



ADVICE TO ESMA

Securities and Markets Stakeholder Group –

Advice on ESMA's public consultation on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

I. Executive summary

The objective of this paper is to provide advice to ESMA on the definition of technical standards and to contribute to achieving the original goals of the financial reforms envisioned by the G20 mandate and the the Regulation on OTC Derivatives, CCPs and Trade Repositories ("EMIR"). Recalling the G20's original goals, the Securities and Markets Stakeholder Group ("SMSG") believes that technical standards should help to achieve those financial reforms objectives, being: Reducing systemic risk through central clearing, ensuring the resilience and safety of Central Counterparties ("CCPs"), strengthening bilateral collateral arrangements, increasing transparency through trade repositories and trading on organized venues and preventing market abuse. This Advice Paper focuses on topics revolving around EMIR technical standards. Given the scope defined above, the key messages the SMSG would like to highlight towards ESMA for consideration in their work going forward regarding drafting EMIR (regulatory) technical standards are:

- Technical Standards should be criteria-based and leave flexibility for market-driven approaches
- New requirements should be phased-in to reduce impact and implementation effort for market participants
- Clearing obligation for OTC derivatives has to be based on clear definitions to ensure legal certainty
- Information requirements for the clearing obligation are disproportionate and not in-line with the approach taken in other jurisdictions for example by the Commodity Futures Trading Commission ("CFTC") in the US
- ESMA should focus on harmonisation of CCP requirements in Europe and ensure the consistent application and enforcement of EMIR standards in Europe
- Ensure international consistency based on principles published by the Committee on Payment and Settlement Systems ("CPSS") and the International Organization of Securities Commissions ("IOSCO") and mutual recognition of European standards by foreign regulators
- CCP Access Criteria for participation should be further strengthened
- Default procedures for CCPs require harmonisation of National Insolvency Regimes

II. Introduction

1. On March 29, 2012 the European Parliament adopted the Proposal for a Regulation on OTC derivative transactions, central counterparties and trade repositories (“EMIR”). The legislation calls ESMA to propose technical standards by September 30, 2012 on various topics regarding the clearing obligation, CCP requirements and trade repositories. ESMA published a first discussion paper on February 16, 2012 inviting comments on several aspects of the draft technical standards. A further consultation paper is planned to be published in June 2012.
2. The objective of this paper is to provide advice to ESMA on the definition of technical standards and to contribute to achieving the original goals of the financial reforms envisioned by the G20 mandate and the EMIR legislation.
3. The EMIR draft (regulatory) technical standards cover a very broad spectrum. In order to provide focused and useful advice, the SMSG dedicates its attention to specific topics. Where for example other supervisory authorities, like the European Banking Authority (“EBA”), are in the lead and e.g. defining standards for capital requirements, the SMSG only alludes to these topics in this advice paper.
4. This paper is organized as follows: Section III recalls the original goals of the G20 mandate and EMIR and develops guiding principles for the technical standards. Section IV highlights important aspects for consideration in defining technical standards and meeting the original objectives of EMIR. The last Section V considers the context of related initiatives relevant to the EMIR implementation.

III. EMIR and the original mandate of the G20

5. In their Pittsburgh declaration in September 2009, the G20 proclaimed the goal to improve the over-the-counter derivatives markets. Specifically, the leaders of the G20 agreed that all standardized OTC derivative contracts should be cleared through central counterparties (CCPs) by end of 2012 and that OTC derivative contracts should be reported to Trade Repositories. Measures to improve the resilience of the OTC derivatives should be targeted to reduce systemic risk, increase transparency and mitigate market abuse on a global scale.
6. In line with the G20 principles, the European Commission published their action plan to ensure efficient, safe and sound derivatives markets in October 2009. It identified a number of recommended policy actions targeted to reducing counterparty credit risk and strengthening clearing, reducing operational risks by standardization, increasing transparency through trade repositories and trading on organized venues as well as improving market integrity.
7. The SMSG supports these principles and welcomes the actions taken to improve the resilience of the OTC derivatives markets. However the implementation of EMIR has to consider efficiency as a further important public policy objective. Therefore a careful consideration of the cost-benefit impact of the technical standards is of paramount importance to avoid harm to the macroeconomic function of the financial system and ensure the global competitiveness of the European financial markets.
8. In implementing the new regulatory framework ESMA should play a key role in (i) defining a robust but efficient set of technical standards, (ii) coordinating a smooth and cost efficient transition to the

new regulatory framework and (iii) ensuring an effective ongoing enforcement of the new standards on a harmonized European basis.

9. The SMSG considers the following aspects to be of critical importance for meeting the G20 mandate:
10. Reducing systemic risk through central clearing:

Systemic risk arises from inter-linkages and interconnectedness in a market or between markets, which could potentially impact or even cause the collapse of an entire market if one market participant were to default or a cluster of failures occurs at once. CCPs are crucial to mitigating systemic risk. Despite the potential failure of individual market participants, CCPs stabilise derivatives markets by acting as shock absorbers that prevent domino effects. CCPs shield off other market participants from any adverse effects and are a cost efficient way for their members to cover tail risks through mutual guarantee fund structures. In the past major bankruptcy cases like Lehman Brothers and MF Global, CCPs have proven resilient. In light of this historical performance, the SMSG believes that the technical standards should contribute to facilitate the central clearing obligation for all standardized derivatives to increase market safety and stability as well as to reduce systemic risk.
11. Ensuring resilience and safety of CCPs:

CCPs reduce counterparty risk by replacing the individual risk of a market participant with the superior credit risk of the CCP. To perform their role, it is critically important that the stability and superior creditworthiness of CCPs continue to be assured. CCPs maintain this stability by running a balanced book at all times, enforcing a strict mark-to-market of all positions and ensuring full collateralization of risk positions, all enhanced by a mutual guarantee structure. The SMSG therefore believes that all CCPs should be subject to the same transparency requirements. In addition they should all have in place robust prudential controls as well as strong risk management and solution plans like those of global systemically important banks. The technical standards are only one aspect of the necessary regulatory requirements to meet this objective. Furthermore, the work by EBA, which has published a Discussion Paper on “Draft Regulatory Technical Standards on the capital requirements for CCPs foreseen by the European Market Infrastructure Regulation on capital requirements for CCPs”, will be a very important component of ensuring the safe operation of CCPs. In relation to transparency requirements, CPSS-IOSCO put forward a disclosure framework for financial market infrastructures which the SMSG recommends as a guideline for European requirements.
12. Strengthening bilateral collateral arrangements:

Despite the efforts to promote standardization, large segments of the OTC markets will continue to have to rely on customized products for their individual hedging needs. The EBA jointly with the ESMA and the European Insurance and Occupational Pensions Authority (“EIOPA”), have issued a discussion paper on regulatory technical standards, which they are required by EMIR to draft jointly, related to risk mitigation techniques for OTC derivatives not cleared by a CCP. The SMSG believes that adoption of appropriate standards will help guarantee that bilateral collateral arrangements are not permitted to impair risk management across the OTC traded derivatives markets.

IV. Are the EMIR technical standards supporting the achievement of the G20/EMIR goals?

13. The SMSG welcomes ESMA's approach to consult market participants and other stakeholders on core definitions and principles of the draft technical standards. Due to the very tight timelines for implementing EMIR, it is important to engage market participants and authorities to identify potential weaknesses and refine requirements in order to meet the targets set by the G20 in an efficient and timely manner. Major areas for technical standards setting are discussed in more detail below.

Technical standards should be criteria-based and leave flexibility for market-driven approaches

14. The SMSG believes that ESMA should pursue a criteria-based approach rather than a prescriptive one in drafting the technical standards. The SMSG therefore recommends that ESMA follows the methodology of the CPSS-IOSCO recommendations. By providing the flexibility necessary for market participants and infrastructure providers to adapt to market developments and avoid unnecessary expense, a criteria-based approach will promote market-driven innovation and competition. Technical standards should promote fair competition and prevent a race-to-the bottom in risk standards. In the context of EMIR, harmonised standards must not block fair and open access between trading venues and CCPs. Such standards must incorporate transparent, proportionate and neutral criteria to ensure that the promotion of competition is not detrimental to the integrity of the market.
15. In particular, the technical standards on risk management should allow CCPs to develop individual risk management approaches for certain asset classes based on specific criteria. CCPs are close to the actual business and have the high degrees of expertise necessary when defining the right risk management approach in consultation with their risk committees. For instance, the SMSG believes it would be a wrongful approach, as currently being considered in the discussion paper for ESMA, to define individual margin coverage percentages for certain asset classes or trying to determine specific margin calculation models.
16. The technical standards must not introduce unnecessary reporting obligations that exceed the original EMIR requirements. An important example that the SMSG would like to highlight is in the interpretation regarding "intragroup transactions" (IGTs). It was stated at the Open Hearing on March 6, 2012, that ESMA considers that (i) IGTs between two counterparties within one group cannot file for a general exemption from the supervisory authorities once in the run-up, but have to notify an exemption with each individual transaction and (ii) IGTs exempted from the clearing obligation are, in contrast to cleared OTC derivative transactions, to be published in addition to the report to a trade repository. Both requirements undermine the actual intention of EMIR legislative text and therefore are to be rejected as unnecessary burden and cost to the industry.

New requirements should be phased-in to reduce impact and implementation effort

17. ESMA is certainly aware of the enormous transformation to current business practices that is implied by EMIR. To avoid needless disruption to the markets and help market participants to better manage their transition costs and reduce the risk of overwhelming CCPs and infrastructure providers, a well-thought-out process of migration to the new regulatory requirements is crucial. The SMSG notes that the CFTC seems to be taking the approach of phasing in its clearing mandate based on the regulatory status of the market participants. As an alternative, ESMA could also consider phased in implementation based on volume thresholds or according to asset classes, tackling for example interest rate swaps first because the clearing services for them are already the most developed, followed later by

equities and commodities. The SMSG further recommends that ESMA provides longer time horizons for moving outstanding bilaterally managed positions into CCPs in order to reduce the operational and market risks of transforming considerable amounts of collateral.

18. It is of crucial importance to provide clarity and certainty about the effective dates for new regulatory requirements as soon as possible. In particular this relates to those new requirements with a substantial market impact such as the clearing obligation and reporting requirements. The SMSG therefore recommends that ESMA clarifies the timeline and approach to phase-in the new standards as soon as possible and includes a proposal in its upcoming consultation on EMIR standards.

Clearing obligation for OTC derivatives: Clear definitions and legal certainty required

19. In general the SMSG believes that a market-driven approach based on setting the right incentives to migrate standardized OTC derivatives to central clearing would be superior to direct intervention. A mandatory clearing obligation raises issues in defining eligible classes of derivatives and subsequently enforcing the clearing obligation, i.e. banning uncleared economically equivalent bilateral transactions. Therefore, it is important to establish clear and exact definitions for those sufficiently standardized derivatives that will be subject to the clearing obligation. Proper economic incentives to promote standardization and central clearing, for instance, in terms of preferential treatment for centrally cleared transactions vis-à-vis financial institutions' capital requirements should naturally be established, but it is vital to preserve market participants' flexibility to conduct bilateral customized OTC transactions. Although not covered in detail in this paper, it is noted that the calibration of capital requirements is discussed further in Basel III and CRD IV consultations and is also addressed by the EBA Discussion Paper.
20. Regarding the proposed clearing obligation (Article 3), the SMSG recognises the challenge to find the right balance in defining the classes of derivatives eligible for a clearing obligation. A definition that is too narrow might lead to circumvention of the clearing obligation by market participants; a definition that is too broad might leave too much ambiguity to be properly implementable and enforceable. The SMSG would like to emphasize that it is of critical importance that ESMA definitions provide legal certainty to the market and do not leave room for interpretation.
21. The SMSG believes that the proposed top-down approach raises significant issues. It remains unclear which contracts could be so systemic they need to be cleared and yet not have the characteristics which would have caused them to be centrally cleared. In addition, CCPs should decide in their own discretion and in coordination with market participants which contracts are suitable for clearing. As a consequence, a top-down approach is not seen as appropriate. Thus ESMA should be very careful in considering a top-down clearing obligation and rely on close consultation with market participants and CCPs.

Information requirements for clearing requirements are disproportionate and not in-line with CFTC approach

22. The SMSG believes that the information requirements for the clearing obligation set forth in the discussion paper exceed the approach taken in other jurisdictions such as the US and will be impractical. For example, depth of orders, tightness of spread and measures of liquidity in stressed markets are not specifically required by the CFTC and will, at any rate, be difficult to obtain prior to the particular swap being subject to a mandatory clearing/trading requirement. No single source may have sufficiently comprehensive information on depth of market prior to it being offered on a trading

facility. Moreover, such information will most likely not even be initially available. In particular, the requirement to provide evidence of the number of transactions, total volume, open interest, depth of orders and tightness of spread may simply not be available for many years. Measures of liquidity for default procedures may not ever be known in advance of an event of default. For these requirements, SMSG recommends that ESMA agrees to accept a flexible level of evidence until the industry gains more experience with reporting and collecting relevant data. SMSG cautions that if ESMA expects hard numbers on these criteria, it may be quite difficult for CCPs to make the requisite showing.

Harmonize requirements and ongoing supervision for CCPs in Europe

23. The SMSG believes that it is among ESMA's core tasks to harmonize CCP requirements in Europe at a safe and prudent level. ESMA should discourage the emergence of national discrepancies which, for instance, are observed as a consequence from the Markets in Financial Instruments Directive ("MiFID") where many rules have been interpreted differently thus opening loopholes and inviting regulatory arbitrage.
24. The development of technical standards should reflect authorisation and supervision of all CCPs by central banks, in consultation with ESMA and other relevant regulators, and should provide for CCP access to central bank liquidity. The technical standards should deliver a sound, effective and consistent level of regulation as well as a supervisory process that is effective in identifying and resolving real regulatory issues in an efficient manner. It must also provide a standard approach to recognising CCPs across the EU, regardless of their location.

Ensure international consistency and mutual recognition of standards

25. In addition to European harmonisation, international consistency is of paramount importance. CPSS-IOSCO published an updated report on "Principles for financial market infrastructures" on April 18, 2012. The report sets new international standards for financial market infrastructures, including CCPs and Trade Repositories.
26. The recommendations define global standards regarding many issues covered by the technical standards for topics such as margining, collateral and liquidity. ESMA should refer to the CPSS-IOSCO standards whenever feasible, ensuring global consistency of the clearing and CCP requirements but not exceeding CPSS-IOSCO standards, for instance, in the areas of liquidity requirements or margining.
27. The SMSG would like to emphasize its view that international mutual recognition must have a high priority for regulators globally. The current wave of new legislation leads to duplicate regulatory regimes for most market participants and market infrastructures despite globally harmonized objectives. Duplicate regulation increases cost, legal risk and compliance complexity. For instance, it should be noted that US legislation does permit US regulators such as the CFTC to exempt a non-U.S. clearing house from the requirement to become registered as a Derivatives Clearing Organization if the CFTC determines that the non-U.S. clearing organization is subject to comparable, comprehensive supervision and regulation by the appropriate government authorities in the home country of the organization. Despite this authorization, neither the CFTC nor the Securities Exchange Commission have proposed rules or a procedure to permit a non-U.S. clearing house to qualify for this exemptive treatment, which is in contradiction to the approach pursued in EMIR. The SMSG strongly endorses all efforts by ESMA and the European Commission to limit extraterritoriality of foreign regulations for European market participants and to achieve mutual recognition of European regulation.

CCP Access Criteria for participation to be strengthened

28. The criteria used by CCPs to grant access to clearing members are key components of CCPs' risk management policies. As such, ESMA could make suggestions in respect to the minimum criteria to be used by CCPs for granting clearing members access, while allowing them to maintain the necessary flexibility to address the CCPs' different needs. In this respect, the suggestions made by CPSS-IOSCO in their recommendations for CCPs provide the appropriate levels of guidance for CCPs to determine the access criteria. In addition, ESMA should require CCPs to report regularly on their monitoring of the compliance function of participants. While there should be a requirement for CCPs to monitor their clearing members' compliance with participation requirements, however ESMA should not be advocating any wider regulatory or supervisory role for a CCP over its clearing members.
29. While drafting recommendations with respect to the systemic importance of clearing members is not in ESMA's mandate, this issue is a central point for the stability of financial markets. The default of a clearing member acting for a commensurate number of clients may disrupt the overall functioning of the European financial markets. It is a crucial issue which although not addressed by the Regulation, should be further investigated by regulators and policy-makers.

Default procedures for CCPs require harmonisation of National Insolvency Regimes

30. The absence of a harmonisation across the EU constitutes one of the main difficulties for CCPs to manage default risk and implement the necessary default procedure. The lack of a harmonized default insolvency regime creates difficulties for CCPs, especially where there are interoperability arrangements, as CCPs must interpret – and in part operate with respect to – the different national legal frameworks for bankruptcy or similar issues. Furthermore, default is not defined in an identical manner amongst Member States. Therefore, while it might be difficult for ESMA to propose at this stage a harmonised definition of what is to be considered as a default, ESMA could nonetheless highlight this problem and suggest the establishment of a mapping of current default regimes in the EU, for the purpose of Article 42 of the Regulation.
31. ESMA in addition to its suggested standards, with respect to the default procedure for the purpose of Article 42 of the Regulation, should further clarify the obligations of CCPs regarding the protection of the clients of the defaulting clearing member. The two alternative solutions are the following: Either the CCP is required to protect its non-defaulting members before any other objectives (i.e. will not perform any actions that could negatively affect the clearing fund), as the current wording of Article 42 of the Regulation suggests, or the CCP is required to establish the appropriate procedures to protect the clients of the defaulting clearing member in order to ensure an as prompt as possible return to normal of the EU financial markets. Accordingly, the segregation of client accounts (both cash and securities accounts) would be needed, in order, notably, to assure the timely transfer of these clients to another clearing member.
32. In any case, ESMA should suggest, as a complement to the default procedure currently set out in Article 42 of the Regulation, that clearing members should be required to keep an updated list of their clients and communicate it either directly to the CCP upon the event of a default or to the relevant regulatory authority upon the event of a default. This would enable these clients to be contacted and informed promptly by the CCP in case of their clearing member's insolvency or default. This would increase the transfer capacities of these clients.

33. Cross-margining provides valuable benefits to clearing members and their customers but it is important to ensure that this practice is not detrimental to the risk management function of CCPs. Accordingly, while restrictions on cross-margining should not be adopted, ESMA could adopt standards specifying that, CCPs should be required to demonstrate that the liquidation of positions and transfer of portfolios for which there is cross-margining would not thereby be impeded and at the same time that the CCPs' liquidation horizon and associated margins always are to be fully aligned. In addition, the development of technical standards in this area should not frustrate future provisions (for example in the upcoming MiFID II) for fungibility of collateral and margin-offsetting.
34. This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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