

Rolls-Royce

Comments in response to

ESMA Discussion paper: Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

Issued by ESMA 16th February 2012 (ESMA/2012/95)

Rolls-Royceⁱ welcomes ESMA's consultation on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories.

Since 2009 Rolls-Royce has been actively involved in advocacy on the unintended consequences for the real economy and companies like Rolls-Royce of the EU's financial regulatory reform, and specifically non-financial end-users' use of OTC derivatives for risk management purposes. Together with The European Association of Corporate Treasurers (EACT) and other European non-financial companies we have formed a cross-industry coalition in 2010 to ensure that non-financial companies' interests are represented and heard and in the context of EMIR that the OTC derivatives market is preserved since these tools are integral to our risk management needs.

Constructive and timely engagement with European regulators has helped shape the principle contained in EMIR. We are relying on ESMA to turn this principle into practice to enable European non-financial end-users' to continue to use OTC derivatives for essential risk management practices.

We would also like to highlight that other regulatory proposals such as CRD IV & MiFID II remain a serious concern for non-financial end users of OTC derivatives. Both of these proposals risk undermining the uncollateralised OTC derivatives market that non-financials rely on to hedge their commercial risks, either through punitive credit charges for non-collateralised transactions or through changes in the structure of the markets, such as the ability to force any class of derivative instrument to be traded solely on an exchange or other regulated trading venue (where posting of cash collateral would be mandatory). These further regulatory developments could effectively mean that money we should be spending in our primary business for product development, research and development and job creation, i.e. investments in growth and continued competitiveness, could instead be either spent on punitive credit charges or tied up in clearing houses as collateral.

Regulators should consider the cumulative impact of all of the forthcoming regulation in terms of the additional costs and administrative burden on non-financials who use OTC derivatives for risk management purposes, and the likely detrimental impact on the real economy if non-financials cash and management resources become tied up in the collateralisation of derivatives and associated regulatory processes.

We hope this is helpful context for our more detailed response to your consultation.

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Response to consultation document

We are limiting our response to questions 10, 11, 12, 16, 17, 21 and 22

Our responses are based on the ESMA discussion paper read in conjunction with a draft of EMIR as amended by the European Parliament which we believe to be dated 16th February 2012. Please note that it would be helpful for future consultations if there was a link to the latest version of the relevant Directive or Regulation to ensure that responses are not based on an out-of-date text.

Text taken from the ESMA discussion paper is presented in the appendix in black font and is shown as a reference to ease explanation of the Rolls-Royce responses. Rolls-Royce responses are in blue font, with any suggested amendment to wording highlighted in purple.

Further Information

Rolls-Royce are available for further comment should you wish to discuss any of the issues raised in the discussion paper in more detail. Please contact: James Harvey (Assistant Treasurer) james.harvey@rolls-royce.com or Charlotte Andsager (Vice President - EU Affairs) charlotte.andsager@rolls-royce.com

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Non-financial counterparties (Article 5/7)

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

For convenience we refer to a derivative contract that is “objectively measurable as reducing risk directly related to commercial activity or treasury financing” as “a hedge”, “hedges” or “hedging”.

The definitions in Paragraphs 27 to 31 are a useful starting point and look like they have been drafted with the intention of defining a broad range of hedging activity that would be deemed to be objectively measurable as reducing risk for non-financials. However for the avoidance of doubt the definition would benefit from some further clarification in a number of areas.

Clarification that hedge accounting is not required for a derivative to be “objectively measurable as reducing risks”

Our interpretation of the text is that a derivative contract can be classified as a hedge if it meets the definition of paragraph 29 or paragraph 30, i.e. that it **is not** a mandatory and cumulative requirement that the non-financial has achieved hedge accounting for the derivative to be classified as a hedge.

It is therefore not immediately clear why paragraph 29 starts with the statement “By reference to European accounting rules...” Our understanding is that paragraph 29 is intended as a wider definition of a hedge to cover non-financials who do not hedge account for their derivatives, but who are still using the derivative to hedge against risk. Assuming that our understanding is correct, the statement would be clearer if the first 6 words “By reference to European accounting rules” were deleted.

We accept that the hedge accounting test is a simple way to determine whether a derivative contract is deemed to be a hedge, but it is not acceptable as the only test as not all non-financials hedge account for their derivatives. There must be an alternative definition that is not solely driven by whether the derivative qualifies for hedge accounting.

Interpretation of Commercial Activity, Treasury Financing Activity and Ordinary Course of Business

The interpretation of the words “commercial activity”, “treasury financing activity” and “Ordinary Course of Business” are critical to the interpretation of Paragraph 29. The interpretation of these words should be wide enough to cover any hedging activity that a non-financial undertakes in its business.

It is difficult to come up with an exhaustive list of potential underlying business risks that non-financials want to hedge against and financial markets will evolve as new products are developed to meet future needs. The following is a non-exhaustive list of underlying business risks (actual or forecast) that Rolls-Royce either currently hedges, or has considered hedging:

- Hedging foreign exchange risk on contracted or forecast cash flows
- Hedging the potential change in the value of contracted or forecast cash flows due to an underlying other than foreign exchange rates (e.g. interest rates, inflation, credit etc)
- Hedging the potential change in the value of financial liabilities (debt) resulting from changes in interest rates, inflation rates or foreign exchange rates or similar.

- Hedging commodity price exposures
- Hedging energy price risk
- Pre-hedging of expected exposures, for example bond issuance, mergers, acquisitions, disposals etc
- Hedging credit risk, for example the purchase a credit default swap (CDS), or other similar instrument.
- Hedging of employee share scheme liabilities
- Hedging of balance sheet risk (Translational Hedging)
- Hedging of emissions trading scheme liabilities
- Changing the nature of interest on a financial liability, e.g. swapping a fixed rate bond to floating rate and vice versa. This might not been seen by some as a “hedge”, as it really a transformation of the nature of a liability. However it is a standard risk management tool used by non-financials to manage risk. For example a non-financial in a net debt position may value the certainty given by the knowledge that the interest payments on their debt will be at a fixed rate. Alternatively a non-financial with a surplus cash position may be more comfortable with floating rate interest on their debt. The decision is equivalent to an individual’s choice of whether to take a fixed rate mortgage or a tracker rate and will depend on the specific circumstances and risk management practices in each case.
- Changing the nature of interest on a financial liability, e.g. swapping a floating rate Libor liability to a different basis (e.g. 6m Libor to 3m Libor, or 3m Libor to SONIA).
- Hedging of interest rate risk through caps, floors, collars, swaptions and similar instruments.
- Hedging of inflation risk through options, caps, floors etc
- Hedging of pensions scheme liabilities with derivatives such as interest rate swaps, inflations swaps, asset swaps, total return swaps, longevity swaps etc
- Using derivatives to transform the nature of an investment or hedge the return on an investment, for example purchasing a corporate bond or government gilt which is then asset swapped to create a Libor based return.
- Proxy hedging where the non-financial entity cannot hedge the exact underlying exposure

Other non-financials are likely to have a different set of risks that they wish to hedge via derivatives (for example, weather derivatives, property derivatives etc). It would therefore seem to make sense to have a “catch all” provision that would allow a non-financial to hedge against any other underlying that could impact the financial performance of the business but which is not covered by the current definition.

Definition of “objectively measurable as reducing risks”

In order to provide further clarification as to what can be considered a hedge for a non-financial entity, and to future proof the definition and allow flexibility we would suggest amendments to the wording of Paragraph 29 as shown below.

~~By reference to European accounting rules,~~ ESMA considers that an OTC derivative entered into by a non-financial counterparty is deemed to be objectively measurable as reducing risks ~~directly related to arising from~~ the commercial activity or treasury financing activity of that non-financial counterparty or of that group, when, whether individually or in combination with other derivative contracts, its objective is to reduce the following risks:

- a. The potential change in the value of assets, service, inputs, products, commodities, liabilities, ~~or cash flows~~ that the non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells, ~~receives, pays~~ or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling, ~~receiving, paying~~ or incurring ~~in the ordinary course of its business;~~ or
- b. The potential change in the value of assets, service, inputs, products, commodities, liabilities ~~or cash flows~~ referred to in letter a, resulting from fluctuation of interest rates, inflation rates, ~~or~~ foreign exchange rates, ~~or commodity prices.~~
- c. ~~the potential change in the value of any other underlying to the extent that such change may affect the financial performance of the non-financial counterparty.~~

Combination of Derivative Contracts

The wording in Paragraph 29 which states that derivatives can be considered a hedge “whether individually or in combination with other derivative contracts” is critical and should be maintained as non-financials often use a combination of derivatives to hedge risk, for example:

- a) Non-financials issue a bond at a fixed rate, swap the interest rate exposure to floating rate, and at a later date want to swap back to fixed rate (e.g. as their net debt / net cash position changes)
- b) Hedging the price risk of a commodity is US\$ and then hedging the related foreign exchange risk with an FX forward.
- c) A non-financial hedges an exposure, and then needs to partially reverse the exposure with a further derivative which is the opposite way around.
- d) Where it is not possible to hedge the underlying exactly, so a proxy hedge is constructed using a number of derivatives, for example hedging the price of Jet fuel with a combination of an oil derivative and a Jet differential derivative.

Hedging of forecast exposures

Our interpretation of the wording in part a of Paragraph 29 “reasonably anticipates owning, producing ...etc ” is that it is intended to allow non-financials to hedge forecast exposures. The ability to hedge a forecast exposure is a critical requirement for non-financials.

Derivative usage for investment

In Paragraph 31 it states that “ESMA considers that an OTC derivative which is used for a purpose in the nature of speculation, investing or trading should not be an OTC derivative objectively measurable as reducing risks directly related to the commercial activity or treasury financing of a non-financial counterparty or of a group as provided above”. In our opinion paragraph 31 is not required as what constitutes a hedge is defined in paragraphs 27 to 30.

It is also not clear why a non-financial cannot use a derivative for investment purposes. As per the previous example given, a non-financial entity could legitimately use derivatives to transform the nature of an investment or hedge the return on an investment. If the paragraph is maintained in the text then the word “investing” should be deleted.

Clearing Threshold

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

In our opinion the clearing threshold should be used as a quick Pareto analysis to exempt non-financials that are unlikely to be systemically important to the financial system from mandatory centralised clearing.

We agree with ESMA’s recommendation that the clearing threshold for non-financials should be simple to implement. We therefore agree with the approach of using the notional value of OTC derivatives subject to the clearing obligation, provided that the threshold levels are set at an appropriate level. Whilst in theory it may be possible to use a more complex process such as looking at a Potential Future Exposure on each specific type derivative in order to recognise their different risk characteristics, this would seem unnecessarily complex to administer, would introduce a degree of subjectivity into the process, could lead to a breach of the clearing threshold due to market movements and is likely to be pro-cyclical.

In order to maintain a simple approach to the clearing threshold, we believe that the clearing threshold should initially be set across asset classes. At a later date ESMA could review the data on derivatives usage of non-financials held in trade repositories and evaluate whether it is sensible to adopt a clearing threshold per asset class.

All of the above is predicated on the clearing threshold being set at a reasonably high level for the following reasons:

- a) It takes into account the simplicity of the approach. The risk on a derivative used by a non-financial is based on the volatility of the underlying and the maturity of the deal. In the vast majority of cases the risk is unlikely to be as high as the notional value of the deal, for example a 5 year \$50m FX forward deals vs GBP may have a risk weighting of c40% of the notional.
- b) To ensure that SMEs and individuals are not unnecessarily drawn in to the administrative burden of being required to prove that they are hedging, or the unnecessarily complexity of

centralised clearing. SMEs and individuals are unlikely to pose a systemic risk to the financial system. A clearing threshold that is set too low risks imposing a real cost onto the economy for little or no benefit in return.

- c) To exclude other non-financial entities that do not pose a systemic risk to the financial system
- d) To ensure that dealing errors or changes within a forecast that is being hedged by a non-financial do not tip a non-financial over the threshold and into forced central clearing

In further work to determine the threshold level, we suggest that ESMA considers the notional volume of derivatives that non-financials who are not a systemic risk to the financial system typically hold. For example, if you take an imaginary company with £2bn turnover who is a large exporter of goods (assume 70% exports, receipts in foreign currency), imports 30% of their resources, with a 5 year hedging policy to hedge 100% of exposure in year 1, 80% in year 2 etc , they could easily have a large outstanding notional volume of derivatives:

Debt

£500m of debt and **£500m** of related interest rate hedging derivatives.

FX Hedging on Forecast Sales

Year	Forecast/Contracted Sales	In Foreign Currency	Hedge %	Notional Hedged
1	£2,000m	£1,400m	100%	£1,400m
2	£2,000m	£1,400m	80%	£1,120m
3	£2,000m	£1,400m	60%	£840m
4	£2,000m	£1,400m	40%	£560m
5	£2,000m	£1,400m	20%	£280m
				£4,200m

FX Hedging on Purchases

Year	Forecast/Contracted Sales	Foreign Purchases	Hedge %	Notional Hedged
1	£2,000m	£600m	100%	£600m
2	£2,000m	£600m	80%	£480m
3	£2,000m	£600m	60%	£360m
4	£2,000m	£600m	40%	£240m
5	£2,000m	£600m	20%	£120m
				£1,800m

As you can see, the notional value of the derivatives can become a fairly large number quite quickly, in this example £6.5bn (£500m + £4,200m +£1,800m). However consideration needs to be given to the fact that the potential risk on the derivatives is likely to be much lower than this figure, and also that in a world where there are US\$ 707,669bn of derivatives by notional outstanding (BIS June 2011) a non-financials relatively small derivative hedge book is unlikely to pose a systemic risk to the financial system.

In summary, the combined effect of the definition of what is deemed to be objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity and the definition and level of the clearing threshold must be that the vast majority of non-financials who are hedging are exempt from mandatory centralised clearing.

Risk Mitigation for non-CCP cleared contracts

When setting the risk mitigation requirements for non-CCP cleared contracts, ESMA should consider both the reasons why the contracts are not cleared by CCPs, for example they could be very simple derivatives that are not cleared by a CCP because they are bespoke or illiquid, or alternatively they could be very complex or risky derivatives. Risk mitigation techniques mandated in regulation should take into account the differences.

The considerable structural differences between financial and non-financial entities should also be taken into account. A non-financial entity will often have a fairly small centralised Treasury or risk management department that is responsible for a wide range of risk management activities. Our answers to questions 12, 16, 17, 21 and 22 are intended to highlight the structural differences in how non-financials operate their businesses compared to financials, and how a generic approach to risk mitigation for non-CCP cleared for all counterparties could have some serious consequences for non-financials.

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

In practice non-financial counterparties tend to enter into derivative contracts with financial counterparties either over the telephone or via electronic trading platforms such as FXall, 360T, etc.

A non-financial may decide to trade over the telephone for a number of reasons, for example:

- They may not have an electronic trading system in place, for example because they only use derivatives infrequently and find telephone execution simple (e.g. SMEs)
- The derivative that the non-financial wishes to execute may be bespoke and cannot be traded on an electronic platform as it may not offer the required functionality
- The non-financial may wish to gain information on the market before execution
- The non-financial may wish to verbally confirm the details of a derivative before and after execution
- The financial counterparty that the non-financial wishes to trade with may not use the specific electronic trading platform that the non-financial has available to use

In cases where a non-financial counterparty enters into a derivative over the telephone, the dealer will usually execute the deal with the financial counterparty and then re-confirm verbally that both parties

are in agreement with the main terms of the trade that has been completed. The deals conducted via the telephone would then be confirmed again independently from the dealers of each counterparty, either electronically on a platform such as MISYS for simple derivatives, or via paper confirmations for more complex or bespoke derivatives.

In cases where the non-financial counterparty enters into a derivative via an electronic platform, the derivative will tend to be fairly standardised or simple in nature, and is therefore more suited to a linked electronic confirmations process.

The primary driver for paper confirmations is often the bespoke nature of the derivative transaction which has been structured to meet the specific hedging requirement of the non-financial entity. Such transactions can range in complexity, confirmations can often run to several pages in length and require input from legal teams meaning dispatch times of a number of days post trade are not uncommon. In a non-financial entity the delay in dispatch of a paper confirmation is often due to the Treasury team having a small department whose staff has a wide range of responsibilities. They are not set up to issue instant confirmations of trades.

As a non-financial entity it is not clear to us that industry systems are sufficiently developed or standardised to allow all deals to be confirmed electronically.

The timeframes discussed in paragraph 38 for non-financials exceeding the threshold would be difficult for the majority of non-financial entities / corporate treasury departments to meet without the implementation of new systems, with an associated increase in cost and personnel.

The timeframe discussed in paragraph 39 for non-financials who are under the clearing threshold should be practical for the non-financial to meet given the fact that the transactions are unlikely to represent a systemic risk to the financial system. We would suggest 2 working days for electronically executed or processed OTC derivatives and 10 working days for non-electronically executed or processed OTC derivatives. However we assume that other non-financials will have different views so ESMA should consult widely on the matter.

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

We agree that portfolio reconciliation is a useful process and is something that a non-financial entity is generally required to complete anyway due to the requirements of the annual financial audit process.

However we believe that non-financials who are under the clearing threshold should only have to perform a portfolio reconciliation on an infrequent basis, for example annually in line with the requirements of the external financial auditors.

It seems excessive and burdensome for a non-financial counterparty who is hedging to have to frequently reconcile derivative portfolios with each counterparty, especially as the details of each OTC derivative will already have been confirmed at inception.

More frequent portfolio reconciliation will be difficult for the majority of non-financial entities / corporate treasury departments to meet without the implementation of new systems, with an associated increase in cost and personnel. We assume that it will also be a challenge for financials to implement daily portfolio reconciliation as is proposed.

Q17: What are your views regarding the threshold to mandate portfolio compression and the frequency for performing portfolio compression?

We believe that a threshold for portfolio compression based on the total volume of non-centrally cleared derivatives is an inappropriate measure for non-financial entities. It is not clear in paragraph 52 as to whether all non-financial counterparties with at least 500 non-centrally cleared derivative transactions, or just those non-financials that are over the clearing threshold and have at least 500 non-centrally cleared derivatives would have to meet the portfolio compression requirements.

In any case, applying portfolio compression to non-financials would potentially cause a range of other problems. For example:

- the non-financial counterparty may have hedged two future cash flows using foreign exchange forwards, one to sell US\$ and one to purchase US\$. As a further step, the non-financial may have applied hedge accounting to match each derivative with the underlying exposure
- if forced to compress the portfolio, the non-financial counterparty would lose the simple match of a separate FX forward deal to each future exposure
- if forced to compress the portfolio, there will no longer be a match between the derivative and the underlying exposure, so the hedge accounting test will fail
- the imposition of portfolio compression to non-financials who are hedging would impose another complex administrative burden onto the end user with little obvious benefit in terms of a reduction in systemic risk.
- portfolio compression will be difficult for the majority of non-financial entities / corporate treasury departments to implement without new systems, and an associated increase in cost and personnel.

Intra-Group Exemptions

Our general interpretation of the text on intra-group transactions (noting that there are several caveats, such as the requirement to have appropriate risk management procedures in place, no impediment to the prompt transfer of funds, prior approval from competent authorities) is as follows:

1. Intra-group transaction between two counterparties established in different member states: Exempted from the clearing obligation under Article 3 (1a), exempted from bi-lateral exchange of collateral (Article 8 (1b)) under Article 8 (1e and 1f). Applies to both financial and non-financial counterparties.
2. Intra-group transaction between a counterparty established in the Union and a counterparty established in a third country jurisdiction with equivalent rules to the EU in place: Exempted from the clearing obligation under Article 3 (1a), exempted from bi-lateral exchange of collateral under Article 8 (1g and 1h). Applies to both financial and non-financial counterparties.
3. Intra-group transaction between a counterparty established in the Union and a counterparty established in a third country jurisdiction that does not have equivalent rules to the EU in place: Does not meet the definition of an intra-group transaction. Presumably this is therefore treated as an inter-group transaction between two separate counterparties. Can an exemption from clearing still be achieved if the transaction is considered a hedge?

4. Intra-group transaction between two counterparties established outside of the Union: There is no statement in the text regarding an exemption from the clearing obligation. Article 8 suggests that bi-lateral collateralisation may be required. It is not clear how the EU could enforce centralised clearing or bi-lateral collateralisation in either jurisdiction.

Q21: In your views, what are the details of the intragroup transactions that should be included in the notifications to the competent authority?

Temporary or permanent intra-group collateralisation is likely to be completely impractical for the majority of non-financial entities / corporate treasury departments to implement. It would require a significant investment in new systems and processes, with an associated increase in cost and personnel, for little obvious benefit in terms of reducing systemic risk.

As part of their risk mitigation strategies, a non-financial entity often has a centralised or regional Treasury/risk management function where the majority or all of their OTC derivatives are managed. The reasons for this are as follows:

- management of financial risks in a centre of expertise / a controlled environment
- efficient internal netting of exposures, reducing the amount of dealing required with external counterparties
- economies of scale and benefits of a central Treasury dealing with the financial counterparties rather than each individual business in a group managing their own exposures
- efficient reporting and risk exposure management at a central level

The non-financial's Treasury or risk management would typically receive instructions or deal requests from its internal counterparty, check that the instruction is reasonable and authorised within internal policies, and then execute the deal in the external financial market with a financial counterparty.

This is an efficient and relatively simple way for non-financials to manage their financial risks and leads to a large number of intra-group transactions and is common practice for most non-financials.

In our view it is questionable why a non-financial with intra-group transactions where the purpose is to hedge risk commercial risk or treasury financing activity should have to notify the competent authorities that they wish to make use of the exemption from clearing or collateralisation of intra-group transactions. By definition intra-group transactions of non-financials do not pose a systemic risk to the financial system. There is also a lack of clarity around how a competent authority may exercise its discretion in granting an exemption.

If there is to be a requirement to notify a competent authority to make use of the exemption then the information to be provided should be relatively simple and not a heavy administrative burden for the non-financial entity or the competent authority. For example:

1. Names of the two intra group counterparties
2. Purpose or type of the derivative transactions
3. Confirmation that appropriate risk management procedures are in place

It is our understanding based on information from the ESMA hearing on 6th March that there may be a requirement for intra-group transactions to be collateralised until the relevant exemption has been approved by the competent authorities in each member state. This causes several practical issues for non-financials. For example a non-financial would have to set up a temporary collateralisation structure. Alternatively a subsidiary may not have enough assets to post as collateral and would have to borrow money internally from the Treasury department in order to post it back to the Treasury department as collateral.

Temporary or permanent intra-group collateralisation is completely impractical for the majority of non-financial entities / corporate treasury departments to implement. It would require a significant investment in new systems and processes, with an associated increase in cost and personnel, for little obvious benefit in terms of reducing systemic risk.

Q22: In your views what details of the intra-group transactions should be included in the information to be publicly disclosed by counterparty of exempted intra-group transactions?

For non-financial entities we do not believe that any detail of intra-group transactions should be publically disclosed, other than the names of the counterparties to which the inter-group exemption refers and at most a general description of the purpose or type of derivative transactions for which the exemption applies. This statement is based on the fact that intra-group information for non financials should remain confidential as it is not relevant to the wider market.

Appendix A – Relevant Text from ESMA Discussion Paper

Non-financial counterparties (Article 5/7)

27. EMIR recognises that non-financials use OTC derivative to protect themselves against commercial risks directly linked to their commercial activities. As a result, these OTC derivative contracts that protect the non-financial against risks directly related to their commercial activities and treasury financing activities as well as those that do not protect against such risk but do not exceed a clearing threshold are not subject to the clearing obligation. At the point where the clearing threshold would be exceeded, the clearing obligation would apply to all OTC derivative contracts the non-financial counterparty will enter into after the time that the firm has exceeded the threshold.
28. In order to calculate whether it exceeds the clearing threshold, a non-financial counterparty shall not include in its calculation the OTC derivative contracts which are objectively measurable as reducing risks directly related to its commercial activity or treasury financing activity or that of its group.

Criteria for establishing which derivative contracts are objectively measurable as reducing risk directly related to the commercial activity or treasury financing.

29. By reference to European accounting rules, ESMA considers that an OTC derivative entered into by a non-financial counterparty is deemed to be objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of that non-financial counterparty or of that group, when, whether individually or in combination with other derivative contracts, its objective is to reduce the following risks:
- a. The potential change in the value of assets, service, inputs, products, commodities, liabilities that the non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises leases, sells or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring in the ordinary course of its business; or
 - b. The potential change in the value of assets, service, inputs, products, commodities, liabilities referred to in letter a, resulting from fluctuation of interest rates, inflation rates or foreign exchange rates.
30. ESMA also considers that an OTC derivative entered into by a non-financial counterparty is deemed to be objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of that non-financial counterparty or of that group, when, the accounting treatment of the derivative contract is that of a hedging contract pursuant to IFRS principles as referred to in IAS 39 paragraph 71-102 on hedge accounting as endorsed by the European Commission.
31. Nevertheless, ESMA considers that an OTC derivative which is used for a purpose in the nature of speculation, investing, or trading should not be an OTC derivative objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of a non-financial counterparty or of a group as provided above.

Q10: In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial or treasury financing activity?

Clearing Threshold

32. For the purpose of setting the clearing threshold, ESMA considers referring to the notional value of OTC derivatives subject to the clearing obligation.

33. As there is a broad definition of the OTC derivatives that do not enter into the calculation of the clearing threshold because they relate to the non-financials' activity directly reducing commercial risks or treasury financing activity, ESMA considers that the clearing threshold should be set at a low level. It should also be simple to implement by non-financials.

34. The clearing threshold could be set across asset classes or per asset class. Nevertheless, referring to a clearing threshold per asset class and per legal entity and group would be difficult to implement. ESMA therefore suggests using a threshold across all asset classes.

35. One may consider that if the threshold is set at the level of the legal entity, a mechanism preventing circumvention of the clearing obligation may be required so that groups cannot multiply the number of their legal entities to use the threshold several times. The mechanism could articulate a double clearing threshold set at the level of the legal entity and of the group. Indeed, application of a total global clearing threshold for all legal entities or groups combined would lead to a situation where the first entities to enter into OTC derivative transactions could consume the full threshold to the detriment of other participants.

36. In order to set up the exact value of the clearing threshold, more data should be gathered, including net positions and exposures related to the OTC derivative contracts that are not centrally cleared by counterparties.

Q11: In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

Risk Mitigation for non-CCP cleared contracts

37. Financial and non-financial counterparties that enter into an OTC derivative which is not subject to the clearing obligation shall mitigate risks by using different techniques. The risk mitigation techniques shall be further specified through technical standards to be developed for a part by ESMA and for another part jointly by ESMA, EBA and EIOPA. This discussion paper relates to the risk mitigation to be specified through ESMA technical standards. Some other risk management techniques are specified in the ESAs joint discussion paper dedicated to joint technical standards.

Timely confirmation

38. ESMA considers financial counterparties and non-financial counterparties exceeding the clearing threshold 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:

- a. within 15 minutes from the execution of the derivative contract, when the transaction is electronically executed;
- b. within 30 minutes from the execution of the derivative contract when the transaction is not electronically executed but is electronically processed;

c. on the same calendar day for transactions that are not executed or processed electronically.

39. ESMA also considers that parties to transactions executed with counterparties other than those indicated above should confirm, where available via electronic means, the terms of any OTC derivative they have entered into and which is not cleared by a CCP:

a. no later than the business day following the execution of the OTC derivative when the transaction is electronically executed or processed;

b. no later than the[x] business days following the execution of the OTC derivative when the transaction is not executed or processed electronically.

40. Financial counterparties should also report to the competent authority designated in accordance with Article 48 of Directive 2004/39/EC the number of unconfirmed OTC derivative transactions that have been outstanding for more than [x] days.

41. ESMA recognises that proposals above would entail a modification of the current practice related to execution of transactions on the OTC derivative markets as the legal terms of the contracts are generally agreed after the execution, but considers they would contribute to a low level of log of unconfirmed trades and thus a reduction of risk of potential legal disputes.

Q12: What are your views regarding the timing for the confirmation and the differentiating criteria? Is a transaction that is electronically executed, electronically processed or electronically confirmed generally able to be confirmed more quickly than one that is not?

Reconciliation of non-cleared OTC derivative contracts

46. ESMA considers that financial and non-financial counterparties should agree in writing or in other equivalent electronic means with each of their counterparties on the terms of their portfolio reconciliation.

47. Also ESMA considers that portfolio reconciliation should be performed by the counterparties to the OTC derivatives with each other, or by a qualified third party duly mandated to this effect by a counterparty. The portfolio reconciliation should cover key trade terms that identify a particular derivative transaction.

48. Furthermore, ESMA's view is that, for the early identification of any discrepancy in the material term of a contract or in its valuation, the portfolio reconciliation should be performed at least:

a. each business day when the counterparties have 300 or more OTC derivatives with each other; or
b. at an appropriate time period based on the size and volatility of the OTC derivative portfolio of the counterparties with each other and at least once per quarter for portfolio of less than x derivative contract with a counterparty and at least once per week for portfolio between x and 300 derivative contracts with a counterparty for any other OTC derivative transaction not captured under (a) above.

49. Finally, and without prejudice to provisions related to dispute resolution, ESMA considers that all counterparties should also have in place the necessary arrangements to timely resolve any discrepancy in a material term of a contract or in its valuation identified as part of the portfolio reconciliation.

Q16: What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

Portfolio compression

50. ESMA considers that portfolio compression is a risk-reducing exercise which should be run on a regular basis.

51. 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.

52. ESMA contemplates that financial counterparties and non-financial counterparties with at least 500 or more non centrally cleared derivative transactions should conduct at least twice a year a portfolio compression exercise for their full portfolio, or provide a reasonable and valid explanation to the relevant competent authority for not conducting such an exercise.

53. Financial and non-financial counterparties should terminate each of the fully offset derivative contract no later than the day following the execution of the fully offsetting derivative contract

Q17: What are your views regarding the threshold to mandate portfolio compression and the frequency for performing portfolio compression?

Intra-Group Exemptions

56. For the application of the intragroup exemption to the exchange of collateral, two sets of draft technical standards are required:

a. in relation to criteria to be used and in particular practical and legal impediments to the prompt transfer of own funds or repayment of liabilities between counterparties;

b. in relation to the details of the intragroup OTC derivatives to be included in the notifications to the competent authority, the details of the information to be publicly disclosed by counterparty of exempted intragroup transaction on the exemption.

57. Draft technical standards under letter a. are expected to be developed jointly by EBA, EIOPA and ESMA and related considerations will be included in the joint discussion paper.

58. Draft technical standards under letter b. are under ESMA sole responsibility. These draft RTS have been added at a late stage in EMIR negotiations and therefore ESMA has only recently started the analysis in this respect. Stakeholders' views would however be valuable in this context.

Q21: In your views, what are the details of the intragroup transactions that should be included in the notifications to the competent authority?

Q22: In your views what details of the intra-group transactions should be included in the information to be publicly disclosed by counterparty of exempted intra-group transactions?

ⁱ Rolls-Royce is a world-leading provider of power systems and services for use on land, at sea and in the air. We have a broad global customer base comprising more than 500 airlines, 4,000 corporate and utility aircraft and helicopter operators, 160 armed forces, more than 4,000 marine customers, including 70 navies, and energy customers in more than 80 countries.

We employ over 40,000 skilled people in offices, manufacturing and service facilities in over 50 countries, with our predominant operations and facilities in Europe and a significant element of our supply chain also based in Europe.

In 2011, Rolls-Royce invested £908 million on research and development, two thirds of which had the objective of further improving the environmental performance of our products, in particular reducing emissions. We support a global network of 28 University Technology Centres, which connect the company's engineers with the forefront of scientific research and our Group has a strong commitment to apprentice and graduate recruitment and to further developing employee skills.

Annual underlying revenues were £11.3 billion in 2011, of which more than half came from the provision of services. The order book stood at £62.2 billion at 31 December 2011, providing visibility of future levels of activity.

We believe we are the sort of company and business that the European economy needs to re-establish growth and an example the European Union (EU) would want to promote as part of their 'Europe 2020 Strategy' placing smart, sustainable and inclusive growth at the top of the European agenda.