

19th March, 2012

AMUNET PARTNERS LLP RESPONSE TO:

ESMA DISCUSSION PAPER ON THE DRAFT TECHNICAL STANDARDS FOR THE REGULATION ON OTC DERIVATIVES, CCPS AND TRADE REPOSITORIES (ESMA/2012/95)

Amunet Partners LLP specialises in providing specialist legal consultancy services, focusing on derivatives and other traded products. In providing these services, we supplement the existing internal legal resources of our clients and, for those clients which do not have in-house legal support, assume the role of in-house legal counsel on a part-time or temporary basis.

This response is based on the comments and concerns that have been raised by our clients, many of which are large regional banks in the EU. We have not attempted to respond to all the questions but have instead focused on those of the greatest relevance and importance to these clients.

Q3: In your views, what should be the characteristics of these indirect contractual arrangements?

As a first comment, we and our clients are very pleased that the EMIR text was amended to provide for indirect contractual arrangements (ICAs).

The primary goal of these ICAs is to ensure that various “end users” continue to have access to the OTC derivatives markets via the relationship structure prevailing prior to the coming into force of EMIR. In other words, the goal is to enable such end users to trade OTC derivatives contracts with counterparties (typically regional European banks) who may only be clearing members of one CCP (or perhaps none). These often long-standing relationships (which are usually broader than a pure derivatives trading relationship) are vital for the participation of many end users and regional banks in the OTC derivatives markets and even to their ability to efficiently fund themselves. A number of our clients had expressed concern that the ability of end users to access the OTC derivatives markets would be significantly impacted without a provision for ICAs within EMIR.

It is therefore essential that ICAs are structured in such a way as to preserve the key elements on which regional / tiered derivatives relationships are based (freedom of choice, understanding of clients’ needs, access to markets) whilst ensuring that those relationships also adhere to, and benefit from, the advantages of transparency and reduced risk that will result from the Clearing Obligation.

[For clarity, in the points made below, we envisage a standard client clearing relationship between Clearing Member A and Client B (principal model, as adopted by LCH SwapClear), which becomes an ICA when Client B also passes for clearing OTC derivatives transactions executed by End Client C which are subject to the Clearing Obligation.]

Perhaps the most conceptually simple solution (and one which would, to a large extent, reflect the current chain of bilateral derivatives contracts) would be a series of back-to-back, principal-to-principal relationships. This would have the advantage of enabling Client B and End Client C to preserve their commercial relationship. However, we do not consider this to be a practical solution since this will stretch settlement timelines (both in terms of collateral / margin and in terms of transactional cashflows) and potentially dilute the safeguards which the Clearing Obligation is intended to introduce. These issues would of course become more pertinent the longer the “chain” becomes.

The required solution must therefore avoid extending this chain of transactions, whilst respecting the commercial sensitivity of the Client B-End Client C relationship (which is likely to involve preserving the anonymity of End Client C).

In our opinion, the only structure which could successfully combine these features is a relationship of agency with undisclosed principal(s). More specifically, Client B would act as an agent for End Client C in its dealings with Clearing Member A. This would of course mean that Clearing Member A and End Client C would contract on a principal-to-principal basis. However, the fact that End Client C would be an undisclosed principal would enable Client B to avoid disclosing End Client C’s identity.

This structure also raises a number of issues, most notably around the fact that neither Clearing Member A nor

the relevant CCP would be aware of the identity of End Client C. For example, KYC procedures and credit monitoring would not be possible in the conventional sense. However, undisclosed agency transactions are also used in the bilateral OTC derivatives world (particularly in the asset management community) and it should be possible to borrow from this approach in the OTC cleared derivatives world. An example of this is the use of a numeric reference (for End Client C) which is shared with a small number of officers / employees of Clearing Member A (a restricted number of those dealing with risk management, with KYC and, possibly, from the legal department: all on a need-to-know basis). This would mean that all essential functions at Clearing Member A could perform their duties. As will be seen below, it is possible that a similar approach would be needed at the relevant CCP.

The Discussion Paper requires that, in an ICA, “the assets and positions of the counterparty [*i.e. End Client C*] benefit from the protection granted by segregation, portability and default procedure”.

Taking each of these in turn:

- (i) segregation: we see no reason why segregation could not happen in the same way as under the direct client clearing model. The only real difference in the model outlined above is that the name of the party benefiting from the segregation is not disclosed. However, as mentioned above, the name could in fact be disclosed to a small team at the CCP;
- (ii) portability: given that the relationship to be ported in the event of Clearing Member A’s default would be an agency relationship involving an undisclosed principal, it stands to reason that the back-up clearing member to replace Clearing Member A must also have (or quickly put in place) the same structure. Although there is a layer of legal and operational complexity to this sort of structure, we believe that the market will recognise the commercial necessity of offering such structures and that it should therefore be a subject of negotiation when selecting back-up clearing members;
- (iii) default procedure: we believe that the outcome of a default under this agency structure would only differ from a default under the direct clearing (principal) model in certain limited circumstances (depending on which entity was to default).

If either the CCP or Clearing Member A were to default, the fact that End Client C is principal would mean that the consequences are similar. End Client C would be registered in the relevant records of the CCP (as principal). If Clearing Member A was to default, a replacement clearing member would have to be selected and all relevant assets and positions transferred to it: the difference is that Client B would select such replacement on behalf of End Client C and that, as highlighted above, the universe of available clearing members may be more limited since acceptance of the agency structure would be a prerequisite. In the standard LCH SwapClear principal model (for direct clearing), the direct clearing client would benefit from an assignment of the relevant receivables by the clearing member in its account with the CCP. This security may well need to be registered (depending on the jurisdiction of establishment of the clearing member) and the recipient of such an assignment under the agency structure would also need to have the security interest registered against its name. This would not work within the confines of an undisclosed principal agency arrangement. We would therefore suggest that another party (the CCP would be the most logical entity) is appointed to act on behalf of End Client C in this respect (*i.e.* as a trustee) only – again, information as to the beneficiary of such a security interest would need to be kept within a restricted group at the CCP.

Given that Client B’s role as agent in the agency structure is a new one, a default by Client B would give rise to new considerations. However, we are of the opinion that this should not lead to increased risk for End Client C. If End Client C was unable to enter into an equivalent arrangement via another regional bank (replacing Client B), a fallback solution (which could be temporary) would be to collapse the agency structure to enable End Client C to become a direct clearing client of Clearing Member A.

A default by End Client C would trigger information an information flow from Client B to Clearing Member A and the Clearing Member would subsequently deal this with in much the same way as a direct clearing relationship.

Q4: 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?

We believe that these heads of information are sufficient (subject to our comments in response to Question 7 below).

Q7: What are your views regarding the specifications for assessing standardisation, volume and liquidity, availability of pricing information?

We believe it to be essential that “contractual terms standardisation” does not merely refer to the use of a master netting agreement recognised by the markets but that it focuses on standardised terms used within the confirmations of a particular class of OTC derivative. The “contractual terms standardisation” requirement must focus on the specific terms contained in such confirmations and must involve an assessment of the impact of any amendments to the standard terms. It will not be possible to set out in advance the requirements for all classes of OTC derivatives contracts, but we believe that a CCP should provide evidence of, and ESMA should review on the basis of, acceptable additional terms and acceptable amendments / deletions to standard terms.

Q8: What are your views, regarding the details to be included in ESMA Register of classes of derivatives subject to the clearing obligation (Article 4b)?

In general, we consider these details to be sufficient, except that paragraph 24.i stands contrary to the aim of standardising cleared OTC derivatives contracts. A “catch-all” category like this would seem to demonstrate a lack of standardisation. We would therefore suggest that only “hard-wired” categories are specified in order to further reinforce the requirement for standardisation when assessing the eligibility of derivatives contracts for clearing (as per our comments in response to Question 7 above).

Q9: 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?

See our responses to Questions 7 and 8 above: additional granularity will be needed the further that the Clearing Obligation moves away from plain vanilla classes of derivative.

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?

It is not clear to us why the language in paragraphs 29.a and 29.b has been drafted in the way it has. Paragraph 29.a refers to the reduction of risk of a potential change in the value of various generic factors occurring in the ordinary course of business. This seems fine. However, paragraph 29.b then refers back to 29.a and sets out that, in addition to this more generic language, derivatives contracts intended to reduce the risk of exactly the same factors (also occurring in the ordinary course of business) will benefit from the commercial / treasury financing activity exemption if the risk is of a change in interest rates, inflation or FX. We are not sure why paragraph 29.b is necessary in light of the more general paragraph 29.a (we cannot envisage any activity which would be caught by paragraph 29.b and not by paragraph 29.a).

However, if we assume that the narrower wording of paragraph 29.b is considered necessary (in addition to that of paragraph 29.a), the risks of changes in interest and FX rates and inflation are the only risks which are covered. We agree that interest rate, FX and inflation risks are ones against which a non-financial counterparty might reasonably wish to hedge itself and, as such, the related derivatives contracts should not necessarily be subject to the Clearing Obligation. However, in our opinion, these risks are not the only ones which should be covered if the intention is to exempt non-financial counterparties for genuine hedging contracts. For example, non-financial entities may well wish to hedge themselves against commodity, equity or credit risks without this being at all speculative and there are also a number of more esoteric asset classes that could form a genuine basis for hedging activity. Moreover, should there not be some sort of discretion to add to this list in order to “future proof” the regulation and its technical standards?

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?

We consider that, provided that the concerns raised above (that transactions in other asset classes should also be regarded to be risk-reducing) are addressed, a relatively low threshold is appropriate as it would be intended to exempt only marginal transactions from the Clearing Obligation.

We agree that the notional amount of a derivatives transaction is the appropriate reference for setting a clearing threshold.

Although it is not clear to us how ESMA intends combined group and legal entity thresholds to operate, we agree that combined thresholds should be used. Our own suggestion is that a global limit is set for the group and that, once this threshold is breached on a group-wide basis, any legal entity within the group for which the outstanding

[non risk-reducing] derivatives notional amount is greater than [x]% of the global threshold would, from that point, be required to clear all derivatives which are not considered risk-reducing. We would expect that any savings from the avoidance strategy of establishing several group subsidiaries to transact derivatives which are not risk reducing (and thereby diluting the notional amounts for each legal entity) would be offset by the cost of establishing such subsidiaries and their derivatives trading capabilities.

We feel that the complications that arise from the applicability of thresholds to multinational groups (with limited presence in Europe) should be resolved in the context of the various extraterritorial issues related to OTC derivatives clearing.

Q18: What are your views regarding the procedure counterparties shall have in place for resolving disputes?

In some respects, market-standard documentation will set out procedures and time periods for resolving disputes (particularly in relation to the valuation of collateral and/or exposure). These procedures should be followed wherever possible. In addition, we believe that the development of a framework procedure and timeline for extra-judicial dispute resolution should be encouraged as it would foster greater consistency and, by reducing timelines and uncertainty, would reduce risk.

Q19: Do you consider that legal settlement, third party arbitration and/or a market polling mechanism are sufficient to manage disputes?

Wherever possible, we believe that parties should attempt to settle disputes by following objective and pre-determined guidelines which avoid escalation of the dispute. Market polling satisfies these criteria to a point but, in our opinion, it is not a solution in itself and should form part of a wider dispute resolution framework.

Q20: What are your views regarding the thresholds to report a dispute to the competent authority?

We believe that either a shorter duration of dispute should trigger a reporting requirement or that the materiality / quantum thresholds should have certain levels with a different duration applied to each. A dispute for an amount of EUR 15m may not have systemic importance (depending on the nature of the parties involved), but three weeks (15 business days) is a long time to have an unresolved dispute in relation to, for example EUR 50m. We would think it advisable for the appropriate regulator to at least be aware of a dispute of this magnitude once it appears that it will not be easily or quickly resolved.