5 August 2012

To Whom It May Concern

Goldman Sachs International welcomes the opportunity to comment on the Consultation Paper relating to "Draft Technical Standards for the Regulation on OTC derivatives, CCPs and Trade Repositories" published by the European Securities and Markets Authority ("**ESMA**") on 25 June 2012 (the "**Consultation Paper**") and the associated Regulatory Technical Standards ("**RTS**") and Implementing Technical Standards ("**ITS**").

Goldman Sachs International supports the intention of the reforms being introduced by the Regulation on OTC Derivatives, Central Counterparties and Trade Repositories ("**EMIR**") and in particular has been a significant promoter of the use of central clearing for OTC derivatives contracts since the inception of this development. We have been intimately involved in the development of clearing solutions, our representatives serve on boards of several clearing platforms and we strongly endorse the G-20's goal of increasing central clearing of OTC derivative contracts as a way to promote the soundness and stability of financial markets.

We have focused our response on certain key themes in the Consultation Paper. We support the comprehensive response submitted by ISDA, to which we have contributed as a member firm, but also provide these comments individually on issues which we consider to be of particular importance.

We look forward to continuing an open dialogue with you on these issues and would welcome a meeting in person to discuss in more detail. Please do not hesitate to contact Martine Doyon (+44 20 7051 5237) should any questions arise.

Our specific comments on certain key issues are as follows:

(A) Draft Regulatory Technical Standards on OTC Derivatives

1. Indirect Clearing Arrangements (Chapter II)

We are concerned that the RTS may not effectively provide indirect clients with the desired level of protection in all circumstances and, moreover, that certain provisions in the RTS will discourage indirect clearing by making it prohibitively expensive for end-users and increasing risks to clearing members. Our concerns fall into 3 broad categories: (i) the mandate on clearing members to facilitate indirect clearing; (ii) the terms which clearing members are required to offer to indirect clients; and (iii) the efficacy of the porting and segregation arrangements in an insolvency.

(a) Indirect Clearing Mandate

We are concerned by the provisions of Article 4 ICA which impose an obligation to facilitate indirect client clearing on all clearing members. As EMIR itself does not contemplate this obligation, we consider that it falls outside the scope of the required RTS. We consider that, subject to the issues identified in the following paragraphs being addressed, a market will arise for indirect clearing services in accordance with usual competitive dynamics, and we submit that whether to facilitate indirect client clearing, and on what terms, should be a commercial decision for individual clearing members. Any obligation on clearing members to offer indirect client clearing, or limitation on what terms clearing members may choose to make available, would remove from clearing members the ability to manage their risk in the manner they consider to be appropriate, thereby increasing the riskiness of those institutions and adding to systemic risk. The indirect clearing mandate could also create undue risk for clearing members by requiring them to assume obligations towards indirect clients in respect of whom they may not have conducted standard account opening procedures, including anti-money laundering and other "know your client checks".

(b) Terms of Indirect Clearing Arrangements

Regardless of whether a requirement on clearing members to offer indirect clearing is appropriate, we think that a number of important issues on the proposed structure need to be addressed for it to work as contemplated. Importantly, these issues impact on both the risk profile to which clearing members and their clients are exposed (especially as compared to direct clearing), and to whether indirect clients would actually receive the level of desired protection.

We consider that paragraph 2 of Article 2 ICA and paragraph 6 of Article 4 ICA would provide indirect clients with protections from clearing members that are not available to direct clients, thereby fundamentally changing the nature of the clearing product. Requiring these protections would also exceed the mandate in EMIR that indirect clients have an "equivalent" level of protection to direct clients[1]. Subject to appropriate protections for segregation and porting being in place, the residual risks associated with a default of the direct client should be borne by the indirect clients, not the clearing member. We note that requiring clearing members to underwrite these risks would give rise to contingent obligations for clearing members, potentially increasing systemic risk and resulting in increased costs for indirect clients. In particular:

- paragraph 2 of Article 2 ICA requires that "*[indirect clearing arrangements] shall include an obligation on the clearing member to honour any obligations between the client and its indirect clients following the default of the client*". This provision would effectively make a clearing member the guarantor of its clients and would impose obligations on clearing members which would be unquantifiable and potentially unlimited (for example as drafted the clearing member would have to compensate indirect clients for unpaid variation margin due from the direct client to the indirect client, even if the clearing member had discharged its obligation to pay the corresponding amount to the direct client). In a direct clearing relationship, if a clearing member defaults in its payment obligations to a direct client, the direct client has no recourse to the CCP. If this requirement were to be mandated, clearing members would, for prudential risk management purposes, likely require either the direct or indirect client to provide substantial margin at all times to cover this contingent risk; and
- paragraph 6 of Article 4 ICA requires that "*in circumstances where the positions and assets of indirect clients cannot be successfully transferred, the clearing member shall offer to hold directly the positions and assets in an equivalent account with the CCP for a period of at least 30 days and on reasonable commercial terms*". In a direct clearing relationship, if cleared transactions are not transferred on a clearing member default those transactions are promptly terminated. If this requirement were to be mandated, clearing members would, for prudential risk management purposes, likely require indirect clients to provide margin at all times to cover this full 30 day window, in addition to standard margin requirements. This would result in initial margin requirements being multiples of current requirements[2].

Further, we submit that clearing members should, consistent with rights available to CCPs and recognised in Article 48(5) of EMIR, have the ability to immediately terminate transactions of indirect clearing members following the default of a client where they consider it necessary to do so for prudential risk management purposes.

(c) Insolvency Protections

Finally, we are concerned that the protections afforded to indirect clients in paragraph 4 of Article 4 ICA may not be compatible with national insolvency regimes, and may therefore not achieve their objective of ensuring that indirect clients may be ported and/or that liquidation of assets and positions will take place.

National insolvency regimes often restrict the ability to terminate transactions with an insolvent entity, and restrict any movement of assets out of the insolvent estate. The ability to transfer assets and positions to

[1] We also note the comment in paragraph 22 on page 9 that "…that structure should be replicated for indirect clients one step lower".

[2] For interest rate swaps, where the current initial margin requirement typically covers a 5 day close out window, we estimate that the requirement would be $\sqrt{35/5}$ (i.e 2.65) times larger.

an alternative client or clearing member, or to promptly liquidate assets and positions of indirect clients, may therefore not be permissible under the insolvency regime in the jurisdiction where the direct client is incorporated. We note the inclusion of recital (4) of the RTS and recital (64) of EMIR, but we are concerned that these provisions are not sufficient to override national insolvency regimes and therefore will not, in the direct client's insolvency, result in the desired transfer of asset and positions. We would also note that, absent further amendments to member state insolvency regimes, in the event that porting or liquidation does occur, indirect clients, clearing members and CCPs will be exposed to the risk of the client's insolvency official subsequently seeking to clawback payments and assets. The uncertainty associated with these insolvency risks would also be detrimental to the stated objective of managing the credit risks of OTC derivatives market participants in a socialised and orderly manner.

We would encourage ESMA to give consideration to ways in which the protections afforded in ICA can be effectively given precedence over member state insolvency regimes. To the extent this is not possible, the obligations of clearing members and CCPs pursuant to paragraph 4 of Article 4 ICA should be expressed to be subject to any limitations imposed by applicable law.

2. Non-financial Counterparties (Chapter VII)

We welcome the criteria set out in Article 1 NFC relating to establishing which OTC derivative contracts are objectively reducing risks. Our interpretation of Article 1 NFC is that derivative transactions entered into by special purpose vehicles to hedge their liabilities arising under their debt obligations (for example, structured note issuance and securitisations) would fall within the scope of paragraph 1(a), but we would submit that ESMA consider including express provisions clarifying this to avoid unintended impacts on this important source of liquidity to financial markets and end users .

3. Risk Mitigation Techniques for OTC Derivative Contracts not cleared by a CCP (Chapter VIII)

We are supportive of the provisions in Article 1 RM which require timely confirmation of transactions. The financial industry has already made significant progress in improving the speed of the post-trade documentation process (including through standardising documentation) and in reconciling portfolios and we are supportive of ESMA's intention to achieve further progress on these issues. However we are concerned that the timeframes set out in the RTS for confirming transactions may not be achievable for certain transaction types. For certain complex and bespoke transactions, although parties will be able to confirm the key economic terms within the envisaged timeframes, the full confirmation process can take longer than electronically matched trades, as counterparties may need to review and agree customised language. Timeliness should not come at the expense of accuracy, and we would encourage ESMA to adopt an approach which acknowledges differences between transaction types.

We would also note that it is common in the market for asset managers to trade on a "block" basis, with allocations to individual accounts being communicated to counterparties later, and we would encourage ESMA to take this practice into account when finalising the RTS.

(B) Draft Regulatory Technical Standards on CCP Requirements

We strongly support ESMA's intention to create CCP risk management frameworks which are responsive to market dynamics and avoid pro-cyclicality. We would however submit that certain of the proposed RTS may not adequately promote the most robust risk management methodologies available to CCPs and may not sufficiently reduce pro-cyclicality.

Firstly, we note that Article 3 SBT does not explicitly require that CCP back testing be undertaken on current rather than historical positions. Ongoing accumulation of historical statistics on the adequacy of historical margins on historical positions does not provide comfort that current margin is adequate for current positions. As the purpose of back testing is to ensure the adequacy of the CCP's current margin methodology for clearing the members' current cleared positions, we propose that ESMA clarify that current positions should be backtested.

As regards CCP margin requirements, a 99% confidence level is consistent with an exceedance 2 to 3 times a year, and is in our opinion, and in our view of current CCP margining practices, too low for systemically important financial markets. As examples the highly used CME S&P 500 and ICE Russell 2000 futures contracts are consistently margined in excess of 99.6%. Interest rate swaps, predominantly cleared at LCH.Clearnet's Swapclear are margined in excess of 99.9%. The notion of a systemically important CCP has been well accepted and we respectively suggest that this notion be extended to individual contracts and clearing services, and a higher level of confidence apply to their margining.

If this is not accepted then we submit that the distinction drawn in Articles 1 MAR and 3 MAR between OTC derivatives and other financial instruments is not the appropriate way in which to reflect available liquidity relative to positions, and the calculation of their respective initial margins. Instead, we submit that the lower confidence level and shorter liquidation period should be assigned to all instruments (including OTC derivatives) (i) that have standard terms (dates, fixed rates, etc) and (ii) where the majority of trading is via central limit order books, and that the higher confidence level and longer liquidation period should apply to all instruments (including listed derivatives) that do not have both those features.

Furthermore, we consider that the standards set forth in Articles 2 and 4 MAR are overly prescriptive and, while attempting to address procyclicality, may not effectively do so, and do not represent risk management best practices. In particular, the proposals in Articles 2 and 4 would be inconsistent with margining based on historical Value-at-risk ("**historical VaR**"), a method that is considered best practice for swaps margining, where there are a very large number of very highly correlated risk factors. We would encourage ESMA to ensure that the RTS accommodate current standard margining methodologies, as well as acknowledging that there may be circumstances in which other methods are appropriate.

As regards Article 2 MAR, we are concerned by the requirement in paragraph 1 that "*…initial margins cover at least with the [relevant confidence interval] an historical volatility calculated weighting equally the two following periods: (a) the latest 6 months; and (b) the 6 months reflecting the most stressed market conditions during the last 30 years or as long as reliable price data is available"*. Specifically in this regard:

- we do not consider using 6 month windows as a volatility estimator to be best practice. Almost all margining methodologies that scale margins to recent volatility use an exponentially weighted volatility estimator, with a daily weighting factor between 0.97 to 0.99, since this smoothes jumps in requirements, which could otherwise cause shocks to the financial system.

- many margining methodologies do not use a volatility estimator to scale to recent levels of market risk at all. For example:
    1. many rely on the 1^{st}, 2^{nd} or 3^{rd} (in general, "n^{th}") worst move over the last 6 months or year, with "n" chosen to achieve a 99% confidence for the period. This is typical with margins based on standardised portfolio analysis of risk ("**SPAN**"). To avoid procyclicality and preserve responsiveness, we consider that it would be good practice to floor the n^{th} worst move over the most recent "m" months, with the pth worst move over the most volatile m months over the last ten years, where "p" is chosen to achieve a 95 percent level of confidence.
    2. instead of volatility, another and more robust estimator of the scale of a distribution is its mean absolute deviation ("**MAD**"), and its exponentially weighted version is used to assess margins in a number of swaps clearing services. MAD is a more robust estimator than volatility for the scale of distributions with very fat tails, e.g. CDS, S&P500, and emerging market currencies.

- while the average of recent and an historically most volatile period is a compromise between the aims of reducing procyclicality and maintaining responsiveness, a better construct would be to floor the recent estimator of volatility with its median value over the last ten years. This construct achieves both aims: when volatility rises, the responsiveness of the estimator is preserved; when volatility is less, the historic median value takes over, ensuring margins do not follow, thereby avoiding procyclicality.

As regards Article 4 MAR, while this would work for margins assessed under a SPAN methodology, it is not generally applicable across the wide spectrum of margining methodologies. For example, it would not work for the many value-at-risk ("**VaR**") based margining schemes, including historical VaR and Monte Carlo VaR. Further, for margining methods that take a range of market moves as inputs, such as SPAN, we believe that the Article is too prescriptive. In particular the requirement in paragraph 2(b) that "*the level of negative price correlation should be at least minus 70% for each pair of financial instruments…where the offsets are allowed*" would rule out many causally related pairs of risk factors and disincentivise their clearing. As one example, inflation swaps and interest rates are structurally negatively correlated, but typically not to minus 70%, and we believe that an offset is proper in this case. Indeed, liquidity and position risk management in the inflation market depends upon the structural relationship between rates and inflation. Instead we would propose that offsets be granted where correlations are stable and the risk factors structurally related.

For VaR based margin schemes we submit the following:

- Historical VaR automatically reflects the co-dependence of risk factors in the loss tails of the distributions, where they are typically higher, so we believe Article 4 MAR is unnecessary where this very conservative margining approach is being used.
- For a Monte Carlo VaR approaches that use a measure of correlation, we would suggest:
    1. That a robust estimator of correlation be used, such as Kendall-Tau;
    2. That a non-Gaussian copula be used to reflect the increased correlation in the tails of the risk factor distributions; and
    3. That the final margin be a linear combination of fully correlated VaR and the sum of VaR margins for each risk factor assessed independently. Using 80% and 20% respectively as weightings in the linear combination would reflect the 80% intent of Article 4 MAR, paragraph 4.

(C) Draft Regulatory Technical Standards and Implementing Technical Standards on Trade Repositories

We support ESMA's approach of requiring the reporting of data at a level of granularity that will enable regulators to fulfill their oversight and prudential functions. We would however propose certain adjustments to the draft RTS and ITS in order to maximise the usefulness of the data, in order for regulators to fulfill their policy objective of systemic risk mitigation.

Global regulators are expected to share some of the data that they will collect in their respective trade repositories. In practice, this will only be useful if these data are expressed in a consistent manner. The Draft Technical Standard specifies a set of data points which, while comparable, are not identical to those specified by other regulators (by way of example, the 'Internationally agreed UTI' (Common Data Table, p. 143), is specified to be of no more than 20 digits (Common Data Table, p. 172), which will make it incompatible with the format that has been adopted by the CFTC as part of its final rules). This will make the sharing and comparison of information by regulators challenging, other than at an aggregated level, and will also lead to increased costs for market participants in complying with differing regimes. We would encourage ESMA to co-ordinate with other regulators globally to ensure that required data points for trade repositories are consistent.

The RTS and ITS make reference to recognised industry data standards in a number of instances, which we welcome. However we submit that to ensure that existing infrastructures are leveraged to the extent possible and that data are provided in a format which will enable ESMA and other European regulators to share comparable information with other regulators, ESMA should leverage existing market terminology and data points are used wherever possible (by way of example, the "Currency of Collateral amount" (Common Data Table, p. 173) is proposed not be expressed using standard ISO Currency Codes, which is not efficient). Further, we submit that free text fields should not be used save where there is no industry standard convention given the lack of uniformity this will necessarily entail and we support the continued development of further standard conventions where this is the case.