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**- Your Ref: Comment letter on ESMA's Draft Technical Standards for
the Regulation on OTC Derivatives, CCPs and Trade Repositories**

Dear Sir.

Thank you for giving us the opportunity to comment on your discussion paper on ESMA's Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories. The proposals will improve transparency, promote market integrity and reduce the risks associated with the OTC derivatives market, particularly systemic risk. It is clear that CCPs will become a core feature of the financial market infrastructure, and it is therefore paramount that the CCPs are themselves robust, safe and risk managed. This will be even more relevant if consolidation will lead to few super-CCPs, which are themselves systemically important financial institutions. I will restrict my comments here to some major points, and make some recommendations, which I hope will be of interest to you.

Non-financial counterparties

The proposed criteria in §§ 29-31 appropriately capture the OTC derivative contracts that are objectively measurable as reducing risk directly related to the commercial activity or treasury financing activity of a non-financial counterparty. However, for completeness I would add that such OTC derivative contracts should not be used to hedge or mitigate the risk of other derivative positions, unless those other positions themselves are held for the purpose of reducing risk directly related to the commercial or treasury financing activity.

The decision as to whether an OTC derivative is used to reduce risk directly related to the commercial activity or treasury financing activity of a non-financial counterparty should ideally

be made at the time the derivative position is entered into, considering the circumstance existing at that time, and taking into account management's general hedging and risk mitigation strategies.

Risk mitigation for non-CCP cleared contracts

Timely confirmation, reconciliation of non-cleared OTC derivative contracts and portfolio compression are important post-trade mechanisms that should increase transparency, promote market integrity and reduce risk by:

- establishing procedures that will promote legal certainty concerning OTC derivative transactions
- assisting with the early resolution of valuation disputes
- effecting the timely and accurate netting and valuation of OTC derivatives
- reducing costs and increasing capital liquidity
- reducing operational risk
- increasing operational efficiency
- reducing systemic risk.

Regarding timely confirmation, ESMA considers that counterparties "should confirm, where available via electronic means, the terms of any OTC derivative they have entered into with each other and which is not cleared by a CCP"¹. It should be noted that certain terms may not be known to the counterparties within the proposed timeframes. For example the counterparty name may not be known if an investment manager executes a single trade and then allocates positions across its clients. The duration of this process depends on the clients instructing the investment manager in a timely manner. However, I agree that the proposals would contribute to a low level of log of unconfirmed trades and that this will facilitate counterparties' management of their OTC derivative-related risk. I also agree with the wording "where available via electronic means". This is a necessary condition, in order to prevent a CCP from arbitrarily delaying the confirmation and trade acknowledgement by choosing to process a transaction non-electronically. It would also help to reduce back-office paperwork.

I particularly support the proposed reconciliation requirements, which require counterparties to carry out portfolio reconciliation for their non-cleared OTC derivative contracts. I support that such reconciliation could be performed on a bilateral basis or by a qualified third party. I also support the principle that the frequency of reconciliation should be tailored to the materiality and size of the derivative portfolio.

Regarding portfolio compression, I would recommend that you clarify in proposed § 51 that, where multilateral portfolio compression services are proposed for a class of OTC derivatives, counterparties, especially when they already use services of that service provider, should include in the portfolio compression cycle all the OTC derivatives in their portfolio that are eligible for such cycle unless including the OTC derivative would be reasonably likely to

¹ See § 38 of the Discussion Paper.

significantly increase the risk exposure of the counterparties.² There could also be compliance or internal risk management policies that would exclude certain transactions from the portfolio compression cycle.

Regarding marking-to-model, counterparties should be required to maintain written documentation on the methodology, procedures, parameters and inputs underlying their marking-to-model valuation techniques. The agreed methodology, procedures, parameters and inputs should be required to constitute a complete and independently verifiable methodology for valuing each OTC derivative. This will increase transparency, operational efficiency and assist in the early and objective resolution of OTC derivative valuation disputes. I would additionally recommend that you should require that the methodology must include alternatives in the event that parameters or inputs to the methodology become unavailable. This is a common sense proposal that will assist counterparties in resolving disputes over the valuation of OTC derivatives.

Chief compliance officer

I fully support the intent of proposed §§ 68-69. The chief compliance officer (CCO) role is the single most important compliance role in a CCP and it is critical that its job description, the rules and the entity's structures and procedures, act to secure and maintain the CCO's independence. For example the CCO should have a single compliance role and no other competing role or responsibility that could create conflicts of interest or threaten its independence, and therefore I would suggest that you should promulgate rules that restrict the CCO position from being held by a lawyer who represents the CCP or its board of directors, such as an in-house legal officer. Furthermore the remuneration of the CCO must be specifically designed in such a way that avoids potential conflicts of interest with its compliance role.

Given the pressures that bear on the CCO with regard to managing conflicts of interest and maintaining independence, I would strongly recommend one specific additional proposal. I would recommend that you should propose that the authority and sole responsibility to designate or remove the CCO, or to materially change its duties and responsibilities, only vests with the independent members of the board and not the full board. This would help to ensure the independence of the CCO within the entity, and would possibly mitigate the need for you to promulgate rules requiring the CCP to insulate the CCO from undue pressure and coercion or to address the potential conflict between and among compliance interests, commercial interests and ownership interests of a CCP.

Record keeping

Proposed §§ 78-80 establish the record keeping requirements. I would recommend that records should be required to be kept indefinitely rather than the general ten years proposed in

² This could be the case with transactions designated as hedges for accounting purposes. IAS 39 states in paragraph 80 that only contracts that involve a party external to the entity can be designated as hedge items.

§ 83. Original documents should be scanned after ten years. There is no technological or practical reason for limiting the retention period, and it would be useful to keep this information for future analytical purposes, including in order to allow a complete long-term forensic examination and verification of transactions and clearing activities.

Margins

I support a proposal that would allow CCPs to use approved internal models to calculate the margin requirements under a criteria based approach, complemented by an approach based on prudent fixed percentages. This is very much the way to go,³ and will surely incentivise CCPs to develop and use the more risk-accurate internal margin models. I agree that the criteria outlined in proposed § 95 are appropriate to ensure that the adequate percentage above 99 per cent is applied in CCP's margin models.

Financial resources requirements

I support your proposals, which should act to improve the robustness of CCPs and help to protect the financial system from contagion. However, I do not think that the proposals go far enough. We have to anticipate and work with the "tail-risk" conditions which would be expected to apply in the event of the default of a significant clearing member. Default of a significant clearing member would almost certainly occur in conditions of financial uncertainty and stress. Such conditions could be accompanied by reduced liquidity and funding, widening spreads, falling solvency and increasing defaults and other systemic impacts. The CCP would also need resources to continue operating and to satisfy the additional expectations of its clearing members post-default. For this reason I would recommend that margins together with default fund contributions should be sufficient to withstand the default of the two largest clearing members under extreme but plausible market conditions.⁴

I support the proposal that consideration should be given to differentiating risk and therefore resource requirements by broad derivative / product class, or at least by exchange-traded and OTC derivative types.⁵ OTC derivatives tend to be more complex, less transparent and less liquid, which presents greater problems to the CCP compared with exchange-traded derivatives.

³ Similar to the approach adopted by Basel for banks, and e.g. Solvency II for European insurers.

⁴ This would comply with Article 41 of EMIR, which states that: "The default fund referred to in Article 40 and the other financial resources referred to in paragraph 1 shall at all times enable the CCP to withstand the default of the two clearing members to which it has the largest exposures". It would also be consistent with principle 4 in the latest CPSS-IOSCO consultative report on Principles for financial market infrastructures - March 2011, which states that: "A CCP should also maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/ two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions".

⁵ E.g. see § 95 and § 103 of the Discussion Paper, which consider product-related criteria in relation to margins and default fund contributions.

Types of financial resources

The types of financial resources that would be available to a CCP to meet its financial obligations to its clearing members include: (1) the margin of the defaulting clearing member; (2) the CCP's own capital; (3) default fund contributions; (4) default insurance; (5) potential assessments for additional default fund contributions on non-defaulting clearing members; and (6) any other financial resource requirements. I would suggest that you should provide more guidance on this, including perhaps splitting these financial resources into two classes. Class A would consist of (1) to (3) above, and should be required to make up the significant part of the total financial resources, and class B would consist of (4) to (6) above, on which larger prudential haircuts should be applied. Care should be taken with (4), as default insurance may be particularly unreliable in times of financial stress, and we should be more careful not to anticipate (5) excessively, as this may cause pro-cyclical problems and increase systemic risk in times of financial stress.

Computation of the financial resources requirements

I agree that a detailed and thorough analysis of testing results should be carried out at least monthly, with the possibility to require more frequent testing in times of increased volatility, reduced liquidity or general conditions of financial stress. Backtesting margin coverage and stress testing should be carried out daily. I would also suggest that you should specifically require at least monthly reverse stress testing in proposed § 157(a). This is a useful tool in order to manage expectations and to help the CCP to anticipate financial resources requirements in extreme conditions.

Reporting of financial resources

It is important that the CCP's available financial resources and its financial resources requirements should be explicitly monitored, managed and reported. In particular, you should require a CCP to report a 10% decrease in the value of its available financial resources compared to either its last quarterly closing or the value as of the close of the previous business day. The types of financial resources that are available to a CCP to meet its financial obligations to its clearing members include: (1) margins; (2) the CCP's own capital; (3) default fund contributions; (4) various insurances. These financial resources are not equivalent. I would argue that (2) and (3) above are more critical, as these represent robust measures, whereas (1) for example changes with market conditions and business exposures and is directly related to risk taken on. I would suggest splitting the available financial resources into two classes for this particular reporting purpose. Class C would consist of robust items such as (2) and (3) and Class D would consist of exposure (market or risk) related items such as (1). I would recommend that the decrease in available financial resources reporting requirement should be applied on both classes of financial resources separately, as well as in total.

I would also recommend that a CCP should calculate and publish its Solvency Ratio, which is defined as [Available Financial Resources / Financial Resources Requirements]. I would recommend that a reduction of 5% or more in this Solvency Ratio should be required to be

reported to the competent authority. Furthermore, the competent authority should be immediately notified when the Solvency Ratio falls below 105%.

Liquidity risk controls

I support proposals which would require CCPs to conduct internal cash flow projections and liquidity stress tests. Liquidity stress tests should consider market stress, idiosyncratic stress and combinations thereof. Importantly, liquidity stress testing should consider the potential actions of other market participants that would experience the same liquidity stresses. In extremity, assets used to offset projected funding needs should be discounted to reflect their credit risk and market volatility.

Trade repositories: reporting obligation

For completeness, it would be preferable if information needed to monitor and verify OTC derivative contracts for all non-financial counterparties was required and reported. I also support that information related to counterparty exposures to uncleared OTC derivative contracts should be reported. This would provide a more complete and consistent reporting framework, and would help to prevent abuse of the reporting requirements.

Product taxonomy

The problem here is that OTC derivatives products are not generic, but rather a bundle of financial elements, which consist of differing fixed or contingent cash flows. The design of a "product" requires bundling the different financial elements in order to match off or mitigate risks, and the classification of the resulting as a "product" is rather arbitrary. I therefore support that the more granular, effective and efficient approach to product classification would be to unbundle or disaggregate the resulting product into the underlying individual financial elements, and base the classification on these more easily identifiable and understandable elements. From a regulatory point of view, I would be concerned if a complex OTC derivative could not be unbundled or disaggregated accordingly, as this could imply that the trading entity has not completely understood the risks underlying the product.

Trade repositories: governance and compliance

I suggest more guidance will be needed on governance and compliance issues. In brief concerning: independent representation on the board and key committees; conflicts of interest; the requirement and role of the chief compliance officer; and access and transparency.

Access and fees

It is important that trade repositories (TRs) should promote fair, open and equal access. Such entity should be required to levy charges in an equitable and non-discriminatory manner. The only reason for charging different charge / fee structures would relate to differing costs of providing access or service to particular categories. Anything else would be discrimination⁶ by definition. I also suggest that any preferential pricing such as volume discounts or reductions should not be generally viewed as equitable. Such volume discounts and reductions tend to discriminate in favour of large players, and a small number of large players dominate the OTC derivatives market anyway.

I would additionally recommend that full disclosure should be required here, including all explicit and implicit charges and fees of any kind. This would formalise the market practice and ensure that informed decisions were being made.

Trade repositories financial resources requirements

I strongly support the requirement that a TR must maintain financial resources exceeding the total amount that would enable the TR to cover its operating costs for a 1-year rolling period. I would also recommend that a TR should calculate and regularly publish its Solvency Ratio, which is defined as [Available Financial Resources / Financial Resources Requirements]. I would recommend that a reduction of 5% or more in this Solvency Ratio should be required to be reported to the competent authority. Furthermore, the competent authority should be immediately notified when the Solvency Ratio falls below 105%.

Yours faithfully

C.R.B.

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⁶ E.g. hidden and unfair cross-subsidy or other anticompetitive measure.