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| 1 October 2014|ESMA/2014/1185 Reply Form |

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| Reply form for the Consultation Paper  On the Clearing Obligation under EMIR (no. 3) |

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| Date: 1 October 2014  ESMA/2014/1185 Reply Form |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Consultation Paper - Clearing Obligation under EMIR (no. 3), published on the ESMA website.

Responses are most helpful:

1. if they respond to the question stated;
2. contain a clear rationale, including on any related costs and benefits; and
3. describe any alternatives that ESMA should consider

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

Responses must reach us by **6 November 2014**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’.

Instructions

Please note that, in order to facilitate the analysis of the responses, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

1. use this form and send your responses in Word format;
2. do not remove the tags of type < ESMA\_CA3\_QUESTION\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
3. if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Disclaimer’.

# General information about respondent

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| --- | --- |
| Are you representing an association? | No |
| Activity: | Investment Services |
| Country/Region | Europe |

# Introduction

**Please make your introductory comments below:**

<ESMA\_CO3\_COMMENT\_1>

State Street Corporation (“State Street”) appreciates the opportunity to comment on the Consultation Paper (CP) issued by the European Securities and Markets Authority (“ESMA”) regarding the clearing obligation under the European Market Infrastructure Regulation (“EMIR”) (no. 3).

Headquartered in Boston, Massachusetts, with branches and subsidiaries throughout the European Union (“EU”), State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With USD 28.4 trillion in assets under custody and administration and USD 2.48 trillion in assets under management, State Street operates in 29 countries and in more than 100 markets worldwide. Our European workforce of 9,000 employees provides services to our clients from offices in ten EU Member States.

The present CP follows the publication in July 2013 of a discussion paper on the clearing obligation under EMIR, the publication of the first consultation papers on the clearing obligation on interest rate classes and credit classes3, and the publication of the Final Report on the clearing obligation on interest rate classes. This paper provides explanations on the draft regulatory technical standards establishing a clearing obligation on a class of foreign-exchange non-deliverable forward (FX NDF) OTC derivatives.

State Street welcomes efforts to strengthen over-the-counter (“OTC”) derivatives markets by introducing a clearing obligation and by creating a framework for determining the eligibility of contracts for which mandatory clearing would apply.

While we are generally supportive of the proposed clearing obligation for FX NDFs, there are a couple of areas where we believe further clarification and details are required, e.g. with regards to the contract characteristics subject to the clearing obligation, the front loading obligation as well as the phase-in of the clearing obligation.

Lastly, State Street strongly recommends refraining from subjecting other FX derivatives to a clearing obligation in the future. Not only are FX markets not organized in the same manner as OTC derivatives markets, and do not share the same core characteristics, but they are global in nature and consistency and coordination with other jurisdictions, in particular the US, are therefore of crucial importance. In the case of FX derivatives, the US has already expressed its determination to exempt FX Forwards and Swaps from the clearing obligation introduced through Title VII of the Dodd-Frank Wall Street and Consumer Protection Act (“Dodd-Frank”). Should a different decision be taken in the EU to subject FX Forwards and Swaps to the clearing obligation, FX derivative markets would be distorted and split.

State Street also supports the views and opinions expressed made in the submissions of the International Swaps and Derivatives Association (“ISDA”) and the Global FX Division of the Global Financial Markets Association (“GFXD”).

<ESMA\_CO3\_COMMENT\_1>

## The clearing obligation procedure

##### Do you have any comment on the clearing obligation procedure described in Section 1?

<ESMA\_CO3\_QUESTION\_1>

In line with the industry State Street believes that a preferable approach would be to adopt a single Regulatory Technical Standards (“RTS”) which is amended, through the addition of multiple annexes, as new classes of OTC derivatives become subject to the clearing obligation as set out in EMIR.

Following such an approach would allow the categorisation of counterparties to be assessed on an asset class basis, meaning a counterparty could be a Category 1 counterparty for one asset class but a Category 2 or 3 counterparty for another. In our view, it has to be ensured that a counterparty that is a clearing member at one CCP for a class of derivatives should only be treated as a Category 1 counterparty for that specific derivative class and not for other classes subject to the clearing obligation in which it is not a clearing member.

Under the cumulative approach contemplated by ESMA, however, if a counterparty was deemed a Category 1 counterparty for one class of derivatives, and thus Category 1 for all classes, it will need to become a clearing member at a new CCP or put in place additional clearing arrangements to ensure that it can clear any in-scope derivatives that it enters into. This in our view cannot be the intended outcome of the categorization as part of the clearing obligation.

<ESMA\_CO3\_QUESTION\_1>

## Structure of the non-deliverable forward derivatives classes

##### Do you consider that the proposed structure for the FX NDF classes enables counterparties to identify which contracts are subject to the clearing obligation?

<ESMA\_CO3\_QUESTION\_2>

State Street would like to emphasise the importance of having sufficiently clear and granular RTS identifying the instruments subject to a clearing obligation. While we generally agree with the FX NDF RTS, it is necessary for ESMA to provide further details, in particular with respect to the contract characteristics to ensure the class is sufficiently standardized.

More generally, we appreciate the effort by ESMA to increase derivatives market participants’ ability to determine which contracts must be cleared and to prevent a situation where the clearing obligation would lead to a de facto trading ban on contracts that meet the seven characteristics of the RTS but that CCPs do not clear because of non-standard features. We are however concerned with the possible situation in which a CCP may choose to withdraw a particular clearing service following its authorization. This does not lead to removing the clearing obligation to the extent that no other CCP offers that service. Firms could hence be left with a situation where a product meets the criteria as specified by the RTS and, despite being clearable product at the time of authorisation, such a service is no longer available.

We do not believe that this was ESMA’s intention and in order to prevent decisions of CCPs to cease clearing a particular contract from dictating whether that contract is tradable, the application of the clearing obligation to a particular contract should be conditional not only on the contract being of a type that would have been accepted for clearing by a CCP at the time of its authorisation, but also on the contract being of a type which will be accepted for clearing by an authorised CCP as at the later of (i) the date of trading and (ii) the date on which the contract is required to be cleared under EMIR.

Lastly, we fully agree with the wider industry recommendation that only FX NDF’s documented on the basis of standardised forms of contract, for example the templates published by the Emerging Markets Trading Association (“EMTA”) and/or ISDA, entered into without material modifications to their terms should be subject to the clearing obligation.

<ESMA\_CO3\_QUESTION\_2>

## Determination of the classes of OTC derivatives to be subject to the clearing obligation

##### In view of the criteria set in Article 5(4) of EMIR, do you consider that the determination of this class addresses appropriately the objective of reduction of the systemic risk associated to NDF derivatives?

<ESMA\_CO3\_QUESTION\_3>

While mandating FX NDF clearing via a CCP would mitigate counterparties’ risk exposure, the amount of risk in the FX NDF market is orders of magnitude less than, e.g. in interest rate or credit derivative markets. It is therefore not clear whether a clearing mandate for these contracts would appropriately address the objective of reducing systemic risk at this time, and that a determination by ESMA that mandatory clearing of a class of FX NDF contracts reduces systemic risk warrants a different analysis with different considerations.

<ESMA\_CO3\_QUESTION\_3>

##### For the currency pairs proposed for the clearing obligation on the NDF class, do you consider there are risks to include longer maturities, up to the 2 year tenor?

<ESMA\_CO3\_QUESTION\_4>

State Street disagrees with a clearing mandate for tenors exceeding one year. Given the insufficient liquidity in these products to support clearing, CCPs would find it difficult to manage the default of a clearing member responsible for transactions in those maturities.

As the CP notes, open interest in FX NDFs is concentrated in instruments with maturities shorter than one year. It acknowledges further indicates that but for one pair, more than ninety percent of trading is in tenors 6 months or shorter. As such, GFXD believes that longer-dated instruments, those in excess of 6 months or 1 year, at this time, do not have sufficient liquidity to support clearing.

While we appreciate the concerns raised in the CP with establishing a one-year tenor cut-off, we believe that other factors may disincentivize any efforts to structure around a cut-off for shorter-dated tenors. The overwhelming majority of FX NDF contracts have a maturity of less than 6 months. The phase-in of margin requirements for uncleared derivative transactions will begin at the end of 2015. This will increase the cost of continuing to transact FX NDFs bilaterally which in turn will reduce any incentive parties may have to try and structure transactions to avoid any clearing mandate. ESMA could also consider adopting a cut-off that is slightly longer than one year. Adopting this kind of cut-off may help to address any concerns with evasive behaviour without unnecessarily introducing the risk associated with clearing illiquid products to the CCPs.

<ESMA\_CO3\_QUESTION\_4>

## Determination of the dates on which the obligation applies and the categories of counterparties

##### Do you have any comment on the analysis presented in Section 4.1?

<ESMA\_CO3\_QUESTION\_5>

Please refer to the responses submitted by ISDA and the GFXD.

<ESMA\_CO3\_QUESTION\_5>

##### Do you agree with the proposal to keep the same definition of the categories of counterparties for the NDF classes than for the credit and the interest rate classes? Please explain why and possible alternatives.

<ESMA\_CO3\_QUESTION\_6>

The effectiveness of the proposed classification of counterparties to ensure a smooth implementation of the clearing obligation must be assessed in the context of the proposed phase-in periods and approach to the frontloading requirement. In our view, these elements cannot be assessed in isolation. When assessed together, we are concerned that the thresholds-based approach for the categorisation of counterparties, and the associated application of the frontloading requirement, will be practically impossible for market participants to implement in the time and manner currently suggested.

In addition, we would recommend having all authorised CCPs submit and maintain their member lists (per asset class) on a single, centralised registry which is freely accessible and machine readable format. This would enable timely and accurate categorisation of clients.

In the absence of any such list, or any confirmation from the client, we support the industry’s comments with regards to a presumption in the absence of counterparty confirmation: It cannot be taken as given that all counterparties will be able to run the threshold calculation in the proposed timeframe so there may be a number of counterparties who are unable to provide a representation or other confirmation promptly. From a perspective of legal certainty, Category 1/2 entities need clear guidance as to how they should classify non-representing Category 2/3 counterparties.

In line with the wider industry, State Street recommends that the Category 2/3 assessment period for financial counterparties (“FCs”) should only be expected to apply from the date that the RTS enters into force and that the three month assessment period should run from that date at the earliest. We would further advise that an additional period at the end of any such assessment be given to allow FCs time to use industry tools available at that time to communicate their status to relevant counterparties. This would have the effect that Period B for FCs not in Category 1 would commence after the expiry of (1) the three month assessment period, which should run from the date that the RTS enters into force, and (2) such additional period of time following the end of the assessment period.

This would allow FCs to have sufficient time to address the practical challenges of applying the assessment and also for a systems-based tool to be developed in good time, based on the final RTS, so as to be available for use by and well publicised to market participants.

We would further welcome confirmation that intragroup transactions (including those which involve a non-EU counterparty) will not be subject to frontloading, or, in any event, clarification as to the interaction of frontloading provisions with the intra-group transaction exemption.

<ESMA\_CO3\_QUESTION\_6>

##### Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

<ESMA\_CO3\_QUESTION\_7>

No. Please see our response to question 6 above. We believe that the Category 2/3 assessment period for FCs should only be expected to apply from the date that the RTS enters into force and that the three month assessment period should run from that date at the earliest.

We further recommend an additional period at the end of any such assessment be given to allow FCs time to use industry tools available at that time to communicate their status to relevant counterparties. This would have the effect that Period B for FCs not in Category 1 would commence after the expiry of (1) the three month assessment period, which should run from the date that the RTS enters into force, and (2) such additional period of time following the end of the assessment period.

Finally, we hope that the envisaged phase-in schedule will give ESMA and other (global) regulators sufficient time to coordinate the timing of clearing requirements and mandatory trading requirements such that they can be aligned as closely as possible. While the proposal at issue here concerns only the clearing of these 11 instruments, and would only apply within the EU’s jurisdiction, the practical impact of a recommendation by ESMA in favour of a clearing mandate as applied to FX NDFs may be to set in motion the clearing and mandatory trading of NDFs in other jurisdictions. It is important that in adopting a mandate, ESMA and other regulators carefully manage and coordinate the knock-on regulatory effects and the timing of both clearing and trading requirements, both in the EU and elsewhere, so as not to create unnecessary risks.

<ESMA\_CO3\_QUESTION\_7>

## Remaining maturity and frontloading

##### Do you have comments on the minimum remaining maturities for NDF?

<ESMA\_CO3\_QUESTION\_8>

In line with the broader industry, State Street is of the view that given the concentration of open interest in FX NDFs in very short-dated tenors and the relatively limited size of this market, there would be limited value in applying a “frontloading” requirement to FX NDF contracts. Any clearing obligation for these contracts should only apply to FX NDF contracts entered into or novated on the date of the clearing obligation takes effect.

Should the decision be made to introduce a frontloading requirement, we would not recommend lowering the minimum remaining maturities (“MRM”) for NDFs to three months, to take into account the fact that the maximum maturity of the NDF classes is lower than the maximum maturity in the IRS class. The MRM should be set at a level aimed at reducing systemic risk. ESMA itself admitted in its 2013 discussion paper on the clearing obligation that if the remaining maturity is very short, contracts may become subject to the clearing obligation only a few days or weeks before the termination dates. According to paragraph 133 of the discussion paper, this may be overly burdensome in view of the overarching aim of the clearing obligation, which is the reduction of systemic risk, given that such risk could in this case only materialise during a very limited period of time. In both the interest rate and credit derivatives consultations, ESMA determined that risk associated with contracts became substantial if the trade matured in over six months. There is no reason why that same analysis shouldn’t hold for FX NDFs. By reducing the MRM for FX NDFs, ESMA will create an artificial asymmetric treatment of the risk associated with different asset classes. Lowering the MRM to capture a greater share of products (because the bulk of NDFs are traded in the short end) is inconsistent with ESMA’s earlier analysis.

<ESMA\_CO3\_QUESTION\_8>

# Annex II - Draft Regulatory Technical Standards on the Clearing Obligation

##### Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA\_CO3\_QUESTION\_9>

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<ESMA\_CO3\_QUESTION\_9>

# Annex III – Impact assessment

##### Please indicate your comments on the Impact Assessment.

<ESMA\_CO3\_QUESTION\_10>

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<ESMA\_CO3\_QUESTION\_10>