



The Secretariat,
European Securities Markets Authority,
103 rue de Grenelle,
75007 Paris,
France

Dear Sir/Madam,

Comments on ESMA's discussion paper 'Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories'

CME Group is pleased to offer stakeholder input to assist in the development of the technical standards. CME Clearing Europe (CMECE) will be directly affected by the standards as a central counterparty incorporated in the UK and regulated by the FSA. CME Clearing in the US will be affected because the technical standards will have a bearing on the assessment of the equivalence of third country CCPs. CME Group will be affected as the owner of the two clearing houses.

General comments

CME Group is aware that ESMA is carrying out its duties and has no direct control over the timetable it is obliged to follow. We nonetheless feel that it is unusual to say the least that the consultative process on technical standards should have begun when the final text of EMIR, which has a bearing on those standards, is not yet available. That situation underlines our concerns that the delays in agreeing EMIR have unreasonably squeezed the time available for proper development of technical standards and consultation on those standards. That need not be such a concern if the intention was to adopt the final CPSS-IOSCO principles at EU level. But the intention seems to be to try to define standards which are more detailed and as such more prescriptive than the CPSS-IOSCO principles. That more ambitious goal makes the consultative process more critical, not least so that respondents can provide ESMA with the information on costs and benefits necessary for it to meet its obligations to provide a proper cost-benefit assessment. We note that the discussion paper invites comment on costs and benefits at this stage. But would point out that the questions asked are typically at a high level of generality and that a proper assessment can realistically only be carried out when the range of options has been refined. Our comments in this regard apply equally to the related discussion paper and consultative process launched by the EBA.

As a member of EACH, CMECE has contributed to input from that association. We fully share EACH's concerns about a significant departure from the international standards embodied in the CPSS-IOSCO principles, and an approach that in some but not all cases moves away from a detailed principles-based framework within which CCPs' policies and practices should operate. In the more specific comments that follow we illustrate areas where we have particular concerns when a over-prescriptive approach is taken.

We also share EACH's concerns about several references to disclosure of information by CCPs. In this area, the technical standards should confine themselves to guidelines, leaving CCPs, because of confidentiality issues, to decide upon the level of disclosure. We would point out that there is a market mechanism that can be expected to act effectively to establish the required level of disclosure : CCPs that do not offer the degree of disclosure required by clients will not receive the degree of support received by others that offer that level of information,.

ESMA's discussion paper contains a large number of questions and questions within questions, and we confine our input to selected areas discussed.

Specific comments

Question 3: In your view, what should be the characteristics of these indirect contractual arrangements?"

We support the extension to provide for circumstances in which end-client (counterparty in the discussion paper usage) transactions may be cleared through the end-client having contractual relations with another party that is not itself a clearing member of a CCP. We believe that the 'other parties' most likely to be active in indirect clearing arrangements are financial intermediaries, credit institutions or investment firms. We do not believe, however, that financial intermediaries so defined should be the only 'other parties' permitted to participate as the second leg of indirect clearing arrangements. Non-financial companies or fund managers might legitimately act in that capacity. We do not understand why it is thought necessary to specify the 'types of indirect contractual arrangements', which implies a significant amount of detail about the legal capacity in which the parties are acting and so on, rather than a clear explanation of the parties who may legitimately be involved, as we have tried to offer above.

Question 4. What are your views on the required information? Do you have specific recommendations of specific information useful for any of the criteria? Would you recommend considering other information?

The list seems very comprehensive as a check list of what information it would be preferable to have, but realistically, as ESMA notes in the discussion paper, not all the information is going to be available. This raises a recurrent theme, which is that ESMA seems to favour the approach of listing all items that may be relevant – information that may be available in the case of Question 4 – rather than adopting a more schematic approach and identifying types of relevant items or information, without trying to be comprehensive and running the risk of omission or over-specification.

Question 6: What are your views on the review process following a negative assessment?

It is clear to us that events may move on and that a negative assessment by ESMA should be re-considered in light of changed circumstances. We have one observation to make : we believe that negative assessments and the grounds for such assessments should be made public by ESMA, on grounds of transparency. We are not sure that that is the current intention.

Question 9: Do you consider that the data above sufficiently identify a class of derivatives subject to the clearing obligation and the CCPs authorised or recognised to clear the classes of derivatives subject to the clearing obligation?

The question asks about the information to identify CCPs. We believe that another salient piece of information should also be included. As EMIR introduces regulatory college oversight of all CCPs in the EU, we believe that members of the relevant college for the CCP or CCPs in question should be listed, to show the level of regulatory involvement and for the sake of transparency.

Question 24: What are your views on the possible requirements that CCP governance arrangements should specify? In particular, what is your view on the need to clearly name a chief risk officer, a chief technology officer and a chief compliance officer?

EMIR contains prescriptive requirements in terms of CCPs' board and risk committee composition, although views on risk committees seemed in a state of flux before political agreement was announced and the final text has not yet been released. Given that level of prescription on matters of board and committee governance in the framework legislation, we believe that the preliminary thinking of ESMA in relation to governance with a slightly broader definition is more than adequate.

Question 25: Are potential conflicts of interests inherent to the organisation of CCPs appropriately addressed?

In general terms, we feel that such potential conflicts have been given too much emphasis and have become distorted and political rather than objective as a consequence. Given that emphasis, we are at a loss to understand why an audit committee, which is a key part of risk control and 'potential conflict avoidance', is not specified as a requirement for CCPs in the framework legislation and why ESMA's guidance maintains that silence. In cases where a CCP is embedded in a group structure, a group audit committee might achieve the required objective, but the lack of reference to an audit committee is an omission that we believe should be rectified by ESMA in its proposals on governance standards.

Question 26: Do the reporting lines – as required – appropriately complement the organisation of the CCP so as to promote its sound and prudent management?

The suggestions seem broadly appropriate. We do not, however, understand the distinction made, if it is intentional, between a 'direct reporting line' of the risk management function to the board, and 'direct access' to the board for the internal audit function. Our view is that in both cases direct access as necessary is appropriate. But both functions, whilst needing authority and independence, and access to the board, also need to be rooted in the overall operations of the CCP and its executive management. In relation to the internal audit function, we believe that, whilst the board should of course be informed of internal audit matters, the direct access of internal audit should be to the audit committee of the board, which should comprise the independent non-executive directors. Our reply to Question 25 explains our views on the neglect of the role of the audit committee in both EMIR and ESMA's discussion paper. We agree that "the risk management function of CCPs should have access to all relevant information [to enable it to undertake its role]" and we presume that the reference is to information available to the CCP rather than more generally. But we are at a loss to understand any circumstances in which risk managers would be denied such information in a CCP.

Question 27: Do the criteria to be applied in the CCP remuneration policy promote sound and prudent risk management? Which additional criteria should be applied, in particular for risk managers, senior management and board members?

We are concerned that issues raised about potentially perverse incentives created by very large variable pay awards elsewhere in the financial sector should be reflected in proposals for CCPs, where the scale of any variable pay awards is rather lower and where the risk management record has been exemplary (which is of course the reason why legislators have proposed the extension of central clearing of OTC derivatives). We believe that any remuneration guidelines should be drawn more broadly in terms of the overall goal of a CCP – to promote the soundness and effectiveness of *all the operations of a CCP*. Instead, a particular implicit definition of risk management and idea of who those risk managers are has been singled out by ESMA – risk management, compliance and internal audit. If that is the particular area of concern, ‘risk management’ should be carefully defined. What about the treasury function run by some clearing houses? Surely that should be in any such list and is arguably an increasingly key area from a risk management perspective? What about legal and finance and accounting support, which are key areas of risk management controls? An alternative would be to define what is meant by those who work in ‘the business areas’ of a CCP, leaving the various ‘risk managers’ to be defined by residual.

The reference to compensation of ‘risk management staff’ being ‘independent of business performance’ seems to relate to a variable pay or bonus element. Unless the thinking is that those staff should never receive a variable pay element – which by the way we would not consider appropriate – we believe that their variable pay must be linked to the company’s ability to fund that variable pay, which is necessarily a function of ‘business performance’. We believe that ESMA is attempting to be too detailed in its level of prescription, as illustrated by the comments above, and that a simpler formulation in relation to a properly defined set of ‘risk managers’ and so on, would be :

- Their core remuneration should be as suggested by ESMA (“...should be adequate in terms of responsibility as well as in comparison to the level of remuneration in the business areas”)
- Their variable pay should relate to their performance of their responsibilities in managing risk and overseeing and checking the observance of policies and practices to manage various business risks, and to the ability of the CCP to fund discretionary variable pay awards for all its employees.

Our suggestion above is an illustration of the alternative ‘schematic’ approach that we suggest in our response to Question 4 as an alternative to a check-list approach.

Question 29: Should a principle of full disclosure to the public of all information necessary to be able to understand whether and how the CCP meets its legal obligations be included in the RTS? If yes, which should be the exceptions of such disclosure requirements? Has the information CCP should disclose to clearing members been appropriately identified? Should clients, when known by the CCP, receive the same level of information?

Insofar as the question about full disclosure relates to paragraph (f) of the ESMA document, we regard the list as a very standard one. It is so standard though that we do not see why it should form part of the proposed technical standards. We believe that there is a danger that the technical standards will become unnecessarily extensive. Because of their descriptive nature they are also open to varying interpretations. For example, it is debateable whether it is a legal requirement for a CCP to publish a list of its clearing members, although it is hard to think that a CCP would not automatically do so. Insofar as the information made available by a CCP does not enable a clearing member or potential clearing member or a client of a clearing member fully to evaluate the risk of clearing directly or indirectly through the CCP in question, they will request additional information from the CCP, and the CCP will

have the incentive to make that information more widely available in order to avoid the need for a number of individual requests for the same information.

Q30: What are your views on the possible records CCPs might be required to maintain?

None of the business record types seems contentious in terms of CCP retention, although not necessarily for as long a period as ten years. Our comments are similar to those made earlier. The approach seems to be to want to produce an exhaustive list instead of a more schematic one, arranged by types of records and generic descriptions. For example, instead of referring only to minutes of board and risk committee meetings, to the exclusion of audit committee meetings for example, we would recommend that there is a grouping entitled governance records, and a generic description 'minutes of board and committee meetings, and records of meetings of consultative and advisory groups'. Another obvious grouping is legal agreements and legal opinions.

We have some more specific comments. 80 (b) refers to a register of shareholders. We do not see why the technical standards, which are 'financial regulatory' standards, should duplicate company law requirements. 'Non-pre-funded resources' are by their nature not 'called' and therefore differ from margin, which is the variable quantity that should be the focus of the fourth bullet of 79 (b). Default fund contributions are 'called' but typically do not relate to clearing member accounts in the same way as margin, nor vary as frequently.

Question 31: What are your views on the modality for maintaining and making available the above records? How does the modality of maintaining and making available the records impact the costs of record keeping?

EMIR increases current standard record retention times quite considerably, presumably on the assumption that there may be more need than previously to review historic records for whatever reason. We question that assumption. Off-line maintenance of a much increased volume of data should be the standard, although we do not see why such a level of prescription is necessary. Such maintenance is less costly but does not imply any inadequacy in data retention and retrieval.

Question 34: Are the criteria outlined above appropriate to ensure that the adequate percentage above 99 per cent is applied in CCP's margin models? Should a criteria based approach be complemented by an approach based on fixed percentages? If so, which percentages should be mandated and for which instruments?

We believe that 99% is adequate for certain products but not for others. Our assessment derives from the risk characteristics of different products. Insofar as a criteria-based approach included in technical standards from ESMA does *not* inappropriately force products with dissimilar risk profiles into a one-size-fits-all approach, and as such replicates best CCP practice, we support that approach.

We would also underline the significance of liquidity as one of the most, if not the most, salient risk characteristics involved in risk assessment of margins by CCPs. The danger of inappropriately increasing initial margins for all cleared products is that liquidity will be damaged, and so, paradoxically and we assume unintentionally, increasing the extent of risk and uncertainty.

Our reply in relation to a criteria-based approach applies also in relation to other questions where ESMA advocates a criteria-based approach. We do not, however, support an over-prescriptive approach, as suggested in Question 36 and the advocacy of a table setting out assumed maximum liquidation periods.

Question 38: (Default Fund) What is your view of the elements to be included in the framework for the definition of extreme but plausible market conditions?

We would question again the approach of trying to offer an exhaustive list – that contains factors whose meaning is open to various interpretations or whose meaning is unclear.

Question 42: What is your preferred option for the determination of the quantum of dedicated own resources of CCPs in the default waterfall? What is the appropriate percentage for the chosen option? Should in option (a), the margins or the default fund have a different weight, if so how? Should different criteria or a combination of the above criteria be considered?

As our practice for CMECE and CME Clearing attests, we agree with CCPs committing their own resources or group resources to the default waterfall. We do not, however, support the level of prescription implied by ESMA's interpretation of its mandate. The important feature is that a CCP should have significant 'skin in the game' before any call on the mutualised default fund contributions of non-defaulting clearing members, and that the size and certainty of that 'skin in the game' should be transparent to all directly interested parties.

Asked to offer a view on options which we believe are both unnecessary, and variants within one of the options, we regard all of them as having significant drawbacks. This is an area in which considerable time is needed to ensure that any technical standard is fully considered and evaluated. We believe that that conclusion is supported by the fact that default funds relating to OTC financial derivatives are mainly undeveloped in respect of client-related clearing. To opt for a percentage basis for 'skin in the game' at this stage would clearly be premature.

Question 43: What should be the appropriate frequency of calculation and adaptation of the skin in the game?

In the context of our response to Question 43, we believe that the size of the CCP's commitment to default resources should be re-examined when there is a significant increase in the size of the total resources, as informed by stress tests, in consultation with a CCP's risk committee and with broader clearing member input.

Question 47: Do you consider that the elements outlined above would rightly outline the framework for determining haircuts? Should ESMA consider other elements?

We consider the elements outlined to be reasonable ones that should be included in a CCP's haircutting policy. We are pleased that ESMA does not seem to be contemplating a centrally imposed list of haircuts. The approach adopted here in offering a framework within which CCPs risk policy and practice should operate is in our view the correct, principles-style approach that should apply across the technical standards. This approach can be contrasted with that proposed in respect of a CCP's 'skin in the game'.

Question 48 : Diversification of collateral (we have given a new description to this question as Question 47 was repeated in the discussion paper)

We believe that ESMA's thinking mirrors the considerations that clearing house risk managers, with their risk committees, must take into consideration in setting and re-evaluating their collateral policies. The proposals are also we believe reasonable in relation to commercial bank guarantees. Whilst we understand the particular nature of the sovereign debt markets currently, we do, however, feel that aspects of ESMA's thinking are driven by that particular circumstance and that there are still legitimate distinctions to be drawn between the quality of debt issued by different governments.

Question 57: What are your views on the definitions of back and stress testing?

We have no problem with the definitions. We would emphasize that products have different liquidity profiles and degrees of risk complexity that should be reflected in their overall risk management by CCPs, embracing both margining and stress testing.

Question 59 : What are your views on the possible back testing requirements ?

We would favour a more general description of the back testing that should be undertaken, concentrating on the importance of varied back-testing of portfolios to examine the continued validity of current model parameters.

Question 60 : Would it be appropriate to mandate the disclosure of back-testing results and analysis to clients if they request such information ?

We believe that release of back-testing results would be of limited use. CCP transparency should take the form of : transparency of target levels of coverage and time periods ; and a summary of the results of back-testing, with a description of the portfolios used, and the relevant time periods.

Question 61: Should the time horizons for back tests specified under 144(e) be more granular? If so, what should the minimum time horizon be? Should this be different for different classes of financial instruments?

We believe that there are clear difficulties if a more granular and prescriptive approach is taken. For example, different time periods might be valid for instruments within the same asset class as new products are developed with shorter price histories.

Question 62: What are your views on the possible stress testing requirements?

The list of factors that should be taken into account is a reasonable one. Our concern is that the underlying principle that the stress tests should be *plausible* might be lost if the list turns into prescription.

Question 63: Would it be appropriate to mandate the disclosure of stress testing results and analysis to clients if they request to see such information?

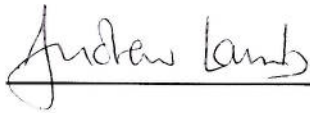
We believe that transparency of the stress-testing method, of the linkage of stress-testing results to determination of the size of the default resources, and of the related governance oversight through the

risk committee and board is fully adequate. We note, however, that EMIR seems to insist that risk committees become less representative of the clearing membership and that a previous channel of transparency in relation to the contributors of mutualised backing to default funds might have been damaged because of that.

Question 65: Should there be any other parties involved in the definition and review of tests? Please justify your answer and explain the extent to which suggested parties should be involved?

We believe that risk committees should have the discretion to invite others to assist in the assessment of tests.

We are at the disposal of ESMA if it should wish to pursue any of our comments in more detail.

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Andrew Lamb
CEO
CME Clearing Europe

A stylized handwritten signature in dark ink, appearing to read 'Kim Taylor', is written over a horizontal line.

Kim Taylor
President
CME Clearing