ESMA/2013/926

ISDA and BBA Response to

ESMA DP on the Clearing Obligation under EMIR

12 September 2013

A. Respondent

Name: International Swaps and Derivatives Association and British Bankers Association

Country: Belgium, United Kingdom

Category:

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

B. Introduction – General comments

ISDA and the BBA[1] welcome the opportunity to respond to the ESMA Discussion Paper on the Clearing Obligation under EMIR. We would be very happy to further discuss the views expressed in this response, as ESMA views appropriate.

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org

The associations believe that the **readiness of CCPs and of market participants to clear derivatives in a way that does not generate unnecessary systemic risk is the most important issue** for consideration in approaching implementation of the clearing obligation.

In this context, we would particularly like to highlight the following aspects of our response:

- Market participants remain **very concerned about the potential impact of the frontloading obligation**. We acknowledge and appreciate ESMA's recognition of these issues. Frontloading is generating great uncertainty in the market, and potential for market dislocation. We propose a number of steps in our response which will mitigate the harmful effects of a frontloading requirement.
- Further to this point, **we believe that the imposition of a clearing obligation should only occur when there is certainty as to the capacity and capability of involved CCPs to effectively manage default and resolution scenarios.**
- We are **concerned about the suggestion in the DP that the Public Register would be updated to distinguish between characteristics of cleared and non-cleared derivatives, and that such contracts would be subject to the clearing obligation without delay**. This approach would lead to a lack of legal certainty for market participants. This would also be a worrying departure from the practice in relation to contracts subject to the clearing obligation listed in relevant RTS, where market participants would have an essential period of time to prepare for implementation of the clearing obligation.
- Experience from CFTC mandatory clearing demonstrates that insufficient product granularity results in confusion regarding products that are in and out of scope of clearing requirements and exclusion from the clearing mandate of a small number of non-standard but clearable products at a single CCP. **We therefore propose that ESMA ensure that the clearing obligation is applied with sufficient granularity to give certainty to the market regarding the application of the clearing obligation to each individual transaction**. We stress that the ultimate determination in respect of the application of the clearing obligation to an individual transaction must be possible by reference to a definitive list maintained and published by ESMA.
- In addressing appropriate **phasing in of the clearing obligation**, we believe that counterparties with direct access to clearing in the relevant product with the relevant CCP(s) could face a shorter time horizon to compliance with clearing than those without such direct access. Firms who have never cleared before could also benefit from additional further time. Of the options put forward for classification of counterparties for phase-in, we prefer a variation on option B, whereby the EMIR 'financial counterparty' category could be divided into two sub-sets by reference to counterparty trading volume and existing access to clearing.
- **We welcome ESMA's discussion of when or how the clearing obligation for a class of derivatives may be lifted.** A major shift in composition of market participants would be a clear basis for re-evaluation of the clearing obligation, given the impact of such a development not only in terms of liquidity (and therefore ability for the CCP to assess and manage risk), but also the cost of clearing (exerting further downward pressure on market composition) and, perhaps most importantly, ability of clearing members to manage another clearing member's default in the market. Another such scenario could be where a market's participants have become very 'directional', which would make default management and auction difficult. Where a decision to lift the clearing obligation has been taken, it should take effect immediately.

The associations believe that – like in the US clearing framework – **new contracts (in classes of derivatives that would otherwise be subject to the clearing obligation) created as a result of portfolio compression exercises should not be subject to the clearing obligation.**

We believe that the **credit and interest rate derivatives asset classes should be the initial focus of the application of mandatory clearing.** We are concerned that a greater depth of understanding needs to be

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developed regarding the equity derivatives asset class, and query the analysis of the market set out in the DP. We have reservations about the application of clearing obligations to FX derivatives (on risk and cost-benefit grounds and in consideration of international convergence).

We continue to have reservations about the possibility that the clearing obligation could be applied to **SPV**s, and believe that this would be disproportionate outcome which would deprive the securitisation and structured finance sector of a valuable hedging tool and significantly impair the securitisation and structured finance markets.

C. Comments on the discussion paper and answers to questions

Comments on paragraphs 1 to 6:

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

Comments on paragraphs 7 to 17:

2. CCP-cleared classes of OTC derivatives

Comments on paragraphs 18 to 30:

We note ESMA's proposal at paragraphs 26 and 27 of the DP that ESMA should define the classes of OTC derivative subject to the clearing obligation in RTS, but that detailed characteristics distinguishing between CCP-cleared and non-CCP cleared derivatives would be published in ESMA's Public Register. In particular, we note ESMA's statement that the Public Register should be updated, in accordance with a procedure defined at RTS level, and that contracts added to the Public Register would fall within the scope of the clearing obligation without delay.

We are concerned that this approach may lead to a lack of certainty for market participants regarding which contracts are subject to the clearing obligation. Where contracts subject to the clearing obligation are listed exclusively in the relevant RTS, market participants will have a period to prepare for implementation of the clearing obligation and frontloading in relation to those contracts, and it would also be possible for the RTS to provide for phase-in of the clearing obligation in relation to particular contracts where this is appropriate. However, if ESMA may bring contracts within scope of the clearing obligation simply by updating its Public Register from time to time, market participants will need to check the Public Register on a daily basis to determine whether their existing contracts may have become subject to the clearing obligation, and may find themselves in a position where they need to renegotiate their agreement with the counterparty the same day in order to avoid breaching the clearing obligation. Clearly this approach has the potential to create significant uncertainty for market participants.

We also note that the clearing obligation procedure set out in Article 5 EMIR does not envisage that all contracts cleared by a CCP should be subject to the clearing obligation, but rather that ESMA should consider in each case, following appropriate consultation, whether it is appropriate for a particular class of OTC derivative contract to be subject to the clearing obligation. As a result, ESMA should identify the contract types within each class of OTC derivative contract which are cleared by a CCP at the point in time when ESMA is considering whether or not that class of OTC derivative contract should be subject to the clearing obligation, and should consult, reach its decision and prepare the RTS on this basis. ESMA's description of a particular class of OTC derivatives should give market participants sufficient certainty to determine which contracts cleared by CCPs are within that class. If there is no certainty over which contracts cleared by CCPs are within a particular class, it is difficult to see how ESMA can properly consider the points that it is required to consider under Article 5 EMIR (e.g., the degree of standardisation of contractual terms, or whether more than one CCP already clears the relevant contracts). If further contract types are subsequently accepted for clearing by a CCP, ESMA should identify these contracts as being within a new class of OTC derivative contract, and should consider in accordance with Article 5 EMIR whether that new class should be subject to the clearing obligation or not.

EMIR does not grant ESMA the power to add contracts to the scope of the clearing obligation except in accordance with the procedure set out in Article 5 EMIR, and we are concerned that ESMA's proposal to create RTS under Article 5 specifying the process by which ESMA may add new contracts to the Public Register would create a parallel process to the procedure set out in Article 5 EMIR. There is no basis in EMIR for ESMA to develop such a process through RTS.

2.1 Credit derivatives

Comments on paragraphs 31 to 39:

Question 1 (Series for Index CDS):

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

Answer:

(Option A) - Would be to include in the classes the first series to be subject to the CO, and indicate that all subsequent series will also fall within the scope of the CO.

(Option B) - to include any new series automatically in the CO, like in Option A, and in addition introduce a possibility for ESMA to remove certain series a posteriori.

(Option C) - ESMA may also adopt a criteria-based approach whereby the draft RTS would include a predefined set of series and a list of criteria that the new series should verify in order to be subject to the CO.

We support a variation of Option B. On the run (new) indices only should be automatically subject to the clearing obligation; off the run should not be included due to the sudden drop off in liquidity. We believe there should be a specific process for making an off the run (previous series) change from mandatorily cleared to optionally cleared once it has rolled.

Our recommendation for calibration is to have a threshold of at least ten (10) unaffiliated clearing members, on average per week over the last year. In addition, ESMA should also use a volume based approach while evaluating eligible indices, where the liquidity of the index plays a significant role in selection criteria.

Question 2 (Index CDS):

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

Answer

We believe another characteristic that should be included in the analysis is whether or not the index trade is using the standard template/terms for trades cleared at one or more of the CCPs clearing the relevant index. Requiring trades executed with non-standard terms to be cleared would essentially bar any trading other than on the standard forms cleared at one or more CCPs. This would prevent and deter any experimentation or development of the product on an incremental basis.

Question 3 (Index CDS):

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

Answer:

In considering what indices should be subject to the clearing obligation, the following criteria should be reviewed. We recommend that ESMA consider the number of unaffiliated clearing members trading in the index as an essential factor. We support a threshold requirement of at least ten (10) unaffiliated clearing members, on average per week over the last year (which is vital both for liquidity purposes and for demonstrating the ability of clearing members to (collectively) participate in the default management process effectively (see answer to question 20). In addition, ESMA should also use a volume based approach while evaluating eligible indices, where the liquidity of the index plays a significant role in selection criteria. If the above considerations are used as eligibility criteria, we believe one CCP should be sufficient to offer clearing in the product. It is understood that for clearing a product a CCP may have lower gating criteria, but we believe the above recommendations are prerequisites to a clearing mandate.

We recommend the following phase-in schedule for the mandatory clearing of indices:

1 – iTraxx Main & CDX Investment Grade

2 – iTraxx Crossover, & CDX High Yield

Given limited liquidity we do not recommend that iTraxx HiVol, CDX.EM IG and CDX IG HiVol should be within the initial clearing mandate.

Comments on paragraphs 41 to 44

Question 4 (Single name CDS):

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

Answer:

(Option A) - The settlement currency could be used as the primary key.

(Option B) - The geographical zone used as a primary key.

(Option C) - Group all the single name entities in the same class which would limit the number of classes to just one.

We believe that both the geographic zone and the settlement currency are relevant characteristics. For the geographical zone, we recommend adopting the Transaction Type groupings found in ISDA's Credit Derivatives Physical Settlement Matrix ("the Matrix") which generally follow along geographic lines, but also provide specificity as to the material trading terms, such as credit events and deliverable obligation characteristics.

Comments on paragraphs 45 to 50:

Question 5 (Single name CDS):

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

Answer:

(Option A) - Would be to identify, in the Class, the set of single names subject to the clearing obligation, for example using an entity identifier.

(Option B) - Would be to define the single name entities using a reference to more stable variables, such as the membership to a specific index.

(Option C) - Would be to use a criteria-based approach, whereby ESMA would use a list of criteria that the classes should fulfil to fall within the scope of mandatory clearing with similar pros and cons.

We agree with the approach in Option B, which would define the single name entities using a reference to more stable variables, such as the membership to a specific index. We believe it is as important for the single name CDS to meet other criteria, however. We suggest a liquidity test for the individual name under consideration. Our recommendation is that the transaction should trade several hundred times, on a daily basis, but if the trading activity were lower it should not fall beneath a fifty per day threshold. In addition, similar to our recommendation for indices, we believe there should be a ten (10) unaffiliated clearing member level of participation in the name, on average per week over the last year.

Question 6 (Single name CDS):

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

Answer:

Similarly, we believe the most relevant approach would be to refer to the transaction type of the single name reference entity. This would be found on the Matrix. Another variable which should be considered is if the reference entity trades with a non-standard reference obligation. A non-standard reference obligation would make the CDS contract bespoke and it should no longer be considered standardized for purposes of the mandatory clearing determination. We also believe the contract's restructuring clause and coupon are relevant distinguishing characteristics.

Question 7 (Single name CDS):

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

Answer:

ESMA should annually review the quarterly Credit SDR Public Data provided by DTCC (latest update published on ISDA website as follows: http://www2.isda.org/images/file_exts/fileext_pdf.png) in order to determine the appropriate liquidity threshold that links to the price point that a CCP can safely use to manage risk. In addition, we believe that single-names should be added only with a delay period following indices.

2.2 Interest rate derivatives

Comments on paragraphs 52 to 58:

Question 8 (Interest rate derivatives):

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

Answer: ISDA member firms agree in general with the list of characteristics as defined.

Industry experience with the CFTC mandatory clearing obligation has shown that the provision of insufficient product granularity results in 1) confusion around whether certain products are subject to the clearing mandate and 2) a small range of non standard derivatives subject to the mandate but clearable at a single CCP. In the context of EMIR, these issues are exacerbated by the issues connected to frontloading that we discuss in our response to question 28 below. We therefore consider it imperative that the final list of products subject to mandatory clearing is as granular as possible. The ultimate determination in respect of the application of the clearing obligation to an individual transaction must be possible by reference to a definitive list maintained and published by ESMA.

We think it is important to consider that even if a product is clearable (i.e. a CCP offers clearing of the product), without the necessary connectivity between CCPs and affirmation platforms it can be difficult or even impossible for trades to be cleared within specified timeframes. This issue has been highlighted following the implementation of mandatory clearing under the CFTC rules where relief has been sought for certain product gaps within the interest rate derivatives space.

ISDA member firms agree with the variables listed in paragraph 55, but feel that there should be a mechanism which allows ESMA to specify which of these variables are currently covered, and also to list very specific examples which are temporarily exempt from mandatory clearing for example due to gaps in middleware providers.

Question 9 (Interest rate derivatives):

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

Answer:

For global consistency it would be preferential to see a convergent approach between the CFTC and ESMA in relation to interest rate derivative products covered by mandatory clearing. Maintaining the same scope of products will create a consistent and fair market for all counterparties regardless of jurisdiction. Operationally, it makes sense to support alignment of the scope of products subject to clearing in each jurisdiction.

We think consideration needs to be given to contracts referencing indices or benchmarks that will potentially be discontinued in the future as the impact on liquidity will be severe making certain products not suitable for clearing.

Related to our response to question 8, the clearing obligation should come into force on a product-by-product basis when a specific OTC derivative product meets the criteria pre-determined as relevant. The analysis of the suitability of the clearing obligation to an OTC derivative product should take place at a level of granularity sufficient to ensure there is no ambiguity with respect to the scope of trades covered by the potential clearing obligation.

OTC derivative products which are complex, non-standard and dynamic (for example swaptions) are not suitable for clearing. OTC products which are traded in low volumes, resulting in a highly concentrated market in which few CCP member participants are able to provide liquidity (for example inflation swaps) are similarly not suitable for clearing.

Further clarity is needed around what should be included in the "Interest Rate Option" class. With Swaptions and Caps/Floors excluded, we are unclear as to which products fall under this class. This class should be removed if further

clarity cannot be given. It is noted that we do not consider "Interest Rate Options" to be currently eligible for clearing at any CCP.

ISDA member firms agree with the proposals given, except for the following specific points:

a) Fixed-to-Float for EUR and USD – there is limited CCP support for maturities up to 51 years, this should be amended to up to 50 years.
b) Basis Swap for GBP and USD – there is limited CCP support for maturities up to 51 years, this should be amended to up to 50 years.

2.3. Equity derivatives

Comments on paragraphs 59 to 70:

Question 10 (Equity derivatives):

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

Answer:

Before directly answering question 10, we would like to highlight some critical differences between the credit and equity derivatives asset classes, in light of commentary in the DP indicating that the equity derivatives asset class exhibits some commonalities with the credit asset class.

i. Credit events are binary - either there is a default or there is not. Equity corporate actions can be myriad in type and impact. For example dividends, stock splits and mergers are all very different and require different processing and management. Further, whereas credit events are determined by reference to a limited set of eventualities described in ISDA's Credit Definitions, the number of different permutations of equity corporate actions which could require fair-value adjustments to an equity-derivative contract is effectively limitless.
ii. Credit performance is opaque - the value is determined by the buyer and seller with no reference to a public listing market. Equities, especially Total Return Swaps, are determined by direct reference to listed markets.
iii. Certain equity products, including Total Return Swaps have a financing leg which is not standard, unlike Credit.
iv. Equity products have a tenor and in the case of Total Return Swaps, often include reset features, which, unlike Credit, are not standard.
v. When taken together, while certain equity products such as the Total Return Swap product can be very straight-forward from a valuation/transparency perspective, it is very difficult to effectively clear. Each transaction is a unique combination of underlier(s), financing rate, tenor (including frequency of reset, if applicable) and corporate action treatment and to clear equity products would result in one of the following:
a. A CCP needing to identify each specific transaction as cleared by reference to the above-identified product features. This would prove incredibly complex and add risk and complexity to the system where it is not needed, essentially having millions of different products with an open interest of one contract between the CCP and a CP; or
b. The CCP requiring all market participants to use standardized underliers, financing, corporate action and tenor. This already exists in the cash equity, listed options and futures markets, which is why market participants use over-the-counter equity products for customization when these markets do not meet their needs.

We highlight these equity product characteristics and the ways in which OTC equity derivatives differ from credit derivatives as we believe this should significantly impact any analysis of which products should be subject to a mandatory clearing requirement. While there are certain index products, e.g., short-dated over-the-counter options on major indices comprised of liquid underliers, which in many cases do not have the issues identified herein and could be reasonable candidates for clearing, most equity products, notably Total Return Swaps, do not readily lend themselves to clearing. Certainly there are some cleared equity product offerings in the market place, but, as

discussed below in some additional detail, these are for only the most standardized products and would not be appropriate substitutes for more bespoke equity derivatives.

With regard to the specific points raised by question 10, while ISDA and its members agree that cross-reference to a defined list of shares and indices updated periodically plays an important role in the methodology to describe Equity derivatives classes on single names, we would caution against this being a singular driver and further suggest that careful consideration should be given to how such a list is maintained in order to avoid overly burdensome monitoring required by market participants. It should be noted that the existence of a clearing offer for certain European single shares, or certain indices, cannot be construed as meaning that clearing solutions exist for all European single shares in EUR, or even for all products on shares for which some clearing solution exists. We would also note that in our opinion the shares on the list of "liquid shares" (Option C) are not sufficiently liquid to justify a clearing mandate on all such underliers. Furthermore, we would suggest that from a liquidity perspective both the liquidity of the derivative contract and the liquidity of the underlier need to be considered. We would note in this regard that, for example, while a particular UK stock may be liquid there may not be equivalent liquidity in the corresponding derivative contracts.

While we recognise that ESMA is not suggesting that the underlying should be the sole key characteristic for determining clearing eligibility we would note that the current proposed approach for product type and sub product type is inconsistent with industry nomenclature and would i) cause confusion and ii) create further challenges to ensuring that only those trades that are suitable for clearing fall under the clearing obligation. Instead we would request that ESMA establish the key characteristics for determining an Equity derivative class align more fully with industry nomenclature and in this regard suggest that product type and sub product type follow the classification as set out in the ISDA Taxonomy.

Furthermore, we are concerned that the assessment made in the Discussion Paper (as illustrated in Table 1 and Table 13) of the availability of CCP clearing for the OTC equity-derivatives asset class is not an accurate reflection of the current availability of clearing. These tables capture exclusively the availability of clearing for exchange-traded derivatives ("ETDs") which are traded on an MTF, and for exchange-like "flex" options and futures which are negotiated off-order book. While these two product-types fall under the definition of "OTC derivative" from an EMIR perspective, they are distinct in many significant ways from most OTC equity derivatives and are closely akin to ETDs (in certain cases they are even fungible with identical ETDs traded on-order book). In making an assessment of OTC derivatives clearing availability which is based solely on these quasi-ETDs, ESMA raises the worrying prospect of creating a clearing obligation where there is no clearing solution available.

Similarly, we also raise concerns around the assimilation of off-exchange cleared futures into the definition of "forwards/swaps" and believe that this should not lead to the conclusion that cleared solutions exist for swaps on the same assets. There are currently no cleared solutions available for equity swaps, and expectations of possible clearing for equity swaps appear to ignore the actual characteristics which drive demand for this product and assume that a cleared product will perform and match customer requirements equivalently to the current OTC product. ISDA does not agree that OTC Equity Swaps and listed futures (whether on indices or single equities) are equivalent and note that they are different products and fulfill different economic requirements. To elaborate on this we would highlight the following points:

i. lack of depth in many of the listed market products compared to the OTC market,
ii. the characteristics of the equity swap product are designed to eliminate the very financial risks introduced by the listed products, namely: (a) term interest rate risk, (b) stock loan recall risk, (c) exposure to unexpected changes in dividend levels, and (d) exposure to changes in fiscal dividend withholding levels,
iii. the trade terms of OTC equity Swaps, especially the single stock product, are continuously negotiated bilaterally throughout the lifecycle of the trade, not just at inception, to reflect changes in market levels or conditions. It is this bilateral negotiation that provides customization and flexibility for clients and at the cheapest possible price (by reducing risks). This product characteristic would not be replicable within a mutualized contract
iv. There are no mechanisms in a mutualized contract to restate financing spreads, alter dividend percentages to reflect fiscal changes in the underlying market or partially recall positions due to changing conditions in the securities lending market. Even if mechanisms were created, risks would by default be shared by clients rather than be applied to a specific client based on its circumstance, and this this would be unacceptable. Customer specific service and reactivity would no longer be possible, and hence interactions and services Dealers could provide to their clients would be irreversibly reduced.

While we recognise that many of these risks can be absorbed for a price, it is likely that this cost would be passed directly to clients. Dealers and clients would find themselves trading a "PV" based instrument instead of an "Accrual" based instrument and therefore absorbing greater financing and dividend risk. Clients will not wish to absorb or

manage this risk themselves and it is unlikely they would be prepared or able to pay the Dealers to absorb it on their behalf. In effect clients would be relegated to trading an instrument which does not meet their investment requirements, and which would be more costly to them. We are concerned that rather than enhancing liquidity and bringing greater transparency, the marketplace will simply shrink and stagnate.

Our further concern is that the existing OTC Equity Swap product will suffer punitive margin if not cleared, even though it is clear from the above that no suitable cleared equity swap product exists today or likely to exist in the near future. We believe that indications from CCPs that they are ready to clear OTC equity swaps are exaggerated as, to date, no CCP has provided details on how they are going to replicate the ongoing bilateral negotiation aspect of the contract, or indeed, to be aware of the issues.

Since the move towards clearing is primarily driven by reduction of systemic risk, it should be noted that OTC equity swaps in general do not result in significant leverage or optionality that would be a driver of such systemic risk. Collateral is taken in the form of Independent Amounts and Mark to Market, subject to daily thresholds and normal CSA arrangements. Regulatory Reporting is already real-time. At every decision point, we ask that the damaging impact of clearing on this product is considered before any mandate or punitive margin requirement is put in place.

As far as the broader OTC equity derivatives market is concerned, we would add that from conversations with CCPs there is little, if any, intention to expand the product set that they currently offer to include true OTC equity transactions, in large part due to the existence of a volume materiality threshold which would need to be breached before developing a product becomes economically viable. Historically conversations between the equity derivatives market participants and CCPs has indicated that CCPs intentions are to develop support for Rates and Credit products first and to the extent there is any ambition in equity derivatives it relates to build out of the existing flex offerings only. ISDA and its members are supportive of this approach and would caution against any rush to create cleared solutions for OTC equity derivatives given the limited appetite of clearing houses and the dangers that this could create a monopoly provider. Furthermore it should be noted that there is much to consider in the detail, for example tax treatment, dividend treatment, corporate actions etc… and CCPs need time to put a product offering together to avoid any cleared product being inferior to its non-cleared form.

Finally, we agree that a criteria based approach, as an extension to the use of agreed key characteristics (i.e. product/sub-product definition, underlier, etc) is essential to further define the clearing obligation and ensure it applies only to those trades for which it is suitable. We would suggest that ESMA works closely with the industry to establish the set of criteria that is wholly appropriate for this purpose.

Comments on paragraphs 71 to 73:

Question 11 (Equity derivatives):

Please indicate your preference between the options presented.

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

Answer:

ISDA and its members believe that Option B is most consistent with how the OTC Equity Derivatives market operates today and would suggest that this would be an appropriate way to further define the set of transactions to which the clearing obligation should apply. However, as noted in our response to question 10 above this should form one of the many characteristics that determine clearing eligibility. In itself geographical zone does not provide sufficient granularity for making the determination of Class+.

Question 12 (Equity derivatives):

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

Answer:

As noted in our response to question 10 we do not think that the current proposed approach to definition of product type and sub-product type is appropriate for purposes of determining trades that should be subject to the clearing mandate. We believe that a richer definition of product is required and this is facilitated by the ISDA Taxonomy which will be extended over time. Furthermore, aligning the classifications with the ISDA Taxonomy would not only allow for narrower definitions of the transaction type (e.g. separation of Forward/ Swap) and incorporation of the Return Parameter characteristics (e.g. Price v Dividend v Variance/ Volatility) but further improve the market wide understanding of each of the product classes.

If the product/sub-product definition were to be changed in this way then along with Geographical Zone and reference to a list of underliers we think that this would provide most of the key characteristics for determining a Class+. However, we would suggest that consideration is also given to criteria such as; availability of listed contracts, capitalisation of the issuer and size of the issuer free float. In addition, and as mentioned previously, we believe that it is necessary to extend the list of additional characteristics which, when applied alongside the key characteristics, creates the desired level of granularity to ensure that only those trades that are wholly suited to clearing are subject to the clearing mandate. In this regard consideration should be given to incorporate elements of standardisation and liquidity. As an extension of the standardisation characteristic, ESMA should also consider incorporating a classification of 'simple' versus 'complex' products. Products could be classified as complex depending on the number of customizable parameters and choices available (see list of additional characteristics below) versus those with limited choices that are designated as simple (i.e. vanilla/ listed lookalike). It is important to note here that there is a distinction of complexity or non standardization through an increased number of customizable parameters (even where the "choices' are well defined) versus the non-standardization that results from customized user preference (e.g. settlement period, roll frequency, roll date).

We would strongly suggest that the role of making determinations, such as Market Disruption Events, corporate action management and Early Termination Events, in the lifecycle of equity derivative contracts is carefully considered and perhaps included as a characteristic for any product that is subject to the clearing obligation. This role is critical and in many cases the calculations and determinations of specific lifecycle events cannot be ascribed to a CCP as they are very specific or exotic in nature and require a range of expertise. Over the past five years ISDA and its members have had multiple discussions with CCPs with a view to expanding the availability of CCP clearing in equity derivatives, and this aspect of product specificity has proven a barrier to expanding clearing to segments of the equity-derivatives markets. We would highlight however that where a migration to clearing has proven possible (with the calculation and determination role assigned to the CCP via its rule-book), this has resulted in a successful migration of significant volumes from OTC to ETD.

Furthermore, as indicated in our response to Q10, we would note that in section 2.3, ESMA has reconstituted an image of the OTC equity derivatives market which is not representative of the true availability of cleared solutions for OTC equity derivatives in Europe (notably in table 13). Under EMIR, derivatives traded on an MTF and derivatives negotiated off-exchange and subsequently given up to a clearing-house are considered to be OTC derivatives. However these products only represent a subset of the range of OTC equity derivatives, and the existence of a limited amount of clearing for MTF-traded derivatives or for Exchange-listed derivatives traded off-exchange should not lead to the conclusion that widespread clearing solutions exist for all OTC equity derivatives of a similar nature on the same asset.

In direct response to question 12 we note additional variables and characteristics that we consider relevant in the context of the clearing obligation include, but are not limited to:

- Option Style – i.e. European, American etc…
- Settlement Type – Cash/ Physical
- Related Exchange (for the purposes of corporate actions)
- Market Pricing (Open/ Closing)
- Barriers
- Non standard settlement currency

In order to develop a comprehensive list of characteristics ISDA would request that ESMA work closely with the industry to develop a better shared understanding of the OTC equity market; and specifically the OTC bilateral/ ISDA based OTC equity market. Table 13 should then be updated based on this shared understanding.

In addition to the OTC equity derivative characteristic mentioned above ISDA would add that, consistent with comments made elsewhere in our response to this discussion paper, consideration needs to be given to the existence of infrastructure to support the process of clearing.

Question 13 (Equity derivatives):

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

Answer:

Taking into consideration points made previously, and conversations with CCPs and other market participants, ISDA and its members would suggest that the specific products that would be the best candidates for the clearing obligation are those standardised exchange lookalike options on European Indices with a maturity cap based on the index and where sufficient liquidity exists. We highlight however that CCP product-development in this segment is held back by constraints on CCP access to index licensing.

We recognise that other products may evolve over time and reach a mature enough state that they could be considered for clearing. Variance and volatility swaps referencing underliers in North America, Europe, and Asian open markets are possible candidates for clearing, should a CCP develop such a clearing offer (although here again the volumes might justify a Clearing Obligation only for the most liquid indices and maturities). Currently, the market is working towards standardization of these products and recently, some clearing organizations have shown interest in these products as well. To the extent that ESMA is considering a staged approach these products should be considered next after the exchange lookalike options referred to previously.

2.4. Foreign Exchange derivatives

Comments on paragraphs 75 to 78:

Question 14 (FX derivatives):

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

Answer:

While we support the rationale behind separating contracts in a manner which is consistent with industry taxonomies, the relevance of the "economic purposes" of the contracts (a concept referred to in paragraph 76) is not clear. With this in mind, we draw ESMA's attention to the FX taxonomy which has been widely adopted for purposes of derivatives regulation by market participants, e.g., in the context of trade reporting in the United States. A copy of this taxonomy is attached as an appendix to the GFMA Global FX Division response to this DP, for convenience.[2] As noted therein, the classifications include non-deliverable forwards (NDF), non-deliverable options (NDO), forwards, vanilla options, simple exotic options (with further breakdown into two sub-products – barrier and binary/digitals) and complex exotic options.

[2] www.gfma.org/uploadedFiles/Initiatives/Foreign_Exchange_(FX)/GFMA%20FX%20Division%20Paper%20(2011-11-30)%20-%20FX%20Market%20Architecture%20Group%20-%20FX%20Taxonomy%20Proposal.pdf.

The two classes of FX products included in section 2.4, paragraph 77, are the (1) non deliverable forward (NDF) class in table 14; and (2) cash settled forward (CSF) class in table 15. However, these two classes proposed in the consultation paper are more appropriately and accurately classified as a single class only. The transactions listed in tables 14 and 15 involve two transacting parties executing an FX forward contract on the basis of non-delivery (i.e., cash, not physical, settlement) which involves the fixing (i.e., valuation) of the contract and therefore settlement in single reference currency. We appreciate that the term non-deliverable forward in the FX context often refers to trades involving currencies subject to restrictions such as general capital controls or other governmental actions, but we believe that distinction is without meaning for purposes of these classifications when the contract is traded on the basis of delivery in a single reference currency. By way of illustration, the Korean won is known as a restricted currency, but may be traded as a non-deliverable forward or a deliverable forward. CLS Bank International, the multi-currency payment system for the institutional FX market, introduced the Korean won into its settlement service in 2004 for deliverable FX spot, forward and single leg of FX swap trades and only subsequently, in 2007 supported settlement services for non-deliverable forwards involving Korean won when its settlement service was extended to non-deliverable forward trades. For these reasons, we strongly recommend that the two classes (NDF and CSF) currently identified in section 2.4 are classified as a single NDF class only. This will also avoid the unnecessary proliferation of classes within and overly complex taxonomy for the FX market.

We also wish to note that within the single class of NDFs we propose, there is not a further breakdown with respect to "product type". The only further product breakdown necessary – and we stress that this is indeed necessary– is based on currency pairs as currently illustrated in section 2.4 tables, along with notional currency, settlement currency and maturity; as currently indicated in the section 2.4 tables, for the single class of NDFs we propose, the "settlement type" will always be cash.

Because liquidity by currency pair varies significantly, clearing is only warranted on a product eligible-for-clearing basis (in this case, the NDF class) for those contracts in the NDF class which (1) are highly standardized; and (2) involve very liquid currency pairs of sufficient volume. Only clearing of such contracts would offer a potential material reduction in replacement risk across the FX market and, importantly, be manageable by CCPs in a default situation. As CCPs launch their initial and additional FX products, and additional currency pairs within each class/ product over time, ESMA should give each product, by currency pair, due and careful consideration to ensure that any clearing obligation is warranted based on the criteria described above for the relevant currency pair. Approving FX derivatives by product class and, within each product class, by currency pair will also enable consideration of the pace of development at competing CCPs to ensure market participants have a choice of venues to ameliorate systemic risk and encourage competition.

It is not clear whether physically settled forward FX transactions fall within the definition of financial instrument as addressed in Annex I Section C (specifically sub-points 4-10, covering 'derivatives' for the purpose of MIFID scope). There are differing views between national competent authorities in this regard. Hence there is uncertainty as to whether such products would be subject to EMIR clearing requirements. The DP appears to operate under the assumption that any FX product that is cleared by a CCP, or for which a CCP obtains authorisation, will by definition be subject to consideration by ESMA for the mandatory clearing obligation.

In event of any physically deliverable FX contract being notified to ESMA under EMIR Article 5, we believe that ESMA should undertake to publicly express a view in the course of its considerations therein regarding whether and on what basis ESMA has concluded that the product falls within the scope of the MIFID financial instrument definition (and is therefore potentially subject to the EMIR clearing mandate).

Question 15 (FX derivatives):

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

Answer:

As previously raised by GFMA with ESMA[3] with respect to its review of a class of an OTC derivative for a clearing obligation, we urge ESMA to require specific information from the CCP on the end-to-end testing conducted with its clearing members for that market. Specifically, in the case of FX products, specific information should be required on: (1) the scenario analyses / stress testing performed by the CCP, the default management processes for the CCP and resulting impact on the underlying liquidity in the FX product(s) that the CCP clears or plans to clear, and the arrangements in place to address management of sovereign risk events (e.g., suspension of trading, sovereign default, unexpected bank holiday or other significant disruption to valuation, payment or settlement processes); and (2) a description of the manner in which the CCP has provided information to the central banks of the relevant currencies on its clearing of FX products, including but not limited to (1) above, and a summary of any views expressed by the central banks to this information – especially if the CCP's services were extended to deliverable OTC FX contracts, whether forwards, swaps and even options. Because the deliverable FX market is a central component of the global payment system, central banks have expressed a need to understand and evaluate the impact of clearing by CCPs, individually and collectively, on the deliverable OTC FX market from a broad policy perspective.

With the foregoing in mind and consistent with Article 5(4) of EMIR, ESMA should include in its evaluation of the specific items in the presented class such as non-deliverable forwards the availability of relevant market practice recommendations and documentation through industry groups such as EMTA[4] which address, e.g., the types of market disruption events referenced above, if applicable for the reference currency traded. It will also be extremely important for ESMA to be aware of the value and volume of contracts in the product class actually being processed not only by the CCP for which ESMA has received notification referred to in EMIR Article 5(1), but other CCPs for which notice has not yet been received, and their value and volume relative to the overall trading activity which may exist for the product (in particular, the currency pair for that product) regionally and globally. While low values or volumes (including zero) for a given currency pair in a product class could theoretically be attributable to the service offerings being new, it is prudent and necessary to confirm this through appropriate consultation with market participants, both buy-side and sell-side, as such consultation may surface the very types of issues raised above. It is for these reasons that the rate and pace which CCPs are listing new products should not drive the rate or pace with which, or importantly the decision, of ESMA to subject a class of contracts to a clearing obligation. It is also worth noting that there are existing/historical markets in the specific items listed in the first table in section 2.4, which is in stark contrast to the specific items in the second table where no such market currently/historically exists. Finally, to further consistency in the treatment of products in the global FX market, we urge ESMA and all regulators to investigate whether other similarly situated jurisdictions have imposed a mandatory clearing obligation for a given currency pair in an FX product class before imposing such a clearing obligation in its own jurisdiction and, in doing so, consider whether the underlying reasons for imposing – or not imposing – such an obligation are also applicable / relevant for its own jurisdiction.

Based on all the reasons noted above, the products in the second category (currently categorized as "cash settled forwards class") would, prima facie, not be appropriate for, and therefore not satisfy, the requirements of EMIR Article 5(4).

2.5. Commodity derivatives

Comments on paragraphs 79 to 84:

Question 16 (Commodity derivatives):

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

Answer:

[3] *See* http://www.gfma.org/Initiatives/OTC-Derivatives/GFMA-Submits-Comments-to-the-European-Securities-and-Markets-Authority-on-Draft-Technical-Standards-for-Regulation-of-OTC-Derivatives/ (GFXD Letter March 2012).

[4] *See, e.g.*, http://www.emta.org/doc.aspx.

The best approach would be to specify assets in line with the ISDA taxonomy already derived by the industry and in use for compliance in other jurisdictions. Market participants have already executed system builds using this standard and industry compliance will be achieved more quickly and efficiently using a taxonomy which is already in use.

Question 17 (Commodity derivatives):

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

Answer:

The required characteristics are not entirely captured within the Discussion Paper as it stands. During the Consultation Paper process, ESMA should work with the industry to examine additional characteristics for clearing based on Product Location, Delivery Method and Tenor to ensure that mandatory clearing is fully aligned with the availability of suitable instruments in the market.

Where firms are hedging their underlying risk with OTC derivative products, pricing and selection of the appropriate instrument is often underpinned by the value of the instrument closest in location and characteristics to the commodity being hedged. For instance, reference can be made to Barges FOB Rotterdam or Cargoes CIF N.W.E basis ARA barges as quoted by Platts pricing service. Within both of these example categories, there are distinct and separate quotes depending on the product being shipped which means a very specific price can be discovered for Gasoil 0.2% delivered Free on board ('FOB') at Rotterdam, or the price of Jet Fuel delivered to either Antwerp, Rotterdam or Amsterdam ('ARA') fully inclusive of Cargo, Insurance and Freight charges ('CIF'). From this we can see that the method of delivery is often specified within the offered instrument – FOB having fewer supply chain pricing components than CIF or DES as part of the risk profile being traded.

Tenor can have a significant effect on the liquidity of instruments available for clearing. For example, Power products pricing is driven by the maturity of the contract and the country of supply / receipt.

Spreads widen considerably down the curve in some products which will affect execution capability - thin liquidity in the cleared space could result in adverse systemic risk elements if there is no OTC market to fall back on.

Because of the link between the derivative markets and underlying physical commodities, a wide range of variables are introduced to purify hedging instruments. These will need to be considered when defining and mandating which products must be cleared.

Question 18 (Commodity derivatives):

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

Answer:

The commodity derivatives asset class has consistently increased cleared volumes over the years as a response to managing counterparty credit risk. There is therefore some depth and liquidity in certain areas of the market, predominantly where products have been standardised and the commodity is widely traded e.g. Crude Oil, Power, Gas, Coal, Gasoline etc.

As suggested in the Discussion Paper, there are a significant number of products which are already defined for clearing and show sufficient liquidity – these logically lend themselves as suitable to be at the forefront of the clearing obligation. Once the existing portfolio of standardised and clearable instruments has been evaluated for the mandate,

a programme of identifying further underlying products which can be standardised should be followed, prioritising those which are viewed to have greater systemic risk.

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

Comments on paragraphs 85 to 105:

Question 19 (readiness of the classes):

Do you agree with this analysis?

Answer:

ISDA member firms agree with the analysis for the interest rate and credit derivatives asset classes. It is expected that following the introduction of mandatory clearing under the CFTC regulation, volumes are likely to have increased.

ISDA member firms would support a phased approach to the introduction of mandatory clearing, with phase one including interest rate and credit derivatives, with phase two incorporating FX, commodities and equity.

We agree with ESMA's conclusion that the FX asset class should not be given a high priority, as compared to the interest rate and credit derivatives, in the context of the clearing obligation, for many of the reasons articulated in the discussion paper.

We also wish to note that, with respect to paragraph 88 in the discussion paper, we welcome the explicit reference to ESMA's consideration of international agreements and consultations prior to making any final determinations regarding which derivatives products will be subject to a mandatory clearing requirement and encourage other regulators globally to do the same. This is consistent with recital 19 of EMIR and, as detailed in our response to question 33 below, is particularly relevant for deliverable OTC FX products in light of the systemic relevance, and unique characteristics of the FX market, and the need expressed by central banks to understand and evaluate the impact of clearing by CCPs, individually and collectively, on the deliverable FX market from a broad policy perspective.[5]

We note the reference in paragraph 88 to use of data reporting to the GTR as the primary source of information. For this reason, we believe it is difficult to make an accurate assessment of readiness of equity derivatives for mandatory clearing before EMIR reporting requirements go live. While there is a correlation between electronic processing and the ability to clear we would note that there is a significant difference between standardisation for purposes of legal confirmation (i.e. the terms of the trade) and standardisation that facilitates clearing (i.e. standardisation of the product). Good progress is already being made with regard to legal standardisation, but product standardisation requires considerably more time to evolve as has been noted in our responses to questions 10 through 13.

Furthermore, we re-iterate the importance of liquidity when assessing a product's ability to be cleared. This, along with the degree of standardisation, impacts a CCP's ability to effectively process and adequately risk manage a product (given the impact on pricing). Increasing a product's fungibility through increased standardisation will also increase the benefits of clearing. As far as liquidity is concerned, it should be noted that both the underlier and the class of OTC Derivative need to be assessed

We also recognize that significant clearing exists for equity derivatives as a broad asset-class (via futures and exchange-listed options), and note that by extension "true" OTC activity (leading to bilateral exposures) is typically of a lesser degree of standardization. We agree with ESMA's findings that activity in the OTC derivatives market is typically of a bespoke nature. We also agree with ESMA's findings in table 17 that the OTC equity-derivatives segment is, at 1.1% of the outstanding notional values, a segment which might not be best suited to be a high priority in the context of the clearing obligation.

[5] *See* http://www.gfma.org/Initiatives/Foreign-Exchange-(FX)/GFMA-Submits-Comments-to-the-ESMA-on-Technical-Standards-for-the-Regulation-on-OTC-Derivatives,-CCPs-and-Trade-Repositories/ (GFXD Letter August 2012).

Finally we would note that the OTC equity market, given the custom demands of its users, is not as standard as other asset classes. We would suggest that even when a CCP has determined that it can offer a product class on an optional basis, the parameters described herein should still be carefully evaluated before a clearing obligation is applied to the product.

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

4.1. Dates, phase in, categories of counterparties

Comments on paragraphs 106 to 115:

Question 20 (dates, phase in):

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

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

Answer:

Considerations for timing

The imposition of the CO should be based on criteria and suitability with the overarching aim of reducing systemic risk, and not any prescribed timeline. Because of the different risk management, legal and operational capacities of the different counterparties which would be subject to the CO, and further because this may differ depending on the type of transaction (and how closely it is aligned with a transaction which is already being cleared, whether on a voluntary or mandatory basis) and class, it is not possible to specify a single time period which could apply in all circumstances, irrespective of the number of CCPs.

In addition to operational and market issues, such as those identified above and within the DP, the imposition and appropriateness of a CO must also consider risk and implementation issues. Adequate time is needed for the myriad of clearing participants (indirect clients, clients, CMs, CCPs) to establish, test and implement required infrastructure (e.g. banking/settlement, legal opinions/documentation, client and indirect client agreements, risk procedures).

There should be suitable time for clearing participants to evaluate and gain comfort with risk management practices employed by the CCP to ensure assumed risks are within a clearing participant's tolerable level and not, rather, assigned by mandate. This considers, at minimum, in addition to that mentioned in the DP, a clearing participant's own assessment of the adequacy of initial margin and the default fund, the robustness of default management practices including any loss allocation / recovery mechanisms, and evaluation of applicable accounting and regulatory capital principles.

Considerations for the number of CCPs

In considering the appropriateness of imposing a CO where there is a single CCP (or multiple CCPs) capable of clearing a product, the interaction between the implementation of a CO and CCP(s) risk management is very important. It is also fundamentally critical that the imposition of a CO considers the capacity of available CCPs to effectively manage default and resolution scenarios.

Although we acknowledge certain circumstances where a single CCP may be deemed suitable, we consider that there is inherent and demonstrable benefit (e.g. capacity, resolution, competition) in only mandating clearing of a product where there are multiple CCPs available to clear that product. Where a product is contemplated for mandatory clearing and there exists only a single CCP, we query the appropriateness of imposing a CO and whether the overarching aim of reducing systemic risk is achieved where the entire market risk of a particular product is mandated to be centralized in one location.

As clearing members underwrite the CCP and mutualise the credit risk of other members, they should be able to make their own assessment of whether they are comfortable with a CCP, its risk management, membership criteria, number and concentration of members and many other factors. If there were only one CCP and a clearing member were not comfortable with that CCP, the clearing member would be forced to either accept the risks associated with membership of the CCP, despite its concerns, or to stop clearing the relevant product – a position clearing participants should not be put in.

For example we consider systemic risk issues would arise where, for example, the quality of the only CCP deteriorates, and clearing members would not have the possibility to transfer business to a second, potentially more stable, CCP. Also as there would not be a fall-back, potential mechanisms in recovery and resolution for this CCP are removed. Further, as such a CCP would have a regulatory monopoly, it would not be subject to the rigours and controls brought by competitive dynamics and it might not be as price efficient and innovative as if there was competition between multiple CCPs. Without competition, market forces would not be effective to find an equilibrium of rights and obligations (e.g. in recovery) of the different clearing members. Finally, we note that the legal mechanisms through which clearing (especially client clearing and indirect clearing arrangements) is achieved need to work in various bankruptcy jurisdictions (ie CCP, clearing member, client) and market participants should not be subject to a clearing obligation where there is not a clearing construct which would be effective in the relevant bankruptcy jurisdictions.

In assessing the appropriateness of a CO where either a single or multiple CCPs are capable of clearing a mandated product, the following *Key Considerations*, in decreasing order of importance, should be adequately demonstrated.

- *firstly*, there must be CCPs that would collectively be able to achieve a successful default management process of the entire European market-wide volume of that product following a major systemic event. The major systemic event should be of the magnitude contemplated in EMIR Article 43(2) (i.e. the default of at least the two clearing members to which the CCP has the largest exposures under extreme but plausible market conditions). An ability to meet this requirement is critical in ensuring that mandating a product for clearing will not introduce systemic risk to a market. A "successful default management process" would be one in which a CCP closes out the positions and covers the losses of a defaulted clearing member's cleared portfolio without exhausting pre-funded resources available to the CCP pursuant to its default management rules;

- *secondly*, there must be a sufficiently high number of clearing member entities (counted at the group level, rather than per affiliate entity)which participate in the default management process of the relevant CCP services. This measure should demonstrate a minimum level of risk mutualisation which should be required, for systemic risk reasons, prior to clearing large volumes (and potentially the entire market) of contracts subject to the clearing obligation. Below that minimum level, a product will have limited liquidity concentrated among few members and there may be an insufficient number of market participants to participate in the auction of a default management process, which will limit the CCPs' ability to effect robust risk management. The G-20's goal of promoting the soundness and stability of OTC derivative financial markets through increasing central clearing of OTC derivative contracts will not be achieved if such products are pushed, as a result of mandatory clearing, through one or more CCPs at which there are limited numbers of clearing members, thereby detrimentally concentrating systemic risk in a handful of firms. The need for a threshold number of clearing members is also relevant to our fourth consideration below;

- *thirdly*, the impact related to establishing regulatory monopoly CCPs could be partially mitigated through application of phase-in periods for the clearing obligation: if only one EMIR authorised CCP offers a clearing service for an OTC derivative product intended to be subject to the clearing obligation then, having positively assessed the ability of that CCP to achieve a successful default management process of the entire European market-wide volume of that product following a major systemic event, ESMA should apply the clearing obligation first to largest market participants (for example, see response to question 25). The clearing obligation could be expanded by ESMA to include other market participants only when a second CCP is authorised under EMIR to clear that OTC derivative product. This phase-in would address both competition concerns and the need to avoid applying the clearing obligation to an OTC derivative product if that mandate could be satisfied via only one CCP at which very limited numbers of clearing members are offering OTC derivative client clearing services, thereby detrimentally channelling systemic risk through a single CCP with only a handful of member firms. However, this proposal to stagger clearing obligation

implementation must be considered in light of its potential negative impact on the frontloading period for smaller participants (see response to question 25), and we therefore propose that for such entities frontloading should apply from the date of the second CCP receiving authorisation under EMIR;

- fourthly, ESMA should require that the CCP(s) at which a product subject to the clearing obligation could be cleared satisfies the requirements under Article 305(2)(b) of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms for "highly likely" portability. Unless this is taken into account, clients clearing OTC derivative contracts subject to the clearing obligation are less likely to be able to achieve one of the central aims of the move to central clearing for OTC derivatives contracts: porting their portfolios of cleared OTC derivative contracts from a defaulting clearing member to a back-up clearing member; and

- fifthly, ESMA should give consideration to the impact of any recovery and resolution procedures in place in respect of any CCP clearing that product, in particular the ability for positions to be transferred to another CCP or re-established by market participants.

Question 21 (dates, phase in):

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

Answer:

The readiness of clearing participants (indirect clients, clients, clearing members, CCP) should be considered rather than a regulatory prescribed timeline (e.g. 6 months). Much will depend upon the complexity of the product, risk management capabilities (including *Key Considerations* listed in response to question 20), acceptance of the new class to the risk committee and board of the CCP, review of which CMs would engage in clearing and offer client clearing for that asset class, and similar issues, to assess whether the offering of the class is viable.

By contrast, however it may be that the CCP in question is already offering or in a position to offer the Class+, in which case the time horizon could be shorter.

Comments on paragraphs 116 to 119:

Question 22 (dates, phase in):

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

Answer:

If the assumption is that the CO could be mandated based on a single CCP being in position to offer clearing in the Class+, then the logical conclusion must be that each CCP must be able to manage the risk (including *Key Considerations* outlined in our response to question 20) associated with 100% of the market share. Beyond this, there is the possibility that one of two CCPs offering such clearing, defaults, with the result that the clearing would be offered only by the (single) remaining CCP.

The consequence of this is that if the CO would be mandated based on a single CCP offering the clearing of a Class+ (or a scenario where one of two CCP defaults and there remains only a single CCP), then the systemic risk and the concentration risk of that risk must be acceptable, based on a clear understanding of the levels of the risk when the competent authority, together with the college, reviews the application of that CCP for authorization (or recognition). As a general matter, where practical, there is inherent benefit from a systemic risk perspective in having more than

one CCP authorized (or recognized) to clear a specific instrument subject to the CO, as such arrangement would foster competition and avoid any excessive risk concentration.

Question 23 (dates, phase in):

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

Answer:

All the elements identified should be taken into account, as well as correlations with existing cleared classes of OTC derivatives. Product specific market components (e.g. bid-offer vs. volume, under normal and stressed market scenarios, trading behavior, profile of relevant market participants - directional or concentrated, pre vs. post CO risk structure of the product) should be assessed to ensure that, when evaluated collectively, the introduction of a CO might only reduce systemic risk.

Another consideration (inferred from the reference to increase in risks) is the complexity of the class and whether it gives rise to special or different risks compared with classes already cleared; and also the clearing members which will be actively clearing in the new class (fewer clearing members means that the impact of the default of a clearing member active in that market will have a potentially disproportionate effect and may lead to the closing of that clearing service).

Question 24 (dates, phase in):

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

Answer:

It is difficult to state such a period with certainty given the criteria which would need to be assessed. Greater clarification is needed on what is meant in stating “time to upgrade its service” as this could be interpreted broadly.

However, as an example, where this term refers to regular technology releases whereby a CCP schedules enhancements, new products or roll out of any new services, due lead time must be provided for participants to prepare and test in order to be able to support. Furthermore, due governance needs to be in place by each CCP to ensure technology releases do not adversely impact CCPs ability to support day-to-day clearing of the volume.

Comments on paragraphs 120 to 128:

Question 25 (categories of counterparties):

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

Answer:

On balance, we believe that Option B is preferable. The EMIR "financial counterparty" category could be divided into two sub-sets of entities by reference to counterparty trading volume and existing access to clearing. This would have further benefits; particularly with respect to the frontloading obligation (see response to question 28).

The date for assessment should be determined by reference to a time horizon (e.g. 30 working days for the clearing threshold test) to avoid the potential for "evasion" should a single reference point be used. That period should be a suitable time horizon before the CO takes place, such as a period of 4 months before the scheduled date the CO takes effect.

Question 26 (categories of counterparties):

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

Answer:

Application of the CO should be considered against the considerations suggested in our response to question 20. Where there exists a limited number of CCPs to clear a product, the CO should be phased-in or otherwise reevaluated altogether. A phase-in could integrate the counterparty classifications suggested in our response to question 25, whereby a phase-in would first apply to the largest market participants in terms of trading volume.

More generally, however, provided that all systems and operational processes are already appropriately configured counterparties with direct access to clearing in the relevant product could be subject to shorter phase-in periods than those without such direct access. A further distinction is also needed for those entities who have not cleared before (therefore requiring significant operational and risk investment to demonstrate sufficient wherewithal) compared with those who are already clearing.

Intuitively a period of at least 6 months for counterparties with access (direct or via a clearing member) and at least 12 months for those without access seems appropriate before the CO can apply. We would note however that phase in periods exacerbate the issues related to frontloading referred to in our response to question 28 below, and refer you to our proposals set out therein.

Comments on paragraphs 129 to 130:

Question 27 (categories of counterparties):

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

Answer:

The number of CCPs capable of offering client clearing services and equally the number of CMs at a CCP capable of offering client clearing services will be key criteria to take into account, together with the other factors detailed in our response to question 20.

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

Comments on paragraphs 131 to 135:

Question 28 (remaining maturity):

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

Answer:

We appreciate ESMA's acknowledgement in the Discussion Paper of the detrimental impact on pricing that a significant frontloading period is likely to have. The scale of the frontloading impact is substantial: it will impact a highly significant proportion of the OTC derivative market and a wide range of market participants, including end-users.

Pricing bilaterally traded OTC derivative contracts entered into or novated after what ESMA refers to in the Discussion Paper as 'date A' (i.e. the date from which the frontloading obligation applies to contracts that could subsequently fall within the scope of the clearing obligation) will be extremely challenging because the parties to such a contract will not know, at the time the contract is entered into, whether or not the contract will ultimately be within the scope of the clearing obligation and, if it is, at which CCP the contract will be cleared and the impact on pricing, as illustrated in example (*Illustration of Frontloading Impact*) in the Appendix to this response. The example illustrates how the types of assets collateralising an OTC derivative contract determine the price and risk associated with that contract. The collateral terms contained in existing bilateral OTC derivative trading documentation are generally different from those applicable to cleared OTC derivative contracts; consequently, OTC derivative contracts entered into during a frontloading period will be subject to price and risk uncertainty in proportion to the likelihood and timing of their required migration as a result of mandatory clearing.

The inability to accurately price OTC derivative contracts will reduce market certainty and discourage end-users from comprehensively managing their risk, thereby increasing systemic risk and reducing market stability. The magnitude of pricing and risk uncertainty will be greater for longer frontloading periods and OTC derivative contracts with longer maturities.

Proposals to minimise negative impact of frontloading

We submit that in light of the negative impact on market stability and systemic risk of a substantial frontloading period, ESMA should seek to minimise the impact of frontloading.

It is our view that this could be achieved by:

- setting the ***minimum remaining maturity of all asset classes of OTC derivative contracts subject to the frontloading period above the OTC derivative product subject to the clearing obligation with the longest maturity*** for ; participants other than a sub-set of market participants with existing access to clearing who exceed certain trading volumes (see our response to Question 25). A shorter minimum remaining maturity threshold may be appropriate for a sub-set of market participants with existing access to clearing who exceed certain trading volumes who are typically early adopters of central clearing of OTC derivative products. Information should be provided to market participants on the minimum remaining maturity of OTC derivative contracts subject to the frontloading period as soon as possible after 'date A';

- categorising OTC derivative products potentially subject to the clearing obligation with ***sufficient granular descriptive detail;*** **as noted elsewhere in this response, ESMA must ensure that the clearing obligation is applied on a product-by-product basis with sufficient granularity to give certainty to the market regarding the application of the clearing obligation to each individual transaction**. We stress that the ultimate determination in respect of the application of the clearing obligation to an individual transaction must be possible by reference to a definitive list maintained and published by ESMA;

- where, following consultation on the suitability of an OTC derivative product for the clearing obligation, ESMA concludes that such product is not suitable for the clearing obligation, ESMA acting to ***close the frontloading period with respect to such product at the earliest opportunity i.e.*** it should let the market know as soon as possible that the contract in question is not likely to be made subject to the clearing obligation. Such a determination will be apparent from the outset in relation to some products and acting swiftly in this manner would promote certainty and encourage market stability. ESMA publishing its considerations on this basis would also give a signal to the market as to whether the contract is likely to remain off the list of cleared product indefinitely, or whether

there are issues pertaining to the current conditions for clearing of that product which make it unsuitable for mandatory clearing now, but which may change, facilitating clearing of the product in the future.

- ***dis-applying the frontloading obligation to categories of undertaking that are exempt (either temporarily or permanently) from the clearing obligation*** at the time they enter into an OTC derivative contract (e.g. non-financial counterparties that do not meet the conditions referred to in EMIR Article 10(1)(b); for three years after the entry into force of EMIR, OTC derivative contracts that are objectively measurable as reducing investment risks directly relating to the financial solvency of pension scheme arrangements). Without this limitation, frontloading periods in relation to contracts traded by, for example, pension scheme arrangements, could stretch out to multiple years, which could consequently negatively impact pricing of the OTC derivative contracts required by such exempt undertakings during that period for the reasons set out in paragraph A(1). ESMA should also consider use of phase-in periods for implementation of the CO with respect to products which are not generally cleared by market participants, including even those with direct access to CCP services for other more widely traded products.

Frontloading Timeline and Triggers

There remains uncertainty over the determination of the frontloading timeline. The Discussion Paper in section 17 states, "… the CO procedure will be triggered by the first CCP authorised to clear a certain class of OTC derivatives. When another CCP is authorised to clear the same class, it will not trigger another CO procedure on the same class…".

We note that EMIR Article 5(2) requires ESMA to conduct a public consultation and develop draft regulatory technical standards specifying the class of OTC derivatives that should be subject to the clearing obligation and other details listed in sub-paragraphs (b) and (c) of EMIR Article 5(2), within six months of receiving notification under EMIR Article 5(1) or accomplishing a procedure for recognition set out in EMIR Article 25.

EMIR does not limit application of this obligation to authorisation of the first CCP to clear a particular OTC derivative product; rather, the obligation applies wherever a competent authority authorises a CCP under EMIR Article 14 or 15 or ESMA recognises a CCP under EMIR Article 25. Consequently, ESMA's powers to consult further on suitability of the clearing obligation in relation to an OTC derivative product following authorisation of a subsequent CCP to clear the product in circumstances where that product was initially assessed to be unsuitable for the clearing obligation do not appear to us to be limited by EMIR in the manner suggested in the Discussion Paper. We submit that the ability of ESMA to consider the clearing obligation more than once is a key element of the clearing obligation process – OTC derivatives markets are dynamic and the authorisation of a second CCP may in of itself be a reason to reconsider a previous decision not to mandate clearing.

Such an approach does however impact on frontloading. In our view, in such a scenario, ESMA should seek to limit the impact of frontloading by (i) acting to end the frontloading period as soon as possible where the clearing obligation will not be applied; and (ii) clarifying that in the event that clearing is subsequently mandated, the frontloading date will be the date on which the authorisation was given to the CCP, the consultation in respect of which the clearing obligation was made.

Clarification regarding the triggering of ESMA's consideration of a class of OTC derivatives: It is clear that ESMA is obliged to consider a class of OTC derivatives upon the first Article 5(1) notification made to it. As noted above, we also believe the correct reading of EMIR is that, upon a further Article 5(1) notification to ESMA in relation to a class of OTC derivatives which ESMA had previously concluded should not be subject to the CO, ESMA is obliged under Article 5 to consider that class of OTC derivatives again. Finally, EMIR also clearly gives ESMA the right to consider a class of OTC derivatives on its own initiative under the "top-down" process set out in Article 5(3), but this is expressed to apply only to products "for which no CCP has yet received authorisation".

There is therefore an apparent gap in EMIR respect of the situation where: (i) a CCP has been authorised to clear a class of OTC derivatives and ESMA has concluded that class should not be subject to the CO following an Article 5 process, (ii) circumstances change such that ESMA does (or should if it had so considered the point) wish to reconsider the appropriateness of applying the CO to that class of OTC derivatives, but (iii) there has been no new CCP authorisation which generates a further Article 5(1) notification to trigger ESMA's reconsideration.

We do not think it is in the interests of the market to conclude that ESMA does not have the power in such circumstances to reconsider the appropriateness of applying the CO to that class of OTC derivatives on its own

initiative. We would be concerned that if this were the case - it would place undue pressure in ESMA's first consideration of a class of OTC derivatives to conclude that the CO should apply, since failure to do so might result in that class of OTC derivatives remaining outside the CO indefinitely (or at least until another CCP obtained authorisation for the same class).

We think it is therefore important that ESMA clarify its views as to its capacity to take such steps on its own initiative and indicate the circumstances in which it might in fact do so. In this context, we would however note that it is essential that any reservation of ESMA's right to revisit a decision does not in any way suggest that the potential frontloading window which was triggered by the first Article 5(1) notification remains relevant. As noted above, ESMA's conclusion not to apply the CO following an Article 5 process should close the frontloading window. Any subsequent determination of a CO by ESMA in exercise of its own initiative should not be subject to any frontloading (EMIR does not contemplate or require this) and should apply only upon the adoption of the relevant regulatory technical standards.

5. The clearing obligation in specific cases

5.1. Contracts concluded with Covered Bond issuers

Comments on paragraph 136 to 138:

Question 29 (covered bonds):

Are there other specific features of the contracts concluded with covered bond issuers or with cover pools for covered bonds, to be considered by ESMA in the context of the clearing obligation?

Question 30 (covered bonds):

What would be the legal or technical challenge faced by covered bonds issuers and CCPs, if a clearing obligation was imposed on some of the OTC derivative contracts included in the cover pools of covered bonds?

Question 31 (covered bonds):

Have CCPs developed solutions to be able to differentiate the derivative contracts of the issuer from those of the cover pool?

Question 32 (covered bonds):

Would an appropriate phase-in for these counterparties alleviate these challenges? If so, how?

ISDA is not offering a response to these questions.

5.2. Foreign exchange OTC derivatives

Comments on paragraphs 139 to 140:

Question 33 (FX derivatives):

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

Answer:

As previously noted to ESMA[6] and other regulatory authorities globally by GFMA FX Division, within the FX asset class, the contracts for which settlement risk is the predominant risk are FX forwards and FX swaps contracts executed on a deliverable basis, *i.e.,* on the basis of physical settlement and not on the basis of cash settlement in a single reference currency (which are the subject of the FX products currently listed in the tables in section 2.4 of the discussion paper).

The shared key characteristic of deliverable FX forwards and swaps is that each contract is executed between two transacting parties as an agreement to deliver one currency in exchange for another on a gross basis at a pre-determined fixed rate of exchange. FX forwards and FX swaps are simple exchanges of currency and have no contingent outcomes because cash flows are known at the outset of such contracts. Further, the main counterparty risk is settlement risk, not mark-to-market risk; settlement risk is the risk that one counterparty does not deliver their side of the currency exchange while the other counterparty has delivered their side. CCPs are designed to mitigate "mark-to-market" risk – not settlement risk.

The G10 central banks identified settlement risk as **the** source of systemic risk associated with FX spot, swaps and forward contracts, expressing their conclusions that (emphasis added):

To be sure, FX trading poses many other forms of risk, including market risk (the risk of loss from an unfavourable exchange rate movement), replacement risk (the risk of having to replace, at current exchange rates, an unsettled yet profitable FX transaction with a failed counterparty) and operational risk (the risk of incurring interest charges or other penalties for misdirecting or otherwise failing to make FX settlement payments on time owing to an error or technical failure). FX market participants must recognise and manage appropriately each of these risks. [footnote: For instance, the Basle Capital Accord currently covers replacement risk. In January 1996 the Accord was amended by the Basle Committee on Banking Supervision to explicitly cover market risk…] ***Nevertheless, since the associated amounts at risk represent only a fraction of the underlying value of each transaction, they are dwarfed by the size of foreign exchange settlement exposures.***

'A bank's maximum FX settlement exposure could equal, or even surpass, the amount receivable for three days' worth of trades, so that at any point in time - including weekends and public holidays - the amount at risk to even a single counterparty could exceed a bank's capital.

Secure and well-functioning payments systems are necessary for the attainment of central banks' monetary, macroprudential, supervisory and other policy objectives. They are also essential mechanisms in the management by individual commercial banks of their assets and liabilities, and in the settlement of their own transactions as well as those of their customers. It is therefore appropriate that central banks should be concerned that the settlement arrangements in the foreign exchange markets should be structured so as to minimise systemic risk (the risk that the failure of one market participant to meet its required FX settlement or other obligations when due may cause significant liquidity or credit problems for other participants, and so may threaten the stability of the financial markets).

The vast size of daily foreign exchange (FX) trading, combined with the global interdependencies of FX market and payments system participants, raises significant concerns regarding the risk stemming from the current arrangements for settling FX trades. These concerns include the effects on the safety and soundness of banks, the adequacy of market liquidity, market efficiency and overall financial stability.[7]'

These conclusions were reached by the G10 central banks at a time when turnover in the FX market was estimated by the BIS to be USD 1.2 trillion, a fraction of the USD 4 trillion estimated in 2010 and USD 5.3 trillion estimated in 2013.[8] According to the result of a recent study, settlement risk comprises 94% of the maximum loss exposure in a trade for FX instruments with maturity of less than one year, and 89% for instruments with maturity of greater than a year.[9] The chart below illustrates the break-down of the maximum risk of loss between settlement risk and the remaining risk, namely replacement cost risk, for FX contracts of different maturities. Only 6% of the maximum risk

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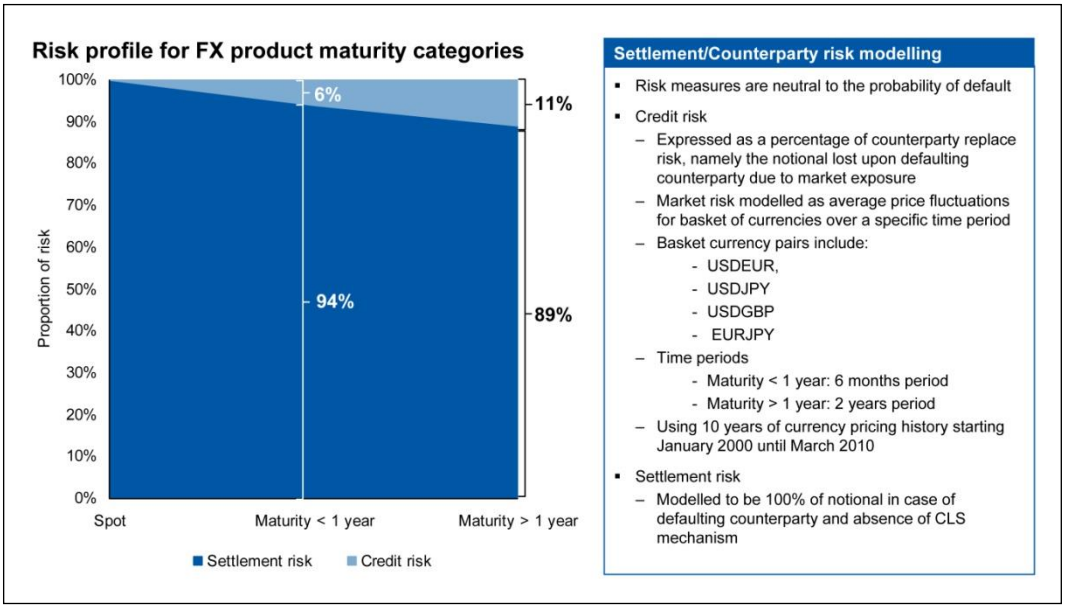
6 *See* GFXD Letter March 2012 and GFXD Letter August 2012.

7 *See* BIS CPSS *Settlement Risk in Foreign Exchange Transactions,* 1996 (Allsopp Report) available at http://www.bis.org/publ/cpss17.pdf. See also BIS *Central Bank Payment and Settlement Services with respect to Cross-Border and Multi-Currency Transactions,* 1993 (Noël Report)("the loss of principal in settling … a foreign exchange trade would dwarf any gain or loss that might have accrued to the counterparties to the original transaction") available at http://www.bis.org/publ/cpss07.pdf.

8 *See* BIS 2013 FX Survey.

9 Oliver Wyman analysis.

of loss associated with a counterparty default for these products is replacement cost risk which is dwarfed by the 94% which represents settlement risk.[10] This stands in sharp contrast to most OTC derivatives for which counterparty credit risk is comprised almost exclusively of replacement cost risk.



CCP Offerings in FX.

With respect to the statement in paragraph 140 of the discussion paper that "some CCPs already clear OTC FX derivatives and other CCPs are planning to add this asset class to their current offer of services", existing clearing services are in fact limited to non-deliverable forwards (as noted in our commentary to section 2.4, question 15 above). And, most importantly, while CCPs may wish to extend their services to other FX products – such as deliverable forwards, swaps *and* options – to date, no CCP appears to have addressed the challenges faced with clearing deliverable FX contracts which are unique to this market, namely same-day liquidity issues, in a manner which satisfies global regulatory expectations. CCPs are historically designed to mitigate "mark-to-market" risk – not settlement risk. In the deliverable OTC FX markets, the residual mark-to market risk is today effectively mitigated through credit support annexes (CSAs).[11]

It is widely recognized by legislative and regulatory authorities globally that directing deliverable OTC FX forwards and swaps to centralized clearing is not, or may not be, appropriate. We believe that a determination by ESMA that such products re not appropriate for a clearing obligation is the only conclusion consistent with recital 19 of EMIR.[12] In contrast to other OTC derivatives that will not be centrally cleared due to lack of standardization or liquidity, clearing deliverable FX forwards and swaps is not appropriate because (1) while central clearing specifically addresses replacement cost risk, it is not the optimal solution for dealing with FX forwards and swaps where the main risk is settlement risk, and (2) central clearing of these products has the real potential of increasing, rather than decreasing,

[10] Oliver Wyman analysis. All else being equal, the amount of replacement cost risk is higher for longer maturities because there is more time for the exchange rate to move.

[11] *See* GFXD Margin Letter, and U.S. Department of the Treasury, *Final Determination on Foreign Exchange Swaps and Forwards Under the Commodities Exchange Act* (November 20, 2012) (Treasury Final FX Determination) at http://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf.

[12] Recital 19 of EMIR: "In determining which classes of OTC derivative contracts are to be subject to the clearing obligation, due account should be taken of the specific nature of the relevant classes of OTC derivative contracts. The predominant risk for transactions in some classes of OTC derivative contracts may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes of OTC derivative contracts (such as foreign exchange) from other classes. CCP clearing specifically addresses counterparty credit risk, and may not be the optimal solution for dealing with settlement risk. The regime for such contracts should rely, in particular, on preliminary international convergence and mutual recognition of the relevant infrastructure."

systemic risk, especially in times of crisis, thereby significantly outweighing the marginal benefits that central clearing would provide.

Unique challenge associated with clearing FX forwards and swaps.

Notwithstanding numerous efforts to do so, no CCP has demonstrated an ability to implement safe and sound measures that ensure the deliverable FX market, with the CCPs, can appropriately manage the liquidity and credit risks associated with clearing deliverable FX forwards and swaps.

In the past few years, central banks[13] have expressed their need, from a broad policy perspective, to receive more information about the FX-related clearing proposals of each individual CCP to understand and review the potential implications of each proposal for their currencies and for the FX market. When approached by CCPs seeking to clear FX transactions, central banks whose currencies settle in CLS raised a number of issues and made requests for further information and analyses regarding the concept of clearing FX contracts. These issues include the potential effects of mandatory clearing on the central banks' home currencies and on the safety and soundness of the deliverable FX market generally, including on CLS.[14] The central banks' concerns stem from their need to understand and evaluate the impact of a CCP's activities on the FX market and on payments in their home currencies from a broad policy perspective. There is also an important policy interest in not seeing settlement risk reintroduced to the financial system. Since settlement risk comprises an overwhelming portion of the counterparty default risk for FX contracts, the failure of an FX CCP to guarantee settlement risk would largely defeat the purpose of clearing through the CCP, particularly for a market that is essentially a payment system. If a CCP that guaranteed settlement did not use CLS, the CCP would need to settle through a private bank, in which case any default by the private bank would pose serious liquidity and other risks to the clearing house and thus to all its participants. If a CCP did not guarantee settlement and did not use CLS, its clearing participants would be subject to settlement risk, which would be substituting settlement risk – by far the larger risk in an FX transaction – for replacement cost risk. In addition to their respective needs to determine the safety and soundness of any CCP's proposal to clear deliverable OTC FX products, central banks have also separately expressed a need to determine the safety and soundness of CLS' acceptance of such cleared transactions for settlement processing.

FMI Principles.

In addition, the CPSS and IOSCO jointly issued in 2012 final principles for financial market infrastructures.[15] These principles include a number of key principles to be considered when seeking to apply clearing to the OTC FX market. Notably these include principle VII on liquidity risk, principle VIII on settlement finality, and principle XII on exchange-of-value settlement systems. Taken as a whole against the unique characteristics of the FX forwards and swaps (*e.g.*, the physically delivery aspect to these products), and confirmed through a number of discussions with regulatory authorities and market participants, these principles would require physically settled OTC FX products to be cleared only by CCPs that can provide a "guaranteed, on-time clearing and settlement model." Specifically, an OTC FX CCP must, for a physically settled market:

- Guarantee of the full and timely settlement of the currencies of the trade;[16] and

- Ensure the guarantee is credible and addresses extreme but plausible market conditions as identified by rigorous stress testing, including default scenarios.

To date, even for the deliverable OTC FX options market which is substantially smaller than the deliverable OTC FX forwards and swaps market, no model put forward by a CCP and/or market participants has demonstrated an ability to implement safe and sound measures that address the above requirements and ensure the market, with the CCPs, can appropriately manage the liquidity and credit risks associated with clearing these products.[17] It is reasonable to

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[13] AUD (Reserve Bank of Australia), CAD (Bank of Canada), CHF (Swiss National Bank), DKK (Denmark), GBP (Bank of England), EUR (European Central Bank, National Bank of Belgium, Bank of France, Deutsche Bundesbank, Bank of Italy and Netherlands Bank), HKD (Hong Kong Monetary Authority), ILS (Bank of Israel), JPY (Bank of Japan), KRW (Bank of Korea), MXN (Bank of Mexico), NOK (Central Bank of Norway), NZD (Reserve Bank of New Zealand), SEK (Svergis Riksbank), SGD (Monetary Authority of Singapore), USD (Federal Reserve) and ZAR (South African Reserve Bank).

[14] See CLS letter to U.S. Department of Treasury (November 23, 2010) in response to request for comment on determination of foreign exchange swaps and forwards.

[15] CPSS and Technical Committee of International Organization of Securities Commissions (IOSCO), *Principles for financial market infrastructures* (April 2012), available at http://www.bis.org/publ/cpss101a.pdf.

[16] This is in contrast to other OTC derivative transactions, such as interest rate swaps and credit default swaps, which create settlement obligations that equal only the change in the market price of the notional value.

[17] In contrast to deliverable FX forwards and swaps, deliverable FX options are derivatives, but once exercised, become a deliverable FX spot or forward transaction. Although deliverable FX options represent a very small portion of the FX market, they face the

assume that central banks will be unlikely to embrace mandatory clearing and trading requirements for the deliverable FX market in the absence of evidence that it can be implemented without causing more harm than good to sovereign currencies and existing settlement processes.

The FX industry has continued to work with regulators and CCPs with respect to the clearing of deliverable OTC FX products and is acutely aware that to meet these requirements for the mainstream FX market a CCP would face significant challenges. This is especially true in light of the need for immediate access to sufficient liquidity in all currencies to be able to meet in full the settlement obligations of a defaulting member, and in a manner that does not put the CCP itself at significant risk during stressed market conditions. As noted above, the specific settlement characteristics of the FX market make this issue significantly more acute than in other asset classes. As a result, this is a formidable challenge for which, to date, no satisfactory solution has been found. The complexities around introducing CCP clearing into the FX market are significant – such as the large currency and capital needs that would arise if CCPs were also responsible for guaranteeing settlement given the sheer size and volume of trades in the deliverable FX forwards and swaps market; and the operational challenges and potentially disruptive effects that arise from introducing a layer of clearing between trade execution and settlement. These would significantly outweigh the marginal benefits from a mandatory clearing obligation.

Deliverable OTC FX options

We also wish to draw attention to a quantitative study commenced last year to understand the scale of transactions in the physically-settled OTC FX options market in order to size the same day liquidity challenge for clearing this market.[18] In contrast to physically-settled FX forwards and swaps, physically-settled FX options are derivatives but, once exercised, become a physically-settled FX spot or forward transaction. Although physically-settled FX options represent a very small portion (6%) of the FX market,[19] they face the same challenges regarding clearing as physically-settled FX forwards and swaps. Quantifying the size of this problem informs CCPs interested in extending their services to deliverable FX products, in this case, for OTC FX options products, of the same day liquidity risk that they must be capable of managing in order to (i) guarantee full and timely settlement of the currencies traded for this product; and (ii) ensure the guarantee is credible. In contrast to other markets, the FX market – as a global payments system – is fundamentally about liquidity, *i.e.*, ensuring funds in the correct (needed) currency are received *when* they are expected to be received by transacting parties.

Quantifying the size of this problem informs not only potential solutions to the problem but how interested stakeholders approach solutioning in the first instance. Further, the same day liquidity risk for physically-settled OTC FX options is *in addition to* the replacement cost risk and market risk which a CCP must manage with respect to its clearing service and which must also be understood and analyzed in relation to those (and other) risks. In light of the size of the same day liquidity challenge identified, whether and when a credible, robust and safe solution for clearing this physically-settled FX product will in fact be implemented remains unknown.

Rationale for not applying a clearing obligation for deliverable OTC FX forwards and swaps.

In the United States, the Department of Treasury has evaluated the appropriateness of mandating clearing of deliverable FX forwards and swaps and, following extensive study and consultation, determined not to apply such a

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same type, though not the same scale, of liquidity challenge as clearing deliverable FX forwards and swaps. See *GFMA GFXD FAQ: The FX Options Clearing & Settlement Project* (March 8, 2012). The objective of this project is to collect and analyze data from each of the 22 GFXD member firms going back over the last five years in order to will help inform potential CCP solutions for OTC FX options. http://www.gfma.org/uploadedfiles/initiatives/foreign_exchange_(fx)/gfxd%20options%20clearing%20project%20-%20faq%20(final).pdf.

[18] *See* http://www.gfma.org/initiatives/foreign-exchange-(fx)/fx-options-clearing/. The question asked and answered by this study: "What is the largest combined funding deficit which could have resulted from the failure of two clearing firms representing the largest combined funding requirements on any given settlement date with respect to executed OTC FX options that were exercised and due for settlement on such date"? The answer to this question informs CCPs desiring to clear these deliverable products of the funds required to cover that deficit and the capabilities needed to convert such funds, same day, into the currencies which its other (non-failing) clearing firms are expecting to receive on that date, in satisfaction of the "cover 2" liquidity requirement under the FMI Principles.
Deliverable OTC FX is traded and settled on the basis of physical settlement, *i.e.*, the exchange of principal in two currencies on the settlement date; the expectation is for CCPs to ensure transacting parties are made "whole" by guaranteeing they will receive what they were expecting to receive on settlement date, *i.e.*, the currencies they purchased (in exchange for currencies they sold). In contrast, most OTC derivatives are traded and settled on basis of net cash settlement in a single currency that reflects the mark-to-market value of the trade; CCPs for these products ensure transacting parties are made "whole" by guaranteeing they will receive what they were expecting to receive during the life of the instrument and on settlement date, *i.e.*, the mark-to-market each day, including on the settlement date.

[19] *See* BIS *Triennial Central Bank Survey: Foreign exchange turnover in April 2013: preliminary global results* (September 2013) (BIS 2013 FX Survey).

requirement to such products.[20] In doing so, the Department of Treasury considered several factors to assess whether the required clearing of these products would create systemic risk, lower transparency, or threaten the financial stability of the United States. Many other legislative and regulatory authorities globally have acknowledged the analysis of the Department of Treasury when considering a similar exemption from clearing for these products. In its determination, the Department of Treasury concluded that, given the reduced counterparty credit risk profile of this market, the challenges of implementing central clearing within this market significantly outweigh the marginal benefits that central clearing and exchange trading would provide. Regulating deliverable FX forwards and swaps would require insertion of a central counterparty into an already well-functioning and highly interconnected settlement process, which could result in unnecessary operational and settlement challenges. Specifically, the Department of Treasury's determination recognizes the different characteristics of these FX products and the way the market functions at present:

- Acknowledges the *high levels of transparency and liquidity* existing in the FX markets as a result of the heavy trading on electronic platforms and the diverse availability of market pricing information.

- Points to *additional transparency through trade reporting to a trade repository*, the requirements of which were being addressed with GFMA Global FX Division members. [we note this is currently live in the United States]

- *Recognizes the unique factors limiting risks in the FX forwards and swaps market*, pointing to the fixed terms (*i.e.*, non-contingent outcomes), the physical exchange of currencies, the well-functioning settlement process and the shorter duration of contracts.

- *Highlights the existing strong, comprehensive and internationally coordinated oversight framework prevalent in the FX markets.*

- Notes the *complexities around introducing CCP clearing* into the FX market – specifically:
  - The large currency and capital needs that would arise if CCPs were also responsible for guaranteeing settlement given the sheer size and volume of trades in the FX (forwards and swaps) market,
  - The operational challenges and potentially disruptive effects that arise from introducing a layer of clearing between trade execution and settlement – concluding that these significantly outweigh the marginal benefits from central clearing.
  - Key unintended consequences of mandating clearing for FX forwards and swaps include potentially undermining the efforts that have been made in addressing settlement risk to date; creating a single point of failure where none exists today; and increasing costs and risk for corporate and buy-side end-users of FX.

Conclusion.

For the reasons set forth above, it would not be appropriate or prudent to apply a mandatory clearing obligation to deliverable OTC FX forwards, swaps – and also options – at this time. Introducing CCPs into the deliverable FX market without ensuring that they only bear risks that they can properly manage would clearly increase, rather than decrease, potential systemic risk, especially in times of crisis. Adoption by ESMA of this view would be consistent with the emerging views of regulators globally and in recognition of international convergence on the treatment of deliverable OTC FX forwards and swaps with respect to clearing requirements.

5.3. Interaction of portfolio compression and the clearing obligation

Comments on paragraph 141:

Question 34 (Portfolio compression):

[20] *See* Treasury Final FX Determination; and *Notice of Proposed Determination on Foreign Exchange Swaps and Forwards Under the Commodities Exchange Act* (April 29, 2011) (Treasury Proposed FX Determination).

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

Answer:

The general expectation is that the CO will narrow the number of trades eligible for compression exercises as counterparties will potentially hold bilateral and cleared risks with the same client that will not be eligible for compression.

Contracts resulting from multilateral compression exercises (e.g. TriReduce) or contracts that are designed to move risk from bilateral to central clearing should be exempt from the CO. Trades which are otherwise non-clearable, if re-characterized as clearable, could defeat the purpose of such risk-reducing services. We suggest consideration of the approach taken by other regulators (ex. CFTC) which provide limited relief that allow contacts created as a result of compression services to remain outside the CO.

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

Comments on paragraphs 142 to 148:

Question 35 (Modification of a Class+):

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

Answer:

The CO should be reevaluated when the composition of market participations dramatically shifts, thereby rapidly impacting the risk profile of the market. Volume, and liquidity, are important criteria for the success (or otherwise) of the clearing offering of a CCP, as are the ability to price cleared trades in the event of an auction and the ability to auction a portfolio of the asset class and thereby default manage.

The decrease in volume can arise as a result of different reasons – as identified in the discussion paper, for instance, there can be a Class+ that is replaced by a "new" version of the contract (such as an ITraxx index series). Another possibility is the cost of clearing, or the fact that the market can move away from certain types of standardized trades if the relevant exposure mitigation (or risk management mechanism) can be achieved more easily / economically elsewhere (e.g. listed derivatives market). Limited liquidity could be assessed by the size of the bid-offer spread, where a widening spread generally indicates more limited liquidity.

In such scenarios, as example, it would appear reasonable to remove the CO. More generally, we believe that on a pre-defined periodic basis, ESMA should review the criteria of a clearable contract to ensure that all necessary technical, operational and liquidity preconditions remain fulfilled to allow for safe clearing.

Question 36 (Modification of a Class+):

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

Answer: The obligation to clear should be ceased immediately. Any uncertainty related to the timeline to dis-apply the CO would generate significant market uncertainty.

Further remarks regarding application of the clearing obligation to derivatives associated with SPVs

Special purpose vehicles ("SPVs") should not be required to clear derivative transactions that they enter into. There are a number of other ways in which counterparty credit risk can be, and currently is, mitigated in transactions with SPVs for structured finance or securitisation transactions. For example, the documentation for SPVs generally provides that: (i) the OTC derivatives counterparty has a security interest over all the assets of the SPV; (ii) the OTC derivatives counterparty has a senior claim with regard to cash flow payments; (iii) SPVs are bankruptcy-remote vehicles and are structured such that they have a limited and identifiable list of creditors; (iv) counterparties to SPVs typically sign-up to limited recourse provisions pursuant to which it is contractually agreed that the SPV shall not be deemed to owe amounts in excess of the assets that it holds; and (v) in many cases any derivatives transactions are entered into for hedging purposes and hence the value of the underlying asset which creditors have security over (or any liability mismatch against the assets) is itself protected by the derivative. Hence, there is no need to impose a clearing requirement upon SPVs to mitigate counterparty credit risk.

In addition, SPVs have limited functionality and resources and are generally unable to comply with the requirements of clearing, in particular the operational burden and the requirement to post collateral that this would involve. Furthermore, derivative transactions entered into by SPVs are, generally, not sufficiently standardised or liquid in nature for clearing to be appropriate or, in many cases, possible – in particular (i) transactions facing SPVs often have a variable or contingent notional amount that may be linked to complex underlying assets; and (ii) even where the derivative transaction itself may appear to be vanilla from a purely economic perspective, securitisation and other structured finance swaps generally include highly bespoke terms such as rating agency driven downgrade provisions and unilateral collateral posting requirements, limited recourse provisions and break clauses and other provisions that are closely linked to a broader transaction.

While it is the expectation that most SPVs would not be obliged to comply with the clearing obligation by virtue of their status under EMIR, the analysis in this respect is not always straightforward and an explicit exemption from clearing for derivative transactions with SPVs would be helpful in providing clarity to the structured finance and securitisation market. This would be a logical extension of the position that ESMA has helpfully taken with respect to covered bond swaps. If clearing were to apply to derivative transactions with SPVs, this would prevent these vehicles from entering into swaps which would deprive the securitisation and structured finance sector of a valuable hedging tool and significantly impair the securitisation and structured finance markets.

APPENDIX

EXAMPLE - ILLUSTRATION OF FRONTLOADING IMPACT

The following example illustrates the detrimental impact frontloading will have on pricing certainty of OTC derivative contracts:

- It is generally recognised in the derivatives marketplace that the net present value (NPV) of a derivatives contract is a function of both its future cash flows and the nature of any collateral associated with that contract. [*quote market surveys, Risk magazine articles etc.*]

- For example, say **Dealer A** transacts an OTC derivative contract (**Trade AB**) to pay a single cash flow of 100 in 5 years to **Counterparty B**. Trade AB is collateralised with euro-denominated cash in respect of which the collateral provider (Dealer A in this example) is paid interest determined by reference to an interest rate of EONIA applied to the NPV of Trade AB on each agreed interest payment date.

- Dealer A subsequently hedges Trade AB using a second OTC derivative contract (**Trade AC**) with **Counterparty C**. Under Trade AC, Dealer A and Counterparty C agree that Dealer A will receive from Counterparty C identical cash flows to those which Dealer A must pay to Counterparty B under Trade AB, except that collateral posted by Counterparty C to Dealer A in respect of Trade AC will comprise corporate bonds.

- In respect of Trade AC, Dealer A receives from Counterparty C daily an amount of corporate bonds equal to the NPV of Trade AC. Dealer A rehypothecates those securities pursuant to separate repurchase arrangements in order to generate the cash it requires to collateralise Trade AB. The rehypothecation requires Dealer A to pledge the corporate bonds to its repurchase counterparty in order to receive cash in return, for which Dealer A pays interest to the repurchase counterparty at a rate of, for example, EONIA plus 25 basis points.

- Dealer A will therefore receive interest at a rate of EONIA in respect of the cash collateral it has posted to Counterparty B and pay interest at a rate of EONIA plus 25 basis points in respect of the repurchase arrangements. If the NPV of each of Trade AB and Trade AC was the same, Dealer A would suffer a loss of 25 basis points; in order to remove this arbitrage between the trades, at the time the trades are entered into the NPV of Trade AC will be determined to be lower than the NPV of Trade AB to reflect the impact on pricing of the different types of collateral posted in respect of each trade. Market participants are able to reach such determinations on the basis of the bilaterally negotiated collateral eligibility schedules in their existing documentation. During a frontloading period, determination of the correct NPV of a contract will be extremely challenging due to the unknown difference between the NPV of a contract traded pursuant to bilaterally negotiated terms as compared to the NPV of the same contract if it were cleared at an undetermined CCP in accordance with that CCP's collateral eligibility schedule.