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Dear Sirs,

Comments on the ESMA Consultation Paper: Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositaries (the "Consultation Paper")

Brevan Howard ("BH") is an alternative investment manager which trades predominantly in global fixed income and foreign exchange markets. BH is one of the world's largest absolute return managers, with offices in seven countries around the globe and assets under management in excess of $36 billion.

This letter contains comments on the Consultation Paper given on behalf of BH by Dr Aron Landy, Chief Risk Officer of Brevan Howard Investment Products Limited.

All acronyms used herein have the same meanings as set out in the Consultation Paper. All references to EMIR are to the version dated 11 April 2012, as referred to in the Consultation Paper ("EMIR").

Linking margin requirements and default funds

The Consultation Paper contains substantial material on margin requirements and default funds. It seems, however, that consideration of the key link between these two layers of protection has been omitted.

The prudential safeguards for any CCP comprise its total resources, being the initial margin, its default fund and its own resources. As mentioned in EMIR "the CCP should have in place stringent participation requirements, collect appropriate initial margins, maintain a default fund and other financial resources to cover potential losses" (EMIR, Preamble 37). These resources must be considered as a whole, because prudential issues such as widespread end-user losses and calls for public sector support of a CCP only arise when all resources are (or are feared likely to be) exhausted.

Regarding the priority order in the case of a clearing member default, EMIR sets out the following default waterfall: "A CCP shall use the margins posted by a defaulting clearing member ... [followed by] the default fund contribution of the defaulting Member ... [followed by] dedicated own resources ... [followed by] default fund contributions of non-defaulting clearing members" (EMIR, Article 45). In other words, the layer of mutualised risk, being the default fund contributions of the CCP and the non-defaulting clearing members, is only called upon after the resources of the defaulting clearing member are exhausted.

The default fund must, according to EMIR, "enable the CCP to withstand, under extreme but plausible market conditions, the default of the clearing member to which it has the largest exposures or of the second and third largest clearing members" (EMIR, Article 42(3)). The default fund must therefore take account of the size of the largest clearing members.

When considering the robustness and safety of CCPs there is therefore a critical interlinkage between the initial margin confidence level, the size of the default fund contributions of clearing members, the amount of the CCP's own resources dedicated to the default fund and the size of the largest clearing member (or members).

This interlinkage should always be considered whenever margins or default funds are discussed in isolation.

It is noteworthy that no CCP called on mutualised resources during the 2008 crisis, demonstrating that Lehman's margin and default fund contributions were sufficient to cover the losses that arose in that case. The Consultation Paper provides no evidence that current margin & default fund practices are inadequate. The RTS should therefore support the continued operation of existing margin and default fund practices.

Margin requirements (EMIR Article 41 & Draft RTS on CCP Requirements ("RTS CCP") Chapter VII Article 1 MAR)

BH notes the proposals to apply a higher minimum confidence level of at least 99.5% to OTC derivatives (compared to at least 99% for other classes of financial products). Since margin requirements are intended to "cover potential exposures that the CCP estimates will occur until the liquidation of the relevant positions" (EMIR Article 41(1)), in our view the only relevant criterion in setting margin levels is the ability to liquidate. In this regard there is no difference in principle between OTC and listed derivatives. OTC derivatives can be highly liquid (Euribor interest rate swaps and EUR-USD foreign exchange options, for example) and listed derivatives very illiquid (single-stock dividend swaps listed on EUREX, for example). BH believes that making this distinction between OTC and listed derivatives is not justified.

In our opinion:

1. CCPs should be strongly encouraged to set margins on the basis of potential liquidation, as per EMIR Article 41(1) "[margins] shall be sufficient to cover losses that result from at least 99 per cent of the exposures movements over an appropriate time horizon".
2. In order to ensure "consistent application" (EMIR Article 41(5)), it would be far preferable to apply a consistent confidence standard of 99% but to vary the time horizon depending on the ability to liquidate. The factors proposed in RTS CCP Article 1(2) MAR should apply to the time horizon. [This would also be consistent with the BCBS-IOSCO and CFTC proposals for non-centrally cleared derivatives, which stipulate a 99% confidence standard and a 10 day time horizon.]
3. It may also be necessary to use different models across the range of markets and instruments. The factors proposed in RTS CCP Article 1(2) MAR should also apply to the risk model.
4. The minimum standard for margin should be 99%, but this could be increased by ESMA or a CA in a case where a CCP's risk management process (including risk modelling, size of default fund, default process, margin collection process or any other relevant aspect) was found to be inadequate. This practice would make the necessary link to the default fund and also incentivise the implementation of sound risk management practices by CCPs.

We also note that since none of the discussion points in paragraphs 163-5 of the Consultation Paper is specifically relevant to OTC derivatives as a class, they do not justify a different treatment for OTC derivatives. In addition, point (d) of paragraph 167 (which notes that a higher confidence interval would have no impact on end clients because 'they are already required to post higher margins to direct clearing members') is incorrect in our experience.

Portfolio margining (EMIR Article 41 & RTS CCP Chapter VII Article 4 MAR)

No discussion is given in the Consultation Paper. In our opinion the proposals could have significant negative impact on robust portfolio margin models currently in use by CCPs, and furthermore may be extremely difficult to implement.

The proposed correlation threshold level of 70% is arbitrary (as is the lower threshold of 50%) and no justification or supporting evidence for this level has been supplied.

Such a rule could have unwanted consequences, for example, the rolling 2 year correlation of daily changes in the EUR 2 year interest rate swap and the EUR 10 year interest rate swap was below 70% from September 2008 to July 2011, a period of nearly 3 years. Margin offsets between these swaps would have been prohibited under the proposed rule, a result which would be surprising to most market participants.

Further, this type of rule may not be helpful in improving the safety of CCPs because in that regard, the most important criterion for portfolio margining is whether instruments will be correlated in a stress or default scenario. Correlation in normal market conditions is less important.

On a technical note, the proposed rule references (pairwise) correlations between instruments and as such would be extremely difficult to implement for a large portfolio (because, for example, in a portfolio of 1,000 instruments, nearly 500,000 correlation tests would have to be carried out).

The proposed maximum offset level of 80% is arbitrary and no justification or supporting evidence has been supplied; such a rule could also have unwanted consequences. Margins for very low risk portfolios such as two virtually identical offsetting swaps or an option hedged with a swap would be dramatically increased. This would create perverse incentives.

Existing CCP portfolio margining systems do not feature specific constraints on correlation. These systems are robust and have withstood the 2008 crisis. Setting the appropriate parameters for margin offset should be the responsibility of each CCP (via its risk committee), under the supervision of its regulator.

Straight-Through Processing ("STP") & Real-Time Acceptance ("RTA")

BH strongly supports STP & RTA for cleared OTC derivatives. Noting the CFTC rule that acceptance or rejection of a transaction should take place "as quickly as technologically possible if fully automated systems were used" (published in the Federal Register, Vol. 76, Issue 147), we would welcome any proposal by ESMA to include such a requirement in EMIR.

Real-time confirmation to clients that trades are accepted for clearing is an essential component of modern electronic markets. It is essential for electronic trading in OTFs, essential for proper operation of a central limit order book ("CLOB"), facilitates competitive markets for execution (which is better for end-users), makes default management much easier (as a CLOB can be used to unwind trades) and moreover requires little or no extra implementation cost as it is already mandated under Dodd-Frank.

Governance (EMIR Article 28)

BH strongly supports the provisions of EMIR regarding the composition of the risk committee: "A CCP shall establish a risk committee, which shall be composed of representatives of its clearing members, independent members of the board and representatives of its clients ... None of the groups of representatives shall have a majority in the risk committee" (EMIR Article 28). It would be welcome if the intent of this provision (that no group should have a majority on the risk committee) could be reinforced in Level 2 and in particular safeguarded (by anti-avoidance provisions) against risk-related decisions being made (or effectively made) by other committees of, or groups within, a CCP.

Please do not hesitate to contact us with any questions you may have regarding our comments.

Yours faithfully,

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