INSTITUT DER WIRTSCHAFTSPRÜFER

Institut der Wirtschaftsprüfer
in Deutschland e. V.

Wirtschaftsprüferhaus
Tersteegenstraße 14
40474 Düsseldorf
Postfach 32 05 80
40420 Düsseldorf

TELEFONZENTRALE:
+49 (0)2 11 / 45 61 - 0

FAX GESCHÄFTSLEITUNG:
+49 (0)2 11 / 454 10 97

INTERNET:
www.idw.de

E-MAIL:
info@idw.de

BANKVERBINDUNG:
Deutsche Bank AG Düsseldorf
BLZ 300 700 10
Kto.-Nr. 7480 213

European Securities and Markets Authority
103 Rue de Grenelle
F-75007 Paris

3 August 2012
466/565/541

Dear Sirs

RE: ESMA Consultation Paper "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories" of 25 June, 2012 – ESMA/2012/379

The Institut der Wirtschaftsprüfer in Deutschland e.V. [Institute of Public Auditors in Germany, Incorporated Association (IDW)] would like to thank you for the opportunity to comment on the above mentioned Consultation Paper.

Throughout the development of the current proposals on the regulatory technical standards (RTS), representatives of the IDW have been involved in discussions with both German non-financial counterparties (NFCs) that will be directly affected by measures to regulate OTC derivative contracts and with the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin) who, it seems would likely be designated as the competent authority in Germany (i.e., also with regard to NFCs). We are aware that the BaFin and the German Ministry of Finance (Bundesministerium der Finanzen – BMF) are already considering calling upon the auditing profession to provide services to assist the BaFin with its monitoring duties regarding NFCs (in particular in assessing whether NFCs' reporting to trade repositories was in compliance with the relevant requirements). In this context, and in conjunction with our comment letter dated 20 March 2012 regarding ESMA's Discussion Paper (ESMA/2012/95) in which we had previously responded to selected spe-

cific issues concerning NFCs, we would like to submit some further comments, restricted again to matters relevant to NFCs. Even though Article 12 EMIR stipulates that each Member State is responsible for monitoring and enforcement of the clearing and reporting obligations, already at the EU-level the criteria for establishing which OTC derivative contracts are recognised as objectively reducing risks need to be as clear-cut and unambiguous as possible and the reporting obligations practicable, including from a cost-benefit perspective.

Criteria for establishing which OTC derivative contracts are objectively reducing risks (Annex II – Draft RTS on OTC derivatives, Article 1 NFC)

As stated in our previous letter, we agree with the approach whereby OTC derivative contracts that are objectively reducing risk are to be exempt from the determination whether one of the clearing thresholds is exceeded. In this context, we would, however, like to raise certain concerns:

Acknowledging hedge accounting according to local GAAP

According to Article 1 NFC (1)(c) an OTC derivative contract is considered risk-reducing if it qualifies as a hedging contract pursuant to endorsed International Financial Reporting Standards (IFRS). We note from paragraph 61 on page 15 of the Consultation Paper and in Recital 14 to Annex II – Draft RTS on OTC derivatives that, whilst ESMA recognises an expectation “that most OTC derivative contracts that would qualify as a hedge under local GAAP, would be able to meet the proposed definition of an OTC derivative contract that would reduce risks directly related to commercial or treasury activity of the NFC or that of its group”, ESMA has chosen not to reflect this in the proposed criteria listed in Article 1 NFC. As a result, those NFCs that apply local GAAP as opposed to IFRS are burdened with having to perform significantly more justification work on an individual basis because subparagraph (c) of Article 1 NFC (1) provides “immediate” legal certainty only to NFCs whose financial statements comply with IFRS. In Europe, and particularly in Germany, a significant number of NFCs are thus likely to be disadvantaged, because those NFCs that comply with local GAAP in preparing their financial statements (as opposed to IFRS), will have adopted an approach to hedge accounting in line with their local GAAP rather than with IFRS. It may not be immediately clear whether their specific circumstances meet the criteria in Article 1 NFC (1)(a) and (b), such that they could be open to challenge during enforcement measures, whereas IFRS compliance under subparagraph (c) gives a more or less cut and dry case.

As, pursuant to the EU-IAS-Regulation Member States must only provide that listed companies prepare their group financial statements under IFRS, many unlisted European companies apply local GAAP. However, Member States' local GAAP have to comply with the provisions of the EU-Accounting Directives and therefore are based on "original" EU-legislation. As both IFRS and local GAAP are in line with European law, differentiation in this manner seems questionable, from a legal point of view.

Furthermore, ESMA appears not to have explored whether individual Member States' local GAAP is acceptable in this context. We do not believe that the mere contention in paragraph 61 "It does not refer to local accounting rules *as indeed such local rules could differ*" provides sufficient justification for such differentiation either.

We would therefore like to suggest adding a fourth subparagraph to reflect the expectation in Recital 14 quoted above (i.e., compliance with hedge accounting rules under local GAAP). Alternatively, if ESMA is convinced that differences between local GAAP may be problematical in some cases, the competent authority in each Member State should be permitted to establish whether or not the particular local GAAP in that Member State shall become a fourth such criteria.

Acknowledging macro and portfolio hedging

Diverse risk-mitigation strategies are evident in corporate practice, many of which can be deemed reasonable from both risk-management and commercial perspectives. Nevertheless, not all of these strategies may be recognised as hedge accounting in the financial statements, irrespective of whether IFRS or local GAAP is applicable, because the prerequisites for hedge accounting can often be quite restrictive. The wording of the introductory sentence to Article 1 NFC (1) stipulates that individual OTC derivative contracts may be taken in combination with other derivative contracts. It is less clear, however, as to whether risks may also be viewed in combination. Therefore and in order to have legal certainty, we suggest explicitly including in brackets within the introductory sentence of Article 1 NFC (1) following the words "or in combination with other derivative contracts" macro and portfolio hedging as examples of "qualifying" risk-mitigation strategies.

Further issues

We are concerned that, as proposed, the wording of subparagraph (b) may be overly limited. For example, hedging for fluctuations in share price and commodity price may also need to be added, on the basis that such hedging activities are not necessarily restricted to speculation, investing or trading. For example,

as part of its ordinary course of business a NFC may wish to secure procurement of a particular item needed in production by affecting a take-over of one of its hitherto regular suppliers. It may then seek to hedge any share price fluctuation in relation to this transaction. Such a hedge ought not to be classified as speculation, investing or trading outside the ordinary course of business.

The last sentence in paragraph 60 on page 15 of the Consultation Paper states that “ESMA does not consider that stock option plans can be considered directly related to commercial or treasury financing activities”. We conclude from this that the stock option plan itself is not considered, but that this does not preclude the derivatives used to hedge the stock option plans from being considered directly related to commercial or treasury financing activities. Our reasoning behind this opinion is that if the derivative contracts used to mitigate the share price risk related to employee stock option plans (ESOP) were not considered directly related to the commercial or treasury financing activities, and therefore should not be considered as risk-mitigating, there would be an inconsistency with/contradiction to subparagraph (c), since under IFRS, derivatives to mitigate the risk stemming from ESOPs generally qualify for hedge accounting. We suggest ESMA provide specific clarification in this area to foster consistent application and understanding by both NFCs and enforcement authorities.

The RTS should address the question if and how existing bilateral netting agreements and collateral already posted are considered when determining whether the outstanding OTC derivative contracts exceed the relevant clearing threshold.

Finally, we find it very difficult to appreciate the material difference in the scope of subparagraph (a) and (b).

Risk-mitigation techniques for OTC derivative contracts not cleared by a CCP (Annex II – Draft RTS on OTC derivatives, Chapter VIII)

Determining, reporting and verifying fair values

In our view, certain requirements relating to NFCs are overly zealous, given the fact that only in few cases these entities are likely to engage in OTC derivative contracts of true systemic relevance. Reporting on fair values to trade repositories on a daily basis is likely to be problematical for some, particularly smaller, NFCs, as they will often lack the systems and infrastructure – beyond those needed for their normal financial reporting requirements – to facilitate this without undue expense.

From our experience in auditing financial statements, we know that both the company's determination of, and the auditor's procedures relating to the verification of fair values can be highly complex and expensive. It is widely acknowledged that, when using valuation models, in most cases there is no single "true" fair value, rather a spectrum of justifiable fair values exists for each item. For NFCs not obligated to clear centrally their derivative contracts we do not believe there is sufficient justification for this approach, certainly from a cost-benefit perspective.

Furthermore, it is inconsistent to obligate *all* NFCs to report fair values to a trade repository whereas, according to Article 11(2) EMIR, only those NFCs shall mark-to-market (or mark-to-model) on a daily basis the value of outstanding derivative contracts that have exceeded the clearing threshold(s). This also contradicts the fundamental assumption underlying the chosen EMIR-approach that only NFCs exceeding the clearing threshold(s) represent a systemic risk. Accordingly, there is insufficient justification for obtaining fair values of the outstanding derivatives contracted by NFCs (while) not obligated to clear centrally. We therefore strongly recommend ESMA exclude fair value from the reporting to the trade repositories and restrict the reporting to changes in the contractual terms of the respective derivative contract. Should ESMA, this notwithstanding, adhere to the obligation to report fair values for all NFCs, it should at least clarify whether the regulations in Articles 5 RM and 6 RM also have to be applied by NFCs (while) not obligated to clear centrally.

Timely confirmation

The obligation for timely confirmation of a concluded OTC derivative contract which is not cleared centrally within, at the most, two business days after the date of execution (Article 1 RM) is problematical. From our audit experience as well as discussions with representatives from NFCs we are aware that small NFCs, in particular, may not be able to confirm a contract within such a short timeframe. Since it would not be practicable to enforce such an obligation we suggest significantly extending the confirmation period.

Portfolio reconciliation

We doubt that it is necessary to obligate NFCs to perform a portfolio reconciliation at least once per month (Article 2 RM (4)(b)(i)). The additional benefit of a monthly reconciliation compared to a yearly reconciliation is expected to be small, since NFCs' operational risks originating from derivative contracts is relatively insignificant.

Other remarks

The counterparty of an intragroup transaction which has been exempted from the requirement laid down in Article 11(3) EMIR shall publicly disclose information on the exemption (Article 11(11) EMIR). The information to be publicly disclosed is listed in Annex II – Draft RTS on OTC derivatives, Article 8 RM. According to paragraph 105 on page 21 of the Consultation Paper, the "disclosure could be made through the annual accounts or the website of the counterparty on a yearly basis". We would like to point out that, if the counterparty chooses to disclose the information within the annual accounts[1], according to International Standards on Auditing (ISA) as well as German generally accepted standards for the audit of financial statements promulgated by the IDW the entity's statutory auditor is required to audit this disclosure. We therefore propose that only the counterparty's website be stipulated as the instrument for disclosure.

According to Annex VI – Draft implementing technical standards on trade repositories, Article 6(1), the starting date by which a derivative contract shall be reported to a trade repository shall be the earlier of 1 July 2013, 60 days after the registration of a trade repository or 1 July 2015. NFCs in particular are presently unlikely to have the infrastructure needed to facilitate such reporting and will need time to establish reporting procedures and systems. We therefore propose postponing the reporting start date, at least for NFCs. Such infrastructure is also a prerequisite for any enforcement measures, which may involve competent authorities and possibly the auditing profession.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely

Manfred Hamannt
Executive Director

Norbert Breker
Technical Director
Accounting and Auditing

[1] The term "annual accounts" is defined in the extant 4th EU-Directive. Proposed changes to that Directive include replacing this with the term "financial statements".