Response of RWE Supply&Trading GmbH (RWEST) to the consultation of ESMA's "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories" of 25 June 2012 (ESMA RTS).

RWEST welcomes the opportunity to comment on the ESMA RTS. RWEST appreciates that ESMA has partly addressed its concerns with regard to the definition of hedging (by also including proxy hedging) and the clearing threshold (by raising the level of the clearing threshold). However, RWEST would like to take the opportunity to explain below its remaining concerns in respect of the clearing obligation for non-financial firms. In this context RWEST makes proposals which would also avoid regulatory arbitrage and establish a level playing field on the global derivative market by aligning the EU rules with the rules already adopted by the U.S. CFTC.

1) Avoidance of unintended clearing cliff-edge

RWEST strongly opposes the idea that crossing a threshold in one asset class would trigger clearing (and thus margining requirements) in other asset classes and for other entities as well. This would have a severe impact on (especially) the commercial hedging treasury- and foreign exchange activities of non-financial firms by creating a clearing 'cliff-edge' resulting in a significant liquidity squeeze on non-financial firms. This additional financial liquidity will need to be funded which is increasingly difficult at a reasonable cost in the current market environment and will divert resources from other productive (investment) activities. RWEST therefore strongly advises ESMA to ensure that crossing the threshold in one asset class would only trigger mandatory clearing of the transactions relating to that specific asset class. This approach is based on the wording of EMIR "that non-financial counterparty shall …clear all **relevant** future contracts…" The relevant contracts are belonging to the OTC derivative asset class in which the non-financial firm has breached the clearing threshold. Furthermore, this approach is also stipulated by EMIR in recital 31 that the "values of the clearing thresholds […] are determined taking into account the **systemic relevance** of the sum of the net positions and exposures […]". It should be acknowledged by ESMA that only those classes of derivatives where the clearing threshold is breached could be considered as systemic relevant. Furthermore, Art. 10 EMIR refers to consequences of a breach of "the" threshold, not "one of the" thresholds. Finally, this approach would be more aligned to the U.S. approach (CFTC rules) to limit the clearing obligation for derivatives of the asset class or classes where the threshold was exceeded;[1]

For the same reasons ESMA should make clear that the breach of a threshold by one non-financial entity of a corporate group should not lead to an obligation for the entire corporate group to clear all of its OTC derivatives. EMIR provides that: "Where a non-financial counterparty takes positions in OTC derivative contracts and those positions exceed the clearing threshold as specified under paragraph 3, **that** non-financial counterparty shall […] clear all relevant future contracts […]". EMIR stipulates in Article 10 (3) that the clearing

[1] See CFTC / SEC, l.c., p. 574: "*A person that is a major swap participant shall be deemed to be a major swap participant with respect to each swap it enters into, regardless of the category of the swap or the person's activities in connection with the swap. However, if a person makes an application to limit its designation as a major swap participant to specified categories of swaps, the Commission shall determine whether the person's designation as a major swap participant shall be so limited.*"

threshold is a group threshold in order to avoid the loophole that positions in OTC derivatives are allocated across several entities which then can stay below the threshold. The intention of this provision was not to make the entire corporate group subject to the clearing threshold in respect of all of its OTC derivatives.

A breach of threshold in a single asset class by a single non-financial entity should not force an entire corporate group to clear all its positions in this asset class or in any other OTC derivative classes which do not contribute to increasing systemic risk for the group. In favour of this approach speaks also the fact that if that single entity were a financial firm its obligation to clear its derivatives would not lead to the result that the entire corporate group has to clear its derivatives; the clearing obligation applies in this case only to the financial firm. It would be a unjustified discriminatory result if the clearing obligation would apply to the entire group in the first case (breach by non-financial group entity) and not in the second case (breach by financial group entity).

2) Discounting certain transactions in the calculation of the clearing threshold

The ESMA RTS should clearly stipulate which kind of transactions are not to be taken into account in the calculation of a firms' position. To be consistent with recital 31 of EMIR, risk mitigation techniques already applied by the non-financial counterparties should be considered in the calculation of the clearing threshold ("[…] recognise the methods of risk mitigation used by non-financial counterparties"). In this context RWEST would like to stress the importance to provide coherence with the U.S. CFTC rules. Therefore, RWEST would prefer to adopt certain features of the U.S. approach, for example to recognise netting agreements. In our opinion the following transactions, respectively, positions should be discounted:

- All transactions falling within the scope of the definition of OTC derivatives contracts objectively reducing risks pursuant to Art. 1 NFC of the ESMA RTS (see also point 3 below).
- All transactions traded over regulated venues (Regulated Markets).
- All transactions, concluded over regulated venues or on OTC markets which are voluntarily cleared. Obviously, those transactions are already centrally cleared, their underlying credit risk is sufficiently mitigated, and they are, therefore, irrelevant for the clearing threshold.
- Positions which are to be netted under netting agreements (see also point 4 below).
- Collateralised derivatives positions; this would be consistent with the rules of the U.S. CFTC which considers that collateralised derivatives are under certain circumstances completely exempted from the calculation of the threshold. Other derivatives which are subject to daily mark-to-mark margining (or are cleared by a CCP) are assigned a multiplier of 0.2 resp. 0.1.[2]
- Any intra-group derivative transaction once the general exemption for these transactions has been granted to a non-financial firm (see also point 5 below).

3) Acknowledge macro and portfolio hedging as risk mitigating

RWEST is concerned that certain risk management practices of non-financial firms might not be covered by the definition of "objectively measurable as mitigating risk related to the commercial and treasury finance activity" as laid down in Art. 1 NFC (Annex II) of the

[2] See CFTC / SEC, l.c., p. 584 et seq.

ESMA RTS. While ESMA so far explicitly considers proxy hedging as risk mitigating according to the definition mentioned above, RWEST miss an unambiguously statement that this applies also to macro and portfolio hedging as well as to the common practice of closing derivative positions by entering into another derivative. This would be in line with the ongoing discussion in the International Accounting Standards Board (IASB) to provide a extended approach regarding macro hedging in the forthcoming IFRS 9 which could be applied also by non-financial companies. Furthermore, e.g. German accounting rules (so called “Bewertungseinheiten”) already recognize these strategies as risk-mitigating. If not, many companies would risk that at least a part of their derivatives is not qualifying as risk-mitigating although, from an economic point of view, they are. As a consequence these derivatives may fall into the category “speculative”, “trading” or “investing” and may have to be included in the calculation of the clearing threshold.

4) Calculation of clearing threshold on the basis of netted positions

RWEST has a strong preference of basing the clearing threshold on a netted figure. Such an approach is more representative of the risk carried by firms. It better reflects the wording in Article 10 (4) (b) of EMIR, where it explicitly states that the clearing threshold “shall be determined taking into account the systemic relevance of the sum of **net** positions and exposures […]”. Therefore, RWEST thinks that the ESMA RTS are not in line with the text of EMIR on this point. The ESMA RTS should limit the positions relevant for the calculation of the clearing threshold to the “net notional amount per class of OTC derivatives”. In addition, this would be coherent with the rules of the U.S. CFTC which acknowledge netting agreements.

According to ESMA, the main reason for favouring a “gross” above a “netted” threshold is that the former would – especially for smaller companies – be easier to calculate and implement. Calculating netted exposures is undertaken as a matter of the normal business of all firms and, therefore, cannot be used to justify a gross approach.

5) Intra-group transactions to be excluded from counting towards clearing threshold

Intra-group transactions do not have an effect on the market and they should be more clearly excluded from counting towards i) the clearing threshold, ii) any requirement for clearing in the event a non-financial firm breaches the clearing threshold, iii) any reporting requirements and iv) any additional risk mitigation requirements. Although part of the draft regulatory standards for intra-group transactions still have to be drafted by the ESAs (EBA, EIOPA and ESMA), these transactions should not be brought within scope of any EMIR requirements, as doing so would provide no reduction in (systemic) risk but would lead to significant additional and unnecessary costs for non-financial firms.

6) Separate commodity derivatives from “other” derivatives

The market has developed a variety of hybrid products combining elements of different asset classes, e.g. cross currency interest rate swaps, which are very useful from a treasury perspective as they can reduce the numbers of transactions necessary for tailored risk-mitigating needs. Nevertheless, it remains unclear in which category these instruments are captured. If these derivatives have to be counted together with commodity derivatives, the threshold amount for this category should be higher than proposed. Otherwise, two separate thresholds for “commodity derivatives” and “Other OTC derivative contracts” should be introduced.

7) Deletion of definition of speculation, investing or trading

In contrast to Art. 1 NFC (2) of the ESAM RTS, RWEST does not see any reason / or benefit to define what in fact constitutes speculation, investing or trading. EMIR does not refer to these concepts when defining which contracts are objectively measurable as reducing risk directly related to the commercial or treasury financing activity. Also, there is no mention of these concepts in the Level 1 text of Article 10 of EMIR, so ESMA has no mandate to define these terms. Also, these concepts are rather fluid and vague and no commonly accepted definitions of those concepts exist, so that it would be quite difficult for regulatory authorities to apply those terms and they are hardly justiciable. For these reasons, the reference to speculation, investing or trading should be deleted. It is sufficient to determine if an OTC derivative is objectively reducing risks or not.

8) Supervision of implementation by non-financial firms

RWEST assumes that ESMA and/or Member States are also implementing a supervision mechanism in order to ensure that the clearing obligation is appropriately applied by non-financial firms, in particular that the calculation of the firms positions is aligned to EMIR and the ESMA RTS. For the benefit of the regulatory authorities, corporates and their stakeholders RWEST would recommend to keep this supervision process as lean as possible. It is imaginable that regulatory authorities might be entitled to order special audits to be executed by external auditors on an infrequently and occasional basis. Furthermore, such audit makes no sense for small and medium sized firms as well as firms of larger corporate groups which are unlikely to breach the clearing threshold, so that for such an audit obligation a de-minimis rule should be applied.

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