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| 11 July 2014|2014/800 Reply Form |

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| Reply form to the Consultation Paper on the Clearing Obligation under EMIR (no. 2) |
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| Date: 11 July 2014  2014/800 Reply Form |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the questions listed in the Consultation Paper on the Clearing Obligation under EMIR (n0. 2), published on ESMA’s website.

Comments are most helpful if they:

* respond to the question stated;
* contain a clear rationale; and
* describe any alternatives 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.

ESMA will consider all comments received by **18 September 2014.**

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

How to use this form to reply

Please note that, in order to facilitate the analysis of the responses, ESMA will be using an IT tool that does not allow processing of responses which do not follow the formatting indications described below.

Therefore, in responding you are kindly invited to proceed as follows:

* use this form to reply and send your response in Word format;
* type your response in the frame “TYPE YOUR TEXT HERE” and do not remove the tags of type <ESMA\_QUESTION\_1> Your response should be framed by the 2 tags corresponding to the question; and
* if you have no response to a question, do not delete the tags and leave the text “TYPE YOUR TEXT HERE” between the tags.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. 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 not to disclose the response 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 ‘Legal Notice’.

Who should read this paper

All interested stakeholders are invited to respond to this consultation paper. In particular, responses are sought from financial and non-financial counterparties of OTC derivatives transactions which will be subject to the clearing obligation, as well as central counterparties (CCPs).

# General information about respondent

|  |  |
| --- | --- |
| Name of respondent | EFAMA |
| Are you representing an association? |  |
| Activity |  |
| Country/Region |

# Introduction

**Please make your introductory comments below:**

<ESMA\_COMMENT\_1>

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 62 corporate members almost EUR 17 trillion in assets under management of which EUR 10.2 trillion managed by 55,000 investment funds at end March 2014. Just over 35,600 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org

Despite the short deadline, we welcome the opportunity to respond to the ESMA Consultation on the Clearing Obligation under EMIR (n°1).

Executive summary

1**. Clearing obligation procedure**. EFAMA welcomes the opportunity to comment the proposal made by ESMA for the clearing obligation procedure, and generally agrees with the proposed structure for untranched index CDS and single name CDS (“Untranched CDS”) OTC derivative classes (see however our detailed reply to Question 2 of the Consultation Paper for further details).

**2. Phase-in approach for regulated investment funds**. We agree with ESMA’s proposal and welcome the lengthy phase-in approach for category 2 counterparties (e.g. UCITS and AIFs), as this gives our members time to prepare for clearing (see our reply to Question 6 of the Consultation Paper).

**3. Front-loading requirements**. Some of our members welcome the proposal to effectively limit front-loading to contracts entered into during period B. We are concerned, however, that the practical impact of

(1) the application of front loading to contracts with a minimum remaining maturity of 6 months, on the date of application of the clearing obligation will mean that the phase-in will be of little practical use to a large number of category 2 counterparties and

(2) the application of front loading to transactions that were still open at the type of the publication but closed by the date of application.

We therefore recommend alternative approaches to ESMA (see our reply to Question 7 of the Consultation Paper).

<ESMA\_COMMENT\_1>

# The clearing obligation procedure

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

<ESMA\_QUESTION\_1>

We have no particular comments on the clearing obligation procedures described in Section 1 of the Consultation Paper.

As expressed in our reply to the Consultation paper Clearing Obligation n° 1 on IRS, we are supportive of ESMA’s approach consisting in grouping the analysis of the notified classes of OTC derivatives in a minimal set of consultation papers, grouped by asset classes

<ESMA\_QUESTION\_1>

# Structure of the credit derivatives classes

Question 2: Do you consider that the proposed structure for the untranched index CDS classes enables counterparties to identify which contracts are subject to the clearing obligation as well as allows international convergence? Please explain.

<ESMA\_QUESTION\_2>

We agree with the structure for the Untranched CDS as proposed by ESMA and enabling counterparties (UCITS/AIFs) to identify the classes which are subject to the clearing obligation.

However, we ask ESMA to take into account two constraints of UCITS funds that enter into credit derivatives transactions:

Fall back settlement method.

The credit derivatives transaction’s confirmation includes provisions detailing the procedure applicable when a counterparty is defaulting. In this procedure, if a transactions is in default and if it cannot be settled in cash, the fall back settlement method of most credit derivatives is the physical settlement method which may lead to the consequence that loans are the deliverable obligations.

In such situations UCITS could be subject to a contractual obligation either to accept or deliver loans.

However, UCITS are generally not allowed to acquire loans (as loans are not an eligible assets as per article 8.2 of Directive 2017-16 in application article 50 of Directive 2009-65).

Consequently and to circumvent this issue, ISDA has developed so-called “Additional Provisions for Credit Derivatives” and prior their first transaction, UCITS must enter into a bilateral arrangement with their counterparties and execute these Provisions. This ensures that, in case of default of the counterparty of the fund, cash settlement prevails on a physical settlement.

Close out clause.

Additionally, for UCITS funds, they have further difficulties complying with the clearing obligations due to their obligation to be able to close any transaction at any time. UCITS are then bound to negotiate addition “close out” provision that must be negotiated with each counterparty. However, this is not an option foreseen at CCP’s level. In order to comply with this provision, UCITS would have to open transactions only with the clearing member that provide them access to CCPs, which is again the diversifications rules.

Consequently, we believe that UCITS would break either UCITS rules or EMIR rules, should the settlement method and close out clause are not duly taken into consideration.

Therefore, we urge ESMA to recognise this situation and to ensure that the clearing obligation only takes place to Untranched CDS if at minimum two CCP (to ensure diversification) that are able to offer clearing of this product that includes those dedicated provisions (please see our detailed answer to question 3).

We would of course be glad to explore possible solutions with ESMA.

On a separate note, we also believe that ESMA should take into account the current market structure for Untranched CDS that use confirmation platforms. This would guarantee that the introduction of a new contract within a class will be considered by all relevant market participants (UICTS/AIFs) in the same way, avoiding any misinterpretation and mishandling of those contracts or conflicts of treatment with pre-existing contracts.

<ESMA\_QUESTION\_2>

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

Question 3: In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to credit OTC derivatives?

Given the systemic risk associated to single name CDS, would you argue that they should be a priority for the first determination as well? Please include relevant data or information where applicable.

<ESMA\_QUESTION\_3>

We agree with the proposed criteria described in section 3 of the Consultation Paper

However, we also have some elements of concern.

We believe that only two classes of Untranched Index CDS should be subject to this clearing obligation RTS:

* iTraxx Europe Main and
* iTraxx Europe Crossover.

Other type might be too specific to be considered eligible for mandatory clearing.

Indeed, we see obstacles to clearing those other types of Untranched Index CDS instruments due to their lower liquidity and their reduced availability of clearing in different CCPs (which is reducing portability capabilities).

We also believe that starting from series 11 to impose mandatory clearing is not appropriate. The fact that there are only two CCPs at this time that are ready to clear these CDS does not appear to be a sufficient element to limit clearing to the sole series 11. Based on the figures presented by ESMA, we believe that at least the last series should also be included (see in table 6 on iTraxx Europe Main, the series 17 to 21 and see table 7 for iTraxx Europe Crossover).

We would also like to insist on the fact that UCITS using a CDS contract are not allowed to receive a loan as payment in a case of a credit event for which no Additional Provision had been executed, which will be causing legal issues (see also our reply to question 2).

We then urge ESMA to ensure that firstly, the scope of tranches submitted to clearing obligation is clarified and that the CCPs are that clears CDS contracts must develop an offer including the required special settlement terms which respects the UCITS constraints or that UCITS funds are relieved of their obligation to clear Untranched CDS (without any impact to their risk profiles nor to the one of their counterparties).

<ESMA\_QUESTION\_3>

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

## Analysis of the criteria relevant for the determination of the dates

Question 4: Do you have any comment on the analysis presented in Section 4.1?

<ESMA\_QUESTION\_4>

We generally agree with the analysis presented in Section 4.1.

However, based on our experience, the client clearing offerings provided by the CCPs and clearing members are not sufficiently broad compared to IRS (see our reply to the ESMA Consultation Paper on the Clearing Obligation under EMIR (n° 1) on IRS) to support the introduction of the clearing obligation for Untranched CDS.

There are several reasons for the more limited offering to UCITS and AIFs for Untranched CDS:

* Those instruments are slightly less standardized than IRS, also from a documentation perspective where “partial cash settlement” clause are specific to each counterparty;
* The offerings are consequently based on less standardized conditions at CCPs and then at Clearing Members’s level;
* Those offerings must then be transformed into bespoke contracts setting up the legal and operational arrangements with the clearing members
* The public pricing model mentioned by ESMA does not provide a real access to pricing information. It mostly insist on the existence of a standard approach for pricing. The question of availability of prices would then become a real concern for smaller participants.

For the above mentioned reasons, this process is often longer as all the contracts have to reviewed and approved.

Therefore, we are raising ESMA attention on possible delays in implementing clearing for Untranched CDS which could also be detrimental to the execution of credit derivatives transactions on CCPs.

Additionally, we would like to insist on the fact that we believe that there should always be two CCPs offering full segregation services before imposing a clearing obligation, especially for UCITS and UCITS-like funds. Otherwise, it would be impossible to port a transaction as long as there is no competition for the central clearing of that instrument.

<ESMA\_QUESTION\_4>

## Determination of the categories of counterparties (Criteria (d) to (f))

Question 5: Do you agree with the proposal to keep the same definition of the categories of counterparties for the credit and the interest rate asset classes? Please explain why and possible alternatives.

<ESMA\_QUESTION\_5>

We agree with the proposed approach.

<ESMA\_QUESTION\_5>

## Determination of the dates from which the clearing obligation takes effect

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\_QUESTION\_6>

We agree with ESMA’s proposal and would welcome a phase-in period that would run at least for 18 months and could even be extended to 24 months for category 2 counterparties (e.g. UCITS and AIFs).

Indeed, we see some differences between the regime of CDS and IRS (see also our reply to Question 4):

* There is a lower number of offering compared to offering to clear IRS;
* There is a lack of clarity in some definitions (e.g. for the definition of the different asset segregation’s regimes) that requires from the CCPs and Clearing Member more analysis and that both delays the communication of their offering and leads to differences in offerings.

Consequently, we believe that 6 additional months compared to the IRS regime could be appropriate.

<ESMA\_QUESTION\_6>

# Remaining maturity and frontloading

Question 7: Do you consider that the proposed approach on frontloading ensures that the uncertainty related to this requirement is sufficiently mitigated, while allowing a meaningful set of contracts to be captured? Please explain why and possible alternatives compatible with EMIR.

<ESMA\_QUESTION\_7>

We agree with ESMA’s proposal that only contracts entered into during Period B (after the RTS publication) should be subject to frontloading but under some conditions as long as some elements are clarified.

Transactions submitted to clearing obligation.

We suggest ESMA to consider that contracts concluded before or on the publication in the Official Journal and terminated before the date on which the clearing obligation takes effect (the date of application) do not need to be frontloaded in a CCP as they no longer create any counterparty or systemic risk.

Novations.

Article 4 (1) of the proposed RTS includes in the scope of clearing obligation ‘OTC derivative contracts entered into or novated on or after the date of the RTS publication’. We believe that this would rather create legal uncertainty and be detrimental to the economic of OTC derivatives transactions already negotiated.

Consequently, we would like EMA to take into consideration a modification to the recital 11 that would refer to BCBS/IOSCO definition of “genuine amendments” in order to clarify the interpretation of a novation (See, BCBS /IOSCO final report on Margin requirement for non- centrally cleared OTC derivatives, September 2013, page 24 and specially foot note 20 that reads: “Genuine amendments to existing derivatives contracts do not qualify as a new derivatives contract. Any amendment that is intended to extend an existing derivatives contract for the purpose of avoiding margin requirements will be considered a new derivatives contract”. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf).

Minimum remaining time to maturity.

We see difficulties in the application of minimum remaining time to maturity.

We are concerned that the practical impact of the application of the front-loading requirements to contracts with a minimum remaining maturity of 6 months, on the date of application of the clearing obligation will mean that the phase-in will be of little use.

Some of our members’ clients execute long-dated OTC contracts (longer than 6 months), often to hedge long-dated liabilities. A minimum remaining maturity of 6 months will mean that the vast majority of OTC contracts subject to mandatory clearing which are executed during the phase-in period will become subject to front-loading requirements. In addition to the often mentioned pricing impact of front-loading, such a large front loading requirement would have a substantial operational impact on clients, clearing members and CCPs, and would require significant time and resources to be effectively implemented.

In order to complete the front loading process by the end of the phase-in period, the process would have to be initiated well in advance of the deadline. The structures for client clearing (including operational procedures and legal documentation) would have to be in place before starting the front loading process. In practical terms, this would significantly reduce the phase-in period for many category 2 counterparties.

Furthermore, market participants will also have to put in place an appropriate process for moving open contracts into clearing. One must remember that the experience of implementing the back-loading requirement in respect of trade reporting had a huge operational impact in terms of imposing retrospective requirements on market participants; and the front-loading of non-cleared contracts into a cleared environment is much more complex than trade reporting.

For these reasons, some EFAMA members would encourage ESMA to consider alternative approaches to the front-loading and phase-in proposals set out in the Consultation Paper.

Those members would recommend, in particular, examining the following alternative options (by order of preference):

• Option 1: remove the front-loading obligation for category 2 counterparties and, if considered necessary, reduce the phase-in period for new trades to be cleared, from 18 to 12 months. This is the preferred option and would result in new OTC contracts entering the cleared environment earlier than originally planned as well as reducing the front-loading burden on firms.

• Option 2: implement a phase-in front loading for category 2 counterparties, so that the front-loading period only starts 12 or 18 months after the start of the phase-in period for category 1 counterparties. This would give market participants sufficient time to put in place the necessary processes, procedures and documentation to ensure compliance with the clearing obligation, before having to consider also front-loading.

Starting date of entry into force.

We also suggest that the effective date for front-loading (i.e. the start of period B) should be the date of entry into force of the regulatory technical standards1, rather than the date of publication in the Official journal. Indeed, it is unlikely that the date of publication in the OJCE will be announced in advance to market participants, which means that they would not be in a position to anticipate with precision the exact start date of front-loading requirements. To the contrary, if the effective start date for front loading is the date of entry into force of the RTS, this will give market participants a 20 days advance notice.

Non-financial counterparties and front-loading

Under the current proposals, front-loading is not applicable to contracts for which at least one of the counterparties is a non-financial counterparty. However it is not clear what the process is for a counterparty that shifts from non-financial counterparty to financial counterparty during a front-loading window. For example, if an AIFM becomes authorised or registered under AIFMD, any AIFs managed by that AIFM would become financial counterparties and so be subject to front-loading. We suggest that ESMA make it clear (either through a recital in the draft regulatory technical standards or in future Q&A) that the front-loading obligation is only applicable to contracts which would, in the absence of a phase-in period, be subject to the clearing obligation at the time the contract was entered into. For example, when an AIFM becomes authorised or registered under AIFMD (and so becomes a financial counterparty), any contracts entered prior to that point would not be subject to front-loading, even if the change in counterparty status occurred in the middle of a front-loading window that would generally require financial counterparties to front-load during that entire window.

1 As stated in the Letter from ESMA to the European Commission dated of 8 May 2014: http://www.esma.europa.eu/system/files/2014-483\_letter\_to\_european\_commission\_re\_frontloading\_requirement\_under\_emir.pdf

Status change for bilateral derivatives under the two components of EMIR.

Finally, we would like to bring ESMA’ attention to the dates that are retained for the clearing obligation’s and front loading’s application in relation to the non-compensated Initial and Variation Margins requirements. We believe that ESMA pays attention to the risk of mismatch that be created by onboarding to CCPs trades that were previously been submitted to the Initial and Variation Margins requirements and that would have to be transferred into a cleared transactions model.

<ESMA\_QUESTION\_7>

# Annex I - Commission mandate to develop technical standards

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

Question 8: Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA\_QUESTION\_8>

We have no additional comments to make on the draft RTS.

<ESMA\_QUESTION\_8>

# Annex III - Impact assessment

Question 9: Please indicate your comments on the Impact Assessment.

<ESMA\_QUESTION\_9>

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<ESMA\_QUESTION\_9>