Vorstand

SAP AG
Dietmar-Hopp-Allee 16
69190 Walldorf
Deutschland
T +49 6227 7-47474
F +49 6227 7-57575
www.sap.com

esma
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SAP AG, Dietmar-Hopp-Allee 16, 69190 Walldorf

ESMA
CS 60747
103 Rue de Grenelle
75345 Paris Cedex 07
France

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Dr. Werner Brandt
Executive Board Member
Chief Financial Officer
T +49 / 6227 / 7-41208
F +49 / 6227 / 78-35403
E werner.brandt@sap.com
http://www.sap.com

Use: Derivatives on stock, employee stock option programs

Dear Sir or Madam,
SAP welcomes the opportunity to comment ESMA's "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories".

As market leader in enterprise application software, SAP helps companies of all sizes and industries run better. The company's applications and services enable customers to operate profitably, adapt continuously, and grow sustainably. Nearly two thirds of the world's transaction revenue touches an SAP system. The company's customers include more than three quarters of the Global Fortune 500. As of 31.12.2011, SAP's revenue stood at €14.2bn with approximately 61.000 employees.
We very closely follow the regulatory initiatives regarding the OTC-derivatives market as we are concerned that the regulation might have negative side-effects on derivatives used by non-financial companies for risk-mitigating purposes. Although we appreciate that the specific needs of non-financial companies are partially acknowledged, we nevertheless think that ESMA should take more care in order to not impair the risk management of non-financial companies.

Please find below a brief overview of our main concerns. ***For a detailed analysis of the draft technical standards we refer to the joint position of DAI, BDI and VDT which we fully support.***

1) Acknowledge macro and portfolio hedging as risk mitigating

We are concerned that certain risk management practices 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). While ESMA so far explicitly considers only proxy hedging as risk mitigating, we miss an unambiguous statement that this applies also to macro and portfolio hedging. E.g. we use macro hedging for the management of our employee option programs. They form an important part of our incentive and remuneration scheme, as SAP provides the right to our employees to participate in option programs. The programs do have a global set-up and are spread throughout hierarchy levels. The option programs ensure that we can recruit suitable candidates and retain important employees. Also, as most of our competitors are US-based and it is common for our US competitors to use employee option programs, providing option programs is essential for us. Given the structure and volume of the programs, most of them are set-up as a "call spread" where we do have a "basis value" and a cap. Increasing stock prices in our share are beneficial for our employees, however create expenses for SAP as an employer, which we hedged in the past and continue to do so at present. Given their specific structure it is necessary to have the flexibility to hedge the programs with our core-banks but with no extra administration.

2) Consider the closing of open positions by reverse derivatives as risk mitigating

We also think that it is very important that ESMA takes into account that derivatives which are entered into on the basis of a planned exposure might turn out to be superfluous ex post if markets move other than primarily expected. Against the background of cost efficiency it is common practice not to terminate the contract but to close this open position by a reversing derivative entered into with another financial counterparty. As the values of both derivatives compensate each other they are risk neutral for the non-financial company. Nevertheless, they are lacking the respective underlying business and bear therefore the risk to not qualify as risk-mitigating. To avoid this obvious misunderstanding we strongly advocate a clarification in the technical standards that the fact whether a derivative is considered as risk mitigating should be determined at the time the derivative is entered into and should take into account the overall risk management strategy of the non-financial company. This would be in line with the rules already adopted by the US-CFTC. We also think it is necessary to clarify that the calculation of the clearing threshold refers to the net notional amount per class of OTC derivatives. This would take into account rec. 31 EMIR which states that the setting of the clearing threshold should refer to the "sum of net positions and exposures per counterparty and per class of OTC derivatives".

3) Align the clearing threshold with already adopted US rules

Although we appreciate the progress made by ESMA in defining the clearing threshold we would like to stress the importance to provide coherence with the US rules. Firstly, a global level playing field on OTC derivative markets should aggravate regulatory arbitrage. Secondly, the approach adopted by the US CFTC takes the specifics of non-financial companies more appropriately into account. Therefore, we would prefer to adopt certain features of the US approach, e.g. regarding the possibility to be determined as clearing eligible for one asset class only, to adjust the nominal value to certain risk multipliers and to recognise netting agreements. We also think that already cleared or bilateral collateralised derivatives should be exempted from the calculation of the clearing threshold or at least be treated in a special manner.

4) Daily reporting of market values

We are very concerned that ESMA proposes to oblige all market participants to daily report the market value of their derivatives. We, as a non-financial-corporation, do not practice a daily mark-to-market of our portfolio as our audit proof third-party provider would charge us additional fees and such a daily or weekly evaluation would not create any benefit for us as evaluation for us is helpful at month end in our closing processes only. We also think that the requirement to daily mark-to-market is not covered by EMIR which states that only the "details of any derivative contract they have concluded and any modification or termination of the contract" should be reported. A market value which is calculated and updated on a daily basis could logically not be such a contract detail.

Furthermore, Art. 11 para. 2 EMIR explicitly exempts non-financial companies not exceeding the clearing threshold from the obligation to daily mark-to-market value the outstanding contracts. In addition, ESMA prefers the notional value as method to calculate the clearing threshold by substantiating that referring to the market value would be too complex for companies. Against this background we do not understand why ESMA proposes to introduce the obligation to daily mark-to-market "through the backdoor".

Taking these arguments together, we strictly oppose the proposed reporting requirement as not coherent with EMIR. At least non-financial companies not exceeding the clearing threshold should be exempted from the daily market value reporting.

5) Required risk mitigating techniques should be proportionate

Although we understand the importance of sound risk mitigating techniques we advocate that the proposed technical standards should be adjusted to take adequately into account the specifics of non-financial companies. As our derivatives precisely serve the purpose of mitigating risks we do not see the benefit from applying such ambitious techniques which solely increase the administrative burden for us. This applies especially for the proposed confirmation period which should be extended from two to four days to reduce our administrative burden. We also think that the duty to reconcile the portfolio at least once a month would be very costly without bringing an additional benefit. Therefore, in our view it is justified that non-financial companies not exceeding the clearing threshold should be allowed to reconcile their derivative portfolio once a year (e.g. as part of the annual audit).

We would welcome the opportunity to discuss the above further with you and remain at your disposal.

Yours sincerely,

Dr. Werner Brandt