Commission (CFTC) to exempt a non-U.S. clearing house from the requirement to become registered as a Derivatives Clearing Organization if the CFTC determines that the non-U.S. clearing organization is subject to comparable, comprehensive supervision and regulation by the appropriate government authorities in the home country of the organization. Despite this authorization neither the CFTC nor the Securities Exchange Commission have proposed rules or a procedure to permit a non-U.S. clearing house to qualify for this exemptive treatment, which is in contradiction to the approach pursued in EMIR.

51. In relation to international relations, the SMSG strongly endorses all efforts by ESMA and the European Commission to limit extraterritoriality of foreign regulations for European market participants.

Annex III – Chapter 4: Organizational requirements

52. It is important that CCP governance arrangements are flexible so that they allow for CCPs with different structures to establish well-defined functions such as compliance, risk and technology. Where a CCP is part of a wider group, the requirement to have dedicated CCP resources should not prevent the use of other group/shared resources to perform certain functions, provided via an outsourcing arrangement, per Article 35 of EMIR. This would ensure a CCP remains fully responsible for discharging its operations and identifies and manages any conflict of interest. However, the Technical Stand-

[6] See (ESMA Consultation Paper - Recognition of third country CCPs - Policy options, pp. 204 – 205)

ards should be clearer about how this would apply and ESMA should clarify what it means by allowing "certain functions" to be outsourced, where EMIR does not preclude the outsourcing of any function (although risk management requires separate competent authority agreement).

Annex III – Chapter 7: Margins

53. Risk management in general and the margin methodologies in particular are a core competence of a CCP. From the SMSG's point of view, it is important that the Technical Standards foster further innovation in prudent and efficient risk management and do not hinder future progress by being overly prescriptive.

54. The SMSG is concerned that the proposed standards are inadequate in picking a few technical details such as the confidence interval used, while ignoring statistical fundamentals like the distribution curve applied for determining a confidence interval. The same applies to other aspects like calculation of historical volatility and the focus on instrument-based methodologies.

55. Furthermore, the SMSG is very concerned that ESMA deviates from international standards. CPSS-IOSCO principles foresee a minimum confidence level of 99% for the margin component of the lines of defense. Using the same distribution curve, a confidence level of 99.5% results in an initial margin increase of 22.8% for an individual clearing member or client. It is wrong to assume that a higher confidence level simply means higher safety, because the overall standard is defined as 99.9% by CPSS-IOSCO to be covered by margins and the default fund. Hence, ESMA mainly redefines margin and default fund split respectively, increasing the individual component substantially with corresponding cost increases for the industry. The SMSG would have expected a quantitative cost-benefit analysis with a resulting rationale why to deviate from international standards in this regard. Finally, the distinction between "OTC derivatives" and "financial instrument other than OTC derivatives" do not seem to be appropriate criteria for determining the confidence interval or holding period, since OTC instruments can be very standardised and liquid. To shed some further light, a confidence level of 99% means 2 exceptions in 200 cases. A confidence level of 99.5% means only one exception in 200 cases. Thus with the small increase of only 0.5% in the required confidence level actually the fear is doubled. Moreover, it is imperative that the same confidence level principles are prevailing as applied in Solvency II.

56. The Technical Standards are overly elaborate and prescriptive in some details, which will lead to higher cost for the financial industry and also the real economy without stipulating a safer or integer framework. The economic disadvantages for very large confidence levels are listed on page 30 of the consultation paper. It is not sensible to have a very high confidence level without being able to obtain reliable and controllable risk figures. It would be preferable to keep the confidence level at 99,0% and work with adjustments addressing certain aspects not covered by the VaR model (like liquidity). Liquidity (and thus the reliability of the price) and other risk factors should be the criteria for differentiating between derivatives and that differences should result in different liquidation periods rather than different confidence intervals.

57. In addition, the threat of prescriptive rules without allowing flexibility to find the best risk model would rather be detrimental and a barrier to be innovative. The ESMA standards should promote state-of-the-art margining concepts replacing the traditional SPAN or TIMS methodologies developed decades ago and explicitly mention alternative state-of-the-art Value at Risk approaches.

58. Portfolio margining provides valuable benefits to clearing members and their customers but it is important to ensure that this practice is not detrimental to the risk management function of CCPs. ESMA should not define restrictions in terms of specific parameters, which might be inapplicable for some methodologies. In particular it is unclear how Article 4 MAR would be applied to OTC derivatives and how an instrument would be defined (a single swap?) Accordingly, rather being prescriptive in details, ESMA should adopt standards specifying that CCPs should be required to demonstrate that the liquidation of positions and transfer of portfolios for which there is portfolio margining would not thereby be impeded and at the same time that the CCPs' liquidation horizon and associated margins always are to be fully aligned. In addition, the development of Technical Standards in this area should not frustrate potential future provisions (for example in MiFIR) for fungibility of collateral and margin-offsetting.

59. The proposals for the time horizon for the calculation of historical volatility (Article 2 MAR) are too prescriptive and create the possibility that inappropriate data is used in the determination of margins.

60. The requirement to publish all stress testing information is not appropriate. Some information should remain confidential to avoid potential "gaming" by clients and the impairment of the default management process.

Annex III – Chapter 10: Default waterfall

61. As ESMA proposes to link the CCP own resources requirement (skin in the game) calculation to the capital requirements established by the EBA (also currently under consultation), ESMA needs to consider the impact of this in the context of the overall impact of proposed changes to capital requirements. In order to develop a proportionate regime, regulators must not treat their own proposals in isolation or ignore the impact of the other standards. There is a risk that the effect of EBA and ESMA rules could impose a combination of the notification threshold and the CCP's own resources in the default waterfall, which could create a requirement for a CCP effectively to hold additional duplicative capital (e.g. 75%, if own resources is 50% and a notification threshold 25%). The rules must be clear and not duplicative.

62. The role of requiring a CCP to have some of its own resources in the default waterfall should be to incentivise CCP operators to undertake effective risk management, but it should not be of such a scale that it becomes part of the risk mitigation arrangements in its own right; this could increase systemic risk by putting the CCP operator at risk of default by the loss of 30% of its capital at a critical time in running a default situation.

63. The increase in capital proposed will not provide any material increase/improvement in the mitigation of risks associated with a default i.e. it heavily penalises the CCP (particularly those that operate a conservative approach to calculating regulatory capital) but provides no real improvement in the risk profile for a default.

64. The SMSG is very concerned about this approach if it would create an incentive for CCPs not to hold higher capital than required and suggests clarifying that for the purpose of calculating the CCP's own resources in the default waterfall, only the requirement (under Article 3 of the EBA RTS) is the relevant basis and not the actual capital held.

65. In regards to the default waterfall, clearly the role of the member default fund contribution in the default procedure is an incentive to participate in a close out auction. With a high amount provided by

the CCP (skin in the game) even before the default fund, members have a reduced incentive for participating in the close out (moral hazard). It is important to keep the proportions in a way that the various participants do not lose their incentive to provide highest efforts in the case of a default. Also the CCPs capital should not be overly impacted potentially raising credit concerns about the CCP before the CCP is able to tap on its additional lines of defence.

66. As a result, striking the right balance is a key consideration. The skin in the game is widely debated and the overall view is that the 50% total might not be too high in some cases, but this should be carefully set by the CCP and its competent authority. However, caution is requested on the processing. Therefore, the SMSG would like to propose that in a first step 10% of the CCP resources are used before the guarantee fund is tapped and 40% pro-rata in the second step. Also, the SMSG would like to highlight that no similar requirements exists in the US rules.

67. By establishing this two-step approach the CCP will not be imperiled due to immediate injection request of 50% capital, which otherwise will put CCPs under stress. With 10% injection the CCP would set a substantial block, but not be overly jeopardized in the first step. As a result, in the second step - pro-rata distribution (on recapitalization), the CCP would satisfy the remaining percentage which would in total sum to 50%. This proposal would be in compliance with EMIR Article 45 (4).

68. In relation to default management the absence of harmonization across the EU constitutes one of the main difficulties for CCPs to manage default risk and implement the necessary default procedure. The lack of a harmonized default regime and harmonized insolvency regimes creates difficulties for CCPs, especially where there are interoperability arrangements, as CCPs must interpret – and in part operate with respect to -the different national legal frameworks for bankruptcy or similar issues. Furthermore, default is not defined identically amongst Member States. Therefore, while it might be difficult for ESMA to propose at this stage a harmonized definition of what is to be considered as a default, ESMA could nonetheless highlight this problem and suggest the establishment of a mapping of current default regimes in the EU, for the purpose of Article 42 of the Regulation.

69. ESMA, in addition to its suggested standards with respect to the default procedure for the purpose of Article 42 of the Regulation, should further clarify the obligations of CCPs regarding the protection of the clients of the defaulting clearing member. The two alternative solutions are the following: Either the CCP is required to protect its non-defaulting members before any other objectives (i.e. will not perform any actions that could negatively affect the clearing fund), as the current wording of Article 42 of the Regulation suggests, or the CCP is required to establish the appropriate procedures to protect the clients of the defaulting clearing member in order to ensure the return to normal of the EU financial markets as prompt as possible. Accordingly, the segregation of client accounts (both cash and securities accounts) would be needed, in order, notably, to assure the timely transfer of these clients to another clearing member.

70. In any case, ESMA should suggest as a complement to the default procedure currently set out in Article 42 of the Regulation that clearing members should be required to keep an updated list of their clients and communicate it either directly to the CCP upon the event of a default or to the relevant regulatory authority upon the event of a default. This would enable these clients to be contacted and informed promptly by the CCP in case of their clearing member's insolvency or default. This would increase the transfer capacities of these clients.

Annex III – Chapter 12: Investment policy

71. Whilst the need for highly secured arrangements for cash deposits is supported, the proposed 98% coverage through secured investments is excessively restrictive and it is questionable whether it is feasible for CCPs to comply with this rule. Such a requirement is inconsistent with the systemic role of a CCP and the need to consider access to immediate liquidity, including in the case of the default of a clearing member. A lower threshold of secured investments would allow a CCP to address the potential trade-off between security and the need for prompt availability of resources. It is believed that ensuring a high level of collateralization of cash deposits is crucial to ensure the CCP fulfills its role in terms of risk management. As such, CCPs should seek the highest degree of collateralization feasible of their investments. However, in practice full collateralization will not be achievable for instance due to the timing of incoming payments late in the day. The SMSG views a threshold figure of 95% allowing exceptions due to circumstances outside the CCP's influence as appropriate. A minority view of the SMSG believes that 90% would be adequate and that ultimately it should be set by each CCP with its competent authority.

72. In general, the SMSG would like to emphasize that it is essential in order to reduce systemic risk that CCPs should be granted Central Bank access for managing their investments in the relevant countries of currencies allowed as margins. In light of late margin calls for instance, it will be entirely impossible for CCPs to place secured investments and to comply with the standard defined by ESMA due to a lack of counterparts that comply with the investment policy of a CCP.

73. Art. 2 INV suggests highly secured arrangements for the deposit of financial instruments. Safeguarding this non-cash (IM) collateral that has been provided – albeit through title transfer – by financial market participants should be a top priority for CCPs. There is a risk that if a CCP becomes insolvent the non-cash collateral could be seen as being part of the estate of the CCP. Of course the issue of what happens to collateral posted with a CCP on insolvency is a difficult one, made even more difficult when considering the different arrangements through which non-cash collateral can be held and the law that applies to those arrangements. Since re-hypothecation of non-cash collateral may make this even more complicated ESMA should therefore consider clearly defining in the Technical Standards the conditions under which a CCP may re-hypothecate posted non-cash collateral.

Draft Technical Standards on Reporting Requirements

74. Reporting requirements address all derivatives – OTC and listed. Some reporting requirements are very prescriptive and address OTC derivatives contracts, disregarding that listed derivatives are already reported in defined structures, and till date no necessity has been seen to update on intra-day margin calls, for example.

75. ESMA has developed an approach to the reporting obligation with a view to delivering the G20 objectives in improving transparency in OTC derivatives markets. The proposals for the content and format of reports reflect this focus on OTC derivatives. However, the reporting obligation applies to all derivatives contracts, including exchange traded derivatives (ETD) and there is no consideration of these, including the use of existing ISO data standards, which would facilitate the reporting of ETDs. This is a serious omission, which potentially undermines both the objectives of reporting all derivatives contracts to trade repositories and seeking consistency with the transaction reporting regime in MiFIR.

ESMA should have more regard to the standards that already apply to listed markets as these are developed/mature markets.

76. Art. 3 and 6 together with Tables 1 and 2 set out an obligation to report the market value (changes in comparison to the last evaluation) and the amount of collateral posted in view of every single transaction to be reported. The reporting obligation is thereby turned into an obligation to constantly evaluate and report the market valuation of each transaction including its collateralization. There is no legal basis for such an extensive and constant reporting obligation in the regulation and the regulation does also not provide for a mandate to regulate such far-reaching and onerous obligations by way of a delegated act. Article 9 (1) EMIR requires reporting on any conclusion, modification or termination of the contract. The market value (and the collateral posted in this connection) and/or changes thereto are neither an element of the conclusion nor of the modification nor of the termination of the contract. Consequently, the relevant provisions in the draft delegated regulations are without any legal footing and clearly exceed the mandate granted under the regulation. ESMA seems to be aware of this lack of mandate as it adds a fourth amendment "other" in field 63 (only Annex V, in Annex VI "other" is missing). The requirement to report "other" events is not covered by the mandate of Article 9 (6) EMIR since the technical standards should define details of format and frequency and not add requirements on content. Finally, due to the expected number of daily amendments and efforts of the market participants ESMA should at least consider an alternative.

77. Moreover, ESMA should clarify, to which extent certificates (not representing the underlying in a 1:1 ratio) and warrants are to be reported. Also, there is uncertainty in the market if the principal is also subject to the reporting obligation regarding (non-OTC-) derivatives traded on an exchange in an agency model (commission basis), as it is not party to the derivative.

78. The recent publication of EMIR in the Official Journal means that as a result of Art. 9 of EMIR the back-loading requirement with regard to reporting of transactions would apply from the 16th of August 2012. Lead time will be required in order to ensure the required data fields are captured and recorded for the relevant trades. It is not that this requirement will be onerous; it will simply be impossible to record each and every field that ends up being in the final form of the regulatory technical and implementing standards with retrospective effect for all trades entered into (that are still outstanding) between 16th August 2012 and the date when those standards are finalized and approved by the Commission and the requirement to report to Trade Repositories goes live. The SMSG suggests that ESMA takes that into account in its technical standards.

VI. Other Comments

Numbering system of Technical Standards too complex

79. The SMSG finds the numbering of articles in the draft Delegated regulations, which reflects the title of each chapter (e.g. Article 1 DF, for Article 1 of Chapter VIII Default Fund or "Article 1 3C" for Third Country) as very confusing. The numbering of articles in each draft Delegated regulation should be purely numerical and reflect their order within each regulation.

Harmonize equivalence requirements and timelines for market participants

80. The timing of development of indirect clearing should be a phased in requirement as it involves a major shift in business, risk and operation models for CMs and CCPs. If ESMA does not take forward the advice, significantly more time for implementation of the rules on listed derivatives should be allowed. Finally, it is suggested to have a longer period for implementation for OTC derivatives especially if there are delays in recognition of CCPs – the key concern here is non-financial services clients not being ready for implementation as they have to adapt to these new regulations (be educated on what is required, implement changes etc.). For example, a small widget manufacturer seeking an interest rate or currency swap may not be able to adapt to these changes quickly and so an investment firm will not be able to provide this product to them harming the EU economy.

CCPs should receive central banks access and be subject to prudential supervision

81. The SMSG believes that the development of technical standards should reflect authorization and supervision of all CCPs by central banks, in consultation with ESMA and other relevant regulators, and should provide for CCP access to central bank liquidity. The technical standards should deliver a sound, effective and consistent level of regulation as well as a supervisory process that is effective in identifying and resolving real regulatory issues in an efficient manner. It must also provide a standard approach to recognising CCPs across the EU, regardless of their location.

CCP Risk Committees to be strengthened

82. Some members of the SMSG believe the role of the CCP Risk Committees should be strengthened beyond its current role according to EMIR. According to EMIR Level 1 Text, Risk Committees have an advisory role, but not any real powers of approval, veto or otherwise – only the CCP is required to report to its regulator if it does not follow the advice of the Risk Committee. Some members support that these committees have the ability and authority to make decisions and properly manage obligations for which they are responsible (as opposed to a pure advisory role). For instance, certain key risk management rules and practices of the CCP which establish the core risk management profile of the CCP to its clearing members should be subject to Risk Committee oversight. There should also be appropriate clearing member participation on the Risk Committee (this is of central importance because in the event that the CCPs risk management fails – primarily it is the clearing members' capital which is at stake).

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