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ESMA Consultation Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

Dear Sir or Madam,

BVI[1] appreciates the opportunity to present its views on ESMA's draft Technical Standards concerning the regulation on OTC Derivatives, CCPs and Trade Repositories.

BVI supports the proposal of the EU-Commission to regulate the derivative market infrastructures (e.g. central counterparty (CCP) and trade repositories (TR).

Implementation of CCPs with the buy-side needs careful planning and should not be rushed. All market participants need sufficient time for preparation. Our members need 6 to 12 months to set up policies and procedures for the collateralization of bilateral OTC derivatives and for using a CCP following resolution of the major legal and operational issues.

In order to achieve a solid level of investor protection in the OTC derivative market ESMA should take into consideration the following points when drafting the applicable Technical Standards:

[1] BVI Bundesverband Investment and Asset Management represents the interests of the German investment fund and asset management industry. Its 82 members currently handle assets of EUR 1.8 trillion in both investment funds and mandates. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households. (BVI's ID number in the EU register of interest representatives is 96816064173-47). For more information, please visit www.bvi.de.

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- Our members are of the opinion that the information provided by the competent authority to ESMA when it authorizes a CCP to clear a class of derivatives must also include a detailed level of segregation on assets and positions.

  Article 39 of EMIR does not oblige ESMA to draft Technical Standards on the subject of segregation and portability. We believe that the overall safety and soundness of the CCP cannot be assessed properly without detailed knowledge about the segregation arrangements offered by a CCP. Therefore, we highly recommend to include the subject in the draft Technical Standards.

- We would like to take the opportunity to address the subject of UCITS having substantial difficulties to provide cash collateral in cases of centrally and bilateral cleared OTC derivative transactions under EMIR. The ESMA Guidelines on ETFs and other UCITS published on 25 July 2012 restrict the re-use of cash obtained from UCITS repo transactions for such purpose. ESMA needs also to amend the Guidelines in order to allow the German investment fund industry to continue to participate in the derivative markets by having sufficient cash available to fulfill the collateral requirement under the EMIR regime.

- BVI disagrees with the proposal by ESMA concerning the scope of assets to be accepted as highly liquid collateral by a CCP. BVI believes that the scope of highly liquid financial instruments accepted as collateral has to include main market index equities. In this context we would like to draw your attention to the BCBS/IOSCO consultation on the subject on Margin requirements for non-centrally-cleared derivatives published on 6 July 2012 which envisages as eligible collateral equities in major stock indices for non-centrally cleared OTC derivative contracts.

- We disagree with the proposal made by ESMA that all not-centrally cleared OTC derivative contracts with a financial counterparty or a non-financial counterparty should be confirmed by the end of the same business day at the latest.

We would like to make the following specific comments:

1. Clearing obligation procedure (Annex II, Chapter III, DET)

Our members are of the opinion that the information provided by the competent authority to ESMA when it authorizes a CCP to clear a class of derivatives must include a detailed level of segregation on assets and positions pursuant to Article 39 of EMIR.

We propose the following amendment (Article 1, DET, 1 (j) **new):**

1. The notification referred to in Article 5(1) of Regulation No xx/2012 [EMIR] shall include the following information:

……
(j) evidence of the capability of the CCPs and the clearing members to provide segregation under the applicable insolvency law to their clients ("omnibus client segregation", "individual client segregation").
……

2. Criteria to be assessed by ESMA under the clearing obligation procedure (Annex II, Chapter IV, CRI)

BVI supports the criteria to be used by ESMA in order to determine the relevant class of OTC derivative that should be subject to the clearing obligation.

We would like to propose the following amendments:

- **The degree of standardization of the contractual terms for the relevant class of OTC derivatives: CCP acceptance of different national master agreements**

BVI supports the proposal made by ESMA to consider the degree of standardization of the contractual terms of the relevant class of OTC derivative contracts when determining the criteria for the clearing obligation procedure. We think that the degree of contractual standardization of OTC products should not only refer to the ISDA master agreements. Market participants use different master agreements, as the language of the documentation and the governing laws are different.

Therefore, we believe that ESMA has to incorporate different national master agreements in its assessment of the contractual standardization. CCPs should be obliged to accept different master agreements (e.g. Deutscher Rahmenvertrag).

We propose the following amendments (Article 1, CRI, para 2 (a)):

2. *In relation to the degree of standardization of the contractual terms and operational processes of the relevant class of OTC derivative contracts, ESMA shall take into consideration:*

a. whether the contractual terms of the relevant class of OTC derivative contracts incorporate common legal documentation, including ***national*** *master* ***(netting)*** *agreements, definitions, standard terms and confirmations which set out contract specifications commonly used by counterparties;*

- **Segregation on assets and positions**

Our members are of the opinion that the information provided by the competent authority to ESMA when it authorizes a CCP to clear a class of derivative must include a detailed level of segregation on assets and positions pursuant to article 39 of EMIR. We think that clients of clearing members (e.g. investment fund management companies) clearing their OTC derivative contracts with a CCP should be granted a high level of protection. The high level of protection depends on the level of segregation that is offered to such clients.

Therefore, BVI thinks that ESMA has to take into consideration the level of segregation on assets and positions provided by CCP applicants and clearing members when determining the relevant classes of OTC derivative that should be subject to a clearing obligation.

We propose the following amendments (Article 1, CRI, para 5 and 6 **new**):

5. In relation to the capability of a CCP to provide segregation to the clearing members and its clients, ESMA shall take into consideration:

a. whether the CCP shall offer to keep separate accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the accounts of its clients ("omnibus client segregation") and

b. ***whether the CCP shall offer to keep separate accounts enabling each clearing member to distinguish in individual accounts with the CCP the assets and positions of that clearing member from those held for the individual accounts of its clients (" individual omnibus client segregation") and***
c. ***whether the CCP shall offer separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients ("individual client segregation") and***

6. In relation to the capability of a clearing member to provide segregation, ESMA shall take into consideration:

whether the clearing member shall keep separate records and accounts that enable it to distinguish both in accounts held with the CCP and in its own accounts its asset and positions from the assets and positions held for the account of its clients. The clearing member shall offer its clients, at least, the choice between omnibus client segregation and individual client segregation and inform them of the costs and level of protection.

3. Public register (Annex II, Chapter V, PR)

BVI supports the proposal of the details to be included in ESMA`s register. ESMA`s register will enable all market participants to access all relevant data belonging to a class of OTC derivative contract which is subject to a clearing obligation in time. The research costs incurred by the market participants (e.g. for investment fund management companies) could be reduced as they do not have to conduct a due diligence process on each CCP for the level of segregation if they can get all details necessary for the assessment of the clearing obligation of a class of OTC derivative contract from ESMA.

We propose the following amendment (Article 1, PR, para 3 (e) **new)**:

3. In relation to CCPs that are authorised or recognised for the purpose of the clearing obligation, the public register shall include for each CCP:

a. the identification code, in accordance with [Article 3 of ITS on trade repositories on Identification of Counterparties and other entities];
b. the full name;
c. the country of establishment;
d. the competent authority designated in accordance with Article 22 of Regulation (EU) N.xxxx/2012 [EMIR]
e. the level of segregation for each class of OTC derivative contracts of all Financial Counterparties.

4. Access to a trading venue (Annex II, Chapter VI, LF)

BVI supports the requirements that a trading venue shall provide trade feeds on a non-discriminatory and transparent basis to any CCP that has been authorized to clear OTC derivatives traded on that trading venue upon request by a CCP. Our members are of the opinion that open access to financial market infrastructure providers and trading venues will offer all market participants the possibility to choose their preferred supplier of services.

We think that a CCP has to accept instruments for clearing regardless of the venue on which they are traded, and that a venue has to provide data feeds and other assistance to any clearing house which wants to clear the instrument in question. Market participants (e.g. investment fund management companies) should have the possibility to use their own choices of trading and clearing channel in order to fulfill their best execution obligation both pursuant to MiFID and additionally agreed on with the investor.

5. Risk mitigation for OTC derivative contracts not cleared by a CCP (Annex II, Chapter VIII, RM)

- **Timely confirmation**

We disagree with the proposal made by ESMA that all not-centrally cleared OTC derivative contracts with a financial counterparty or a non-financial counterparty should be confirmed by the end of the same business day at the latest.

We think that non-centrally cleared OTC derivatives should be confirmed as soon as possible and could include the Fed target time frame as an alternative confirmation benchmark.

We feel that the timely confirmation of non-centrally cleared OTC derivative contracts is complex, especially for very bespoken OTC derivative products and requires an efficient handling of the confirmation process by all market participants which is currently not the case.

We think that the intended time frame does not leave enough time to resolve possible discrepancies in the confirmation process between the counterparties and could therefore reduce the quality of the confirmation process.

We know that the handling of electronic confirmation and execution of OTC derivatives in the back office by investment fund management companies is slightly different from that at credit institutions. Credit institutions in general have more resources (e.g. more staff in the back office) than the buy-side in the electronic confirmation of OTC derivatives.

- **Outstanding transactions**

We think that the reporting of outstanding OTC derivative transactions for more than five business days on a monthly basis to the competent authority should be made by the sell side and where appropriate by a third entity.

We propose the following amendments (Article 1, RM, para 2 and 3):

1. *This Article specifies procedures and arrangements for the purpose of Article 11(1)(a) of Regulation (EU) No X/2012 [EMIR].*
2. *An OTC derivative contract concluded with a financial counterparty or a non-financial counterparty that meets the conditions referred to in Article 10(1)(b) of Regulation (EU) N0 xxxx/2012 [EMIR] and which is not cleared by a CCP shall be confirmed, where available via electronic means, as soon as possible* ***~~and at the latest by the end of the same business day.~~ and could incorporate the Fed target time frame as confirmation benchmark.***
3. ***~~Where a transaction referred to in paragraph 2 is concluded after 16.00 local time, or when the transaction is concluded with a counterparty located in a different time zone which does not allow same day confirmation, the confirmation shall take place as soon as possible and at the latest by the end of the next business day.~~***

4. ~~***An OTC derivative contract concluded with a non-financial counterparty that does not meet the conditions referred to in Article 10(1)(b) of Regulation (EU) N0 xxxx/2012 [EMIR], shall be confirmed as soon as possible and at the latest by the end of the second business day following the date of execution.***~~

5. *Financial counterparties shall have the necessary procedure to report on a monthly basis to the competent authority designated in accordance with Article 48 of Directive 2004/39/EC the number of unconfirmed OTC derivative transactions referred to in paragraph 1 to 2 that have been outstanding for more than five business days.* ***The reporting of unconfirmed derivative transactions could also be conducted by a third entity.***

- **Reconciliation of non-cleared OTC derivative contracts**

Our members are of the opinion that the suggested number of contracts to be reconciled with the counterparty should apply on the level of the individual investment fund and not on the level of the investment fund management company**.**

We think that the suggested procedure is compliant with EMIR, where each investment fund (UCITS and AIF, Article 2 para 8) is deemed to be a separate financial counterparty. It is the investment fund management company that agrees on OTC derivatives acting on behalf of the investor of the respective investment fund. The basis for a OTC derivative transaction is a separate master agreement with respect to each investment fund concluded between by the investment fund management company and the counterparty.

We propose the following amendment (Article 2, RM, para 4 (c) **new**):

4. In order to identify at an early stage, any discrepancy in a material term of the OTC derivative contract, including its valuation, the portfolio reconciliation shall be performed:

a. *each business day when the counterparties have 500 or more OTC derivative contracts outstanding with each other;*

b. otherwise, at an appropriate time period based on the size and volatility of the OTC derivative portfolio of the counterparties with each other and at least:

i. per month for a portfolio of fewer than 300 OTC derivative contracts outstanding with a counterparty;

ii. once per week for a portfolio between 300 and 499 OTC derivative contracts outstanding with a counterparty.

c. for UCITS and AIF the number of contracts shall apply on the level of the individual investment fund.

- **Portfolio compression**

BVI`s point of view is that the portfolio compression exercise for UCITS and AIFs should not be allowed across investment funds. According to investment fund law restrictions, German investment fund management companies are obliged to separate assets and positions belonging to different investment funds. Therefore, investment funds are not allowed to fulfill any liability belonging to another investment fund. If the investment fund management company enters into a OTC derivative which cannot be fulfilled with the assets of the relevant investment fund, it would be liable with its own assets.

We propose the following amendment (Article 3, RM, para 2):

2. Financial counterparties and non-financial counterparties with 500 or more OTC derivative contracts outstanding which are not centrally cleared shall have procedures to regularly, and at least twice a year, analyse the possibility to conduct a portfolio compression exercise in order to reduce their counterparty credit risk and engage in such a portfolio compression exercise. Financial counterparties and non-financial counterparties shall ensure that they are able to provide a reasonable and valid explanation to the relevant competent authority for concluding that a portfolio compression exercise is not appropriate. ***A portfolio compression exercise between financial counterparties across different UCITS and AIFs shall not be allowed.***

- **Dispute resolution**

BVI disagrees with the proposal that financial counterparties and non-financial counterparties have agreed on detailed procedures and processes related to disputes when they conclude OTC derivative transactions. Our members hold of the view that any potential dispute could be solved rapidly according to the (automated) trade confirmation details. The conditions of the OTC derivative contracts are reviewed and confirmed at the beginning of the maturity of the OTC derivative. Moreover, during the lifetime of an OTC derivative there might be only different opinions by the contractual counterparties related to the value of the OTC derivative and the collateral exchanged.

As EMIR requires the mandatory collateralization for OTC derivatives, the counterparties will be aware of any essential differences of the valuation of the OTC product and the collateral exchanged and would therefore start the agreed dispute process on the basis of the applicable master agreements. In light of the expected costs of the implementation of a new dispute resolution process, it should be sufficient for the market participants to adhere to the trade confirmation details and the reconciliation process based on agreed applicable master agreements.

Therefore, we consider the trade confirmation details and the reconciliation process as sufficient in order to solve any potential dispute between the counterparties.

We propose the following amendment (Article 4, RM, para 2):

2. In order to identify and resolve any dispute between counterparties, financial counterparties and non-financial counterparties, shall, when concluding OTC derivative contracts which each other, have agreed ***~~detailed~~*** *procedures and processes* ***~~in relation on the following matters~~****:*

*a. i****~~dentification, recording, and monitoring of disputes relating to the recognition or valuation of the contract and to the exchange of collateral between counterparties. Those procedures shall at least record the length of time for which the dispute remains outstanding, the counterparty and the amount which is disputed;~~***

~~b.~~ which support the *resolution of disputes in a timely manner;*

c. resolution of disputes that are not resolved within five business days, including third party arbitration or a market polling mechanism.

- **Intra-group exemptions: notification details**

BVI believes that the information proposed by ESMA to be included in the notification to the competent authorities is too complex and extensive. We think that intragroup transactions do not contribute to the systemic risk as the parties involved conclude OTC derivatives in order to hedge their existing market risk.

We propose the following amendment (Article 7, RM, para 2 and para 3):

2. The application or notification shall be in writing and shall include the following information:
a. the legal counterparties to the transactions including their identifiers in accordance with [Article 3 of ITS on trade repositories on Identification of Counterparties and other entities];
b. the corporate relationship between the counterparties;
c. details of the supporting contractual relationships between the parties;
d. the category of intragroup transaction met by the counterparties as determined by
Article 3 paragraphs 1 and 2 of Regulation (EU) N0 xxxx/2012 [EMIR];
e. details of the transactions for which the counterparty is seeking the exemption, including:
(i) the general class of OTC derivative contracts;
(ii) the type of OTC derivative contracts;
(iii) the underlyings;
(iv) the notional currencies;
(v) the range of contract tenors;
(vi) the settlement type;
(vii) the anticipated size, volumes and frequency of OTC derivative contracts per annum;
(viii) the total credit limits for engaging in OTC derivative contracts between
the parties.

3. As part of its application or notification to the relevant competent authority a counterparty shall also submit supporting information evidencing that the conditions of Article 11 (6) to (10) of Regulation

~~(EU) N0 xxxx/2012 [EMIR] are fulfilled including legal opinions or summaries, copies of documented risk management procedures, historical transaction information, copies of the relevant contracts between the parties.~~

- **Intra-group exemptions: Information to be publicly disclosed**

BVI is of the opinion that the information to be disclosed to the public should be only made mandatory for aggregated data. BVI feels that the disclosure of individual intragroup transactions and positions to the public should be avoided in order to protect proprietary (portfolio) information.

We propose the following amendment (Article 8, RM):

For the purpose of Article 11(11) of Regulation (EU) xxxx/2012 [EMIR], a public disclosure of an exemption under paragraph 3 of that Article shall contain the following information:
a. the legal counterparties to the transactions including their identifiers in accordance with
b. the relationship between the counterparties;
c. whether the exemption is a full exemption or a partial exemption, and
d. the notional aggregate amount of the OTC derivative contracts for which the intragroup exemption applies.
e. the information to be disclosed should only be made for aggregated open positions.

6. Collateral requirements (Annex III, chapter XI, COL)

BVI disagrees with ESMA`s proposal concerning the scope of assets to be accepted as highly liquid collateral.

BVI believes that the scope of highly liquid financial instruments accepted as collateral must include main market index equities. Investment funds are subject to investment restrictions, e.g. equity funds must be invested predominantly in equity securities and cannot hold large amounts of bonds.

In this context we would like to draw your attention to the BCBS/IOSCO consultation on the subject on Margin requirements for non-centrally-cleared derivatives published on 6 July 2012 which envisages as eligible collateral equities in major stock indices for non-centrally cleared OTC derivative

contracts (page 22 of the consultation). We would expect that European Supervisory Authorities agree with BCBS/IOSCO on a consistent framework for highly liquid collateral, including equities.

We propose the following amendments (Article 1, COL, para 3 (b)):

……

(b) in the case of financial instruments:

(i1) fixed income instruments that

(i) ~~they~~ have been issued by an issuer that the CCP can demonstrate to the competent authority with a high degree of confidence has low credit risk based on a stable and objective internal or external assessment, taking into consideration the risk arising from the establishment of the issuer in a particular country.

(i2) equities that are included in major stock indicies.

……

7. Investment policy (Annex III, Chapter XII, INV)

BVI supports the proposal that a CCP should only invest its financial resources in highly liquid financial instruments. However, we think that the criteria defined by ESMA should also include "Short Term Money Market Funds" as defined in the Guidelines on a Common Definition of European Money Market Funds. Short Term Money Market Funds have a lower credit risk than deposit accounts and usually carry high credit ratings by at least one of the three leading rating agencies.

We propose the following amendment (Article 3, INV, para 1 (b) (iii) **new**):

(iii) Short term money market funds as defined in the CESR/ESMA Guidelines on a Common Definition of European Money Market Funds.

8. Reporting obligation (Annex V, RTS and VI, ITS)

Our members support the use of globally accepted identifiers for all trades/counterparties in all reporting. In particular, the required identifiers should be available on a license and fee free basis. Primarily ISO standards should be considered for this purpose. The International Securities

Identification Number (ISIN) should be used for the identification of securities/transactions. Identification of the counterparties to the trade or the underlying entities should be based exclusively on a globally agreed Legal Entity Identifier (LEI).

BVI strongly supports the introduction of developing and implementing a system of LEIs. We believe that the recommendations will enhance the transparency of information to relevant authorities and the public and will therefore improve financial stability. BVI acknowledges the efforts made by the industry to develop the introduction of LEIs.

BVI believes that ESMA also has to consider the cost of implementation of the reporting. We think it should be avoided that market participants have to acquire the services of a trade repository (TR) with regards to a specific class of OTC derivative if another TR will cover the same class of OTC derivatives a short time later.

- **Format of reporting/codes**

BVI believes that the identification of OTC derivatives should only be based on the ISIN Code. Also commodity (indicies) can be identified with the ISIN**.** However, our members feel that for the description of the OTC products the ISDA taxonomy could be used.

We propose the following amendment (Article 4, para 2):

1. A report shall identify a derivative contract using ***primarily an International Securities Identification Number (ISIN) or ~~a unique product identifier (UPI)~~*** *which is:*

a. unique;
b. neutral;
c. reliable;
d. open source;
e. scalable;
f. accessible;
g. ***~~available at a reasonable cost basis;~~ available to end-users on a license and fee free basis***
h. subject to an appropriate governance framework;

2. Where ***an ISIN or*** ~~***a UPI***~~ *does not exist,* ***the ISDA taxonomy should be used to identify a derivative contract. A derivative contract can also be identified on the following basis.***

a. The asset class of the underlying shall be identified as one of the following:
(i) equity:
(ii) interest rate products;
(iii) credit;
(iv) currency;
(v) commodities;
(vi) other
b. The derivative type shall be identified as one of the following:
(i) options;
(ii) futures;
(iii) swaps;
(iv) forward rate agreements;
(v) contracts for difference
c. In the case of hybrid derivatives, the report shall be made on the basis of the asset class that the counterparties agree on the derivative contract most closely resembles.

- **Data on exposure/collateral**

Our members disagree with the proposal to report the collateral for non-centrally cleared OTC derivatives to trade repositories. BVI believes that the reporting of the valuation (e.g. the valuation models) of the collateral for non-cleared OTC derivatives to trade repositories is too complex and should not be made mandatory. For such reporting the buy side would need to collect all relevant information on the valuation of the collateral from different market participants (e.g. collateral manager, custodian). Therefore, the German buy side would not be able to provide the trade repositories in time with relevant information.

The practical implementation of the reporting obligation of collateral to trade repositories could be very expensive for the investment fund industry. We believe that the requirements to report collateral and the high costs involved in order to implement the process for the reporting obligation by the investment fund industry outweigh the benefit for the information required by regulators to mitigate the counterparty risk.

We propose the following amendment (Annex V, Article 6, para 2 in conjunction with Annex VI, Article 5):

- **Annex V, Article 6, para 2:**

1. The data on collateral required under Table 2 of the Annex shall be reported on the basis of all collateral exchanged, including cash, securities, pledges and any other relevant interests.
2. In the event counterparties exchange collateral on a portfolio basis and it is not possible to report collateral exchanged for an individual contract, counterparties may report to a trade repository collateral exchanged on a portfolio basis, in which case the following information shall be reported for all the collateral exchanged:
i. collateral type;
ii. collateral amount;
iii. currency of collateral amount.
3. The counterparties shall report to the trade repository the specific contracts over which collateral has been exchanged.

- **Annex VI, Article 5:**

1. Where collateral is reported as exchanged on a portfolio basis, the following information shall be reported for all the collateral exchanged:
a. collateral type;
b. collateral amount;
c. currency of collateral amount.
2. Where collateral is reported on a portfolio basis, the specific contracts over which collateral has been exchanged.

We hope that you find our suggestions are helpful. We are happy to answer any questions you may have in the context of this matter.

Yours sincerely

Rudolf Siebel, LL.M.
(Managing Director)

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