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AMUNET PARTNERS LLP RESPONSE TO:

ESMA CONSULTATION PAPER ON THE DRAFT TECHNICAL STANDARDS FOR THE REGULATION ON OTC DERIVATIVES, CCPS AND TRADE REPOSITORIES (ESMA/2012/379)

Amunet Partners LLP specialises in providing specialist legal consultancy services, focusing on derivatives and other traded products. In providing these services, we supplement the existing internal legal resources of our clients and, for those clients which do not have in-house legal support, assume the role of in-house legal counsel on a part-time or temporary basis.

We have not attempted to comment on each section of the paper but have instead focused on those areas dealing with the regulation of OTC derivatives.

Clearing obligation: types of indirect clearing arrangements (Annex II, Chaper II, ICA)

As we stated in our response to ESMA discussion paper ESMA/2012/95, we are pleased that the final version of EMIR envisaged the creation of indirect clearing arrangements (ICAs). Given the last-minute (and very high-level) nature of this inclusion in EMIR, we are also grateful to ESMA for its efforts to produce workable technical standards for ICAs.

We also firmly believe that ICAs will represent one of the most fundamental components of the cleared derivatives market. They will ensure that derivatives end users continue to have access to the derivatives markets without the need to forge new relationships, ensuring in turn that regional players are not disintermediated and that market choice is ultimately not reduced.

Article 2(1) ICA provides the initial basis for a client of a clearing member to provide clearing services to its own clients. However, the proviso to this permission is vague, requiring the client of the clearing member to be "subject to appropriate regulatory requirements, including authorisation". We agree that it is important to the integrity of the cleared OTC derivatives market that only those entities that are capable of providing a professional, efficient and secure service should be permitted to participate in order to avoid compromising the market as a whole. However, we feel that the proviso as currently drafted is not useful: it either needs to be fleshed out and clarified or it should be made clear that criteria will be set out as part of the Level 3 guidance. We would advocate the former approach since clients providing ICAs to indirect clients may need to apply for specific authorisation and will almost certainly need to enhance or amend their processes, connectivity and (potentially) their structure in order to be able to provide these services to their clients. Additionally, there will be a heavy documentary burden to put in place the (as yet undetermined) agreements to give effect to the rights and obligations of the various relationships involved in an ICA. These ICAs

need to be in place in time to enable compliance with the first clearing obligation and, given the complexity involved, the maximum possible notice of the regulatory requirements associated with the clearing obligation will be required to meet that deadline.

We agree with ESMA's generally non-prescriptive approach with respect to the documentation of ICA relationships since the parties involved must be able to come up with a document structure that fits their circumstances, jurisdiction and other specific requirements. We recognise, however, that EMIR sets out certain requirements which must be included in this documentation.

Clearing obligation procedure: notification from the competent authority to ESMA (Annex II, Chapter III, DET)

We consider that, in general, the categories of information required to be submitted by a competent authority (and therefore a CCP) under Article 1 DET are appropriate but that significant granularity will be required in order to make the information useful. We believe that some form of benchmark is required in order to achieve this granularity and also an element of consistency.

Whilst we acknowledge that the technical standards cannot provide the level of detail one would expect in Level 3 guidance, it is also likely that many CCP applications to their relevant competent authorities will predate any guidance that is forthcoming. The information provided by a CCP to its competent authority will also have been given with a different aim (approval of CCP as a fit and proper body to provide clearing services as opposed to the appropriateness of a particular class of OTC derivatives to be subject to the clearing obligation). Therefore, it would be beneficial for each category of information to be linked to a specific purpose to ensure that the correct information flows from CCP to ESMA. For example, Article 1(f) DET refers to a requirement to provide "data on the volume of the class of OTC derivative contracts", which is not particularly precise. This could usefully be clarified so that it requires data of a specific kind and in a specific format to enable ESMA to determine whether a class of OTC derivatives should be subject to the clearing obligation. As mentioned above, we say this not because we believe any CCP will be unaware of the ultimate use for this information but because we feel that consistency from the start of the process is essential.

Given that ICAs are now envisaged by EMIR and are being facilitated by ESMA's technical standards, it would seem logical to ensure that the notification details set out in Article 1 DET also envisage indirect clients. As a result, the term "counterparties" should also be clarified to include indirect clients when used in Article 1 DET. Additionally, the tasks to be completed in order to start clearing with a CCP (Art 1(2)(e) DET) should also include an assessment of the additional tasks required to facilitate ICAs: the bulk of these will be between the client and the indirect client, but a number of arrangements will need to be made at CCP level too. These will need to be contemplated from the very beginning of the process.

We shall comment on contractual terms / operational standardisation below in relation to Chapter IV (CRI). However, we are puzzled by Art 1(4), which purports to give further detail on paragraph 1 point (e) (contractual terms and operational standardisation) but instead requires data in relation to the reference price. Was this instead intended to be a reference to paragraph 1 point (h)?

We understood from comments made by the panel at the most recent open hearing in Paris that the phasing-in of the clearing obligation by counterparty would be considered on a case-by-case basis.

This suggests to us that there will be a per product and per counterparty-type phase-in, with perhaps further focus on this point in each consultation prior to an OTC derivatives class becoming subject to the clearing obligation. Whilst this focus in these consultations will be very important, it is also essential to recognise that the circumstances which will give rise to a phase-in requirement are not necessarily product-specific. We would argue that the greatest obstacles to readiness for clearing OTC derivatives for many market participants are more general: understanding the specific relevance of the clearing obligation to them; negotiation of fair and appropriate terms for clearing business, collateral management & optimisation and potentially also additional execution relationships – bearing in mind that most of the market participants involved as clients and indirect clients in the more complex ICAs will not be major players; preparing policies and procedures, including those for execution, risk management and operational integrity; ensuring connectivity via middleware providers, etc.

We therefore ask ESMA to consider a generic phase-in per counterparty type for at least the first set of OTC derivatives classes since immediate compliance will be challenging both in absolute terms (the timetable between adoption of ESMA's technical standards and required compliance could otherwise be fairly short) and in relative terms (resource will be far more scarce at the less sophisticated counterparties). Indeed, Recital 16 of EMIR refers specifically to the possibility of a phase-in per counterparty type rather than a phase-in which is limited to product types only. A phase-in by counterparty type becomes all the more important when one considers that the clearing obligation is likely to apply first to the more vanilla classes of OTC derivatives and that these classes are likely to be most relevant to the less sophisticated (and arguably less prepared) market participants.

As ESMA has recognised, it is important for market participants to be informed of notifications submitted by competent authorities as soon as possible. ESMA also points out that the RTS in relation to a particular class of derivatives subject to the clearing obligation will specify an effective date and will therefore leave ample time for implementation. However, we believe that this addresses only half of the concern: with the front-loading requirement being triggered as of the date of notification to ESMA by a competent authority, market participants must be given the opportunity to adjust their behaviours in order to avoid becoming subject to a clearing obligation for which they may not be operationally ready. It is not just a question of being given enough time to adapt, it is also a question of having freedom to contract (i.e. to enter into derivatives transactions in relation to the relevant class of OTC derivatives) in full knowledge of the ensuing obligations (in this case, the clearing obligation and attendant requirements).

We therefore advocate that, at the very least, the notification to ESMA by a competent authority should be a public notification, notwithstanding that ESMA may ultimately determine that the relevant class(es) of OTC derivatives shall not be subject to the clearing obligation. There is also a case for applications for authorisation to clear by CCPs to their competent authorities to be made public (although this publication should not extend to any commercially sensitive details of those applications) in order to give parties time to adjust trading / hedging models and for competent authorities to report upon the attainment of specific milestones in the authorisation process.

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

We welcome the additional detail provided in Chapter IV CRI and believe that these criteria generally give more of a flavour as to what sort of OTC derivatives classes will become subject to the clearing obligation. However, we are concerned that the criteria dealing with contractual terms may actually cause some confusion.

Bearing in mind that this section focuses on the suitability or otherwise of various classes of OTC derivative to become subject to the clearing obligation, we consider the reference to master netting agreements to be misleading. Virtually all OTC derivatives relationships will be subject to a master netting agreement, whether actually executed or deemed to apply via a confirmation, and this does not therefore represent a distinguishing factor.

Furthermore, it is relatively rare for master netting agreements, such as the ISDA Master Agreement, to address product-specific details and, when they do, it is usually only to provide a blanket amendment to product-specific definitions. Master netting agreements therefore deal with the commercial relationship between the parties to OTC derivatives transactions and not the specifics of those transactions: their existence should therefore have no bearing whatsoever on whether a class of OTC derivatives should be subject to the clearing obligation. They are extremely unlikely to set out "contract specifications commonly used by counterparties" (per Art 1(2)(a) CRI).

It should also be noted that master netting agreements only represent a part of the suite of documentation to be put in place between clearing member and client. The principal document in this relationship will become the client clearing agreement, which will *inter alia* bring into existence a clearing master agreement and will make reference to this and to any existing (non-clearing) master agreement.

The reference to confirmations and definitions in Art 1(2)(a) CRI is more relevant and we note ESMA's view (expressed in the most recent open hearing in Paris) that further granularity on this point must be left to Level 3 or to separate consultations on a specific class of OTC derivative. However, we would urge greater clarification even at this stage of the legislative process. All sets of definitions and confirmations will, by their nature, "set out contract specifications commonly used by counterparties". However, it is the way in which those definitions and confirmations are used (common incorporations, elections and amendments) that will define whether a class of OTC derivative has a degree of standardisation. This cannot therefore be assessed by looking at the confirmations or definitions themselves and must instead relate to their actual use by counterparties (including the prevalence of master confirmation agreements, for example).

Non-financial counterparties: criteria for establishing which derivative contracts are objectively measurable as reducing risk directly related to commercial activity or treasury financing Annex II, Chapter VII, NFC)

We welcome ESMA's stated revision of the technical standards so that they extend to proxy hedging and pre-hedging and we also welcome ESMA's aim of ensuring legal certainty wherever possible. With this in mind, it is important for market participants entering into OTC derivatives transactions with non-financial counterparties to have certainty as to whether or not a transaction will be mandatorily clearable. Whilst some of the determinations for "hedging" transactions are intended to

lead to an objective determination, a counterparty to a non-financial counterparty is heavily reliant upon the non-financial counterparty to inform it as to whether a transaction will or will not be subject to the clearing obligation (in accordance with Article 10 EMIR). We would therefore urge ESMA to consider a statement in the technical standards to confirm that those dealing with non-financial counterparties are not required to investigate further when the "hedging exemption" is claimed (absent this being something of which a counterparty should be aware).

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

We largely agree with the risk-mitigation techniques set out by ESMA in its technical standards. However, we feel that Article 1 RM (in relation to timely confirmations) would benefit from some clarification. What constitutes a confirmation? Confirmation could be seen as a one-way process (i.e. one party sends a confirming document or message to the other), but in practice it is a two-way process with one party checking the details of the confirming document or message prepared by the other party (or, in some cases, both parties exchange confirmations). Is the obligation to confirm satisfied just by sending the confirmation or by both parties agreeing on the terms?

Where there is an obligation to confirm a non-cleared OTC derivative contract by a certain time, it is not clear who has that obligation: is it only the party charged with preparing and sending confirmations? should it be the obligation of the more sophisticated of the two parties? should it be the obligation of both parties, even though in practice one party has limited control over the process? In the same way, who should be responsible for the delay when genuine discussions / disagreements as to terms result in a failure to confirm by the relevant deadline?

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