DACSI 12-1106

Remarks on EMIR technical standards

Response to the ESMA consultation paper "Draft technical standards for the Regulation on OTC derivatives, CCPs and Trade Repositories" of 25 June 2012

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DACSI (the Dutch Advisory Committee Securities Industry) is the principal not-for-profit association in The Netherlands for firms active in the securities industry. The association represents the interests of its members as users/clients of infrastructure providers in the field of securities, e.g. exchanges, central counterparties, central securities depositories. With 12 members, DACSI represents the vast majority of the banks active in The Netherlands, and positions the Dutch view to the market infrastructure service providers and the regulatory authorities in The Netherlands and the European Union.

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Thank you for the opportunity to comment on your consultation paper "Draft technical standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories". We hope that our contribution can add to the finalisation of the technical standards on the various issues addressed in the paper and are of course more than prepared to provide further detail and explanation on particular items when helpful.

As we represent the interests of our members as users/clients of infrastructure service providers in the field of securities, we have restricted our comments to those parts of the paper that are most relevant in this perspective and where we think a remark might be helpful.

General issues

- II Introduction recital 7
  What is the result of the discussion with the European Commission regarding an application date subsequent to the date of endorsement

  III.II Clearing obligation procedure

- The focus in this chapter is classes of OTC derivatives, is there another clearing obligation procedure in place for other financial instruments (set out in points (1) to (3) of Section C of Annex I to directive 2004/39/EC as implemented by article 38 and 39 of Regulation (EC) No 1287/2006.

Remarks on individual issues

Section III – OTC Derivatives

1. Indirect clearing arrangements (provisions III.II, Annex II Ch II - art. 1-4 ICA).

As rightfully stated in article 4 ICA under 7 (page 67) the potential conflict of interest between the clearing member and its client which offers indirect clearing services, should be properly managed. To our opinion the paragraph should be made more specific. For example there should be a Chinese Wall between the activities of the clearing member for clients offering indirect clearing activities and the acquisitions activities of the clearing member for new clients. Adequate safeguards should be in place that information regarding indirect clearing arrangements (including information about the clients of the client offering indirect clearing) remains with the staff of the clearing member responsible for these indirect clearing arrangements.The first sentence of article 7 could be deleted because in the framework of an indirect clearing arrangement it is the responsibility of the client of the clearing member to manage the counterparty risk of the indirect client.

2. A clearing member shall be required to facilitate indirect clearing arrangements on reasonable commercial terms. These terms shall be publicly disclosed by the clearing member.

new text proposal

2. A clearing member shall be required to facilitate indirect clearing arrangements on reasonable commercial terms. These terms shall be disclosed on request of a client or a prospect.

explanation: It is not a common practice to disclose publicly commercial terms.

9. a client that provides indirect clearing services shall request the clearing member to open a segregated account at the CCP.The account shall be for the exclusive purpose of holding the assets and positions of its indirect clients. The client shall not be required to disclose information on individual indirect clients to the clearing member, except for the purposes specified in paragraph 7 or in the event of default. In the event of default, all information held by a client in respect of its indirect clients shall be made immediately available to the clearing member.

new text proposal :

9. a client that provides indirect clearing services shall request the clearing member to open a segregated account at the CCP. The account shall be for the exclusive purpose of holding the assets and positions of its indirect clients. The client shall not be required to disclose information on individual indirect clients to the clearing member, except in the event of default. In the event of default, all information held by a client in respect of its indirect clients shall be made immediately available to the clearing member.

explanation :
There is no direct legal relation between the clearing member and an indirect client, it should be the responsibility of the indirect client and its clearing provider (direct client of the clearing member) to open "direct" accounts at clearing member level (equivalent manner as direct client with an individual account at the CCP level).

It is not the responsibility for the Clearing member to manage the counterparty risk arising from indirect client arrangements, this is the full responsibility for the direct client of the Clearing member.It is the choice of a client to open an arrangement with a direct client of a clearing member, part of this legal arrangement should be the protection of the positions for these indirect clients in case of a default of this direct client. This issue can't be managed by the clearing member but should be part of the oversight and the authorisation of a direct client.

2. Public register (provisions III.III, Annex II Ch V – art. 1 PR).

As we understand the public register will contain the classes of OTC derivatives subject to the clearing obligation. It would be important for market participants to know as well the classes of OTC derivatives which are notified by competent authorities to ESMA for obligatory central clearing and when that has happened. This because these transactions could fall under a future central clearing obligation.
Not necessarily this publication should be done in the public register. A separate timely publication by ESMA easily available to market participants would be sufficient. This publication could be combined with the public consultation as meant in article 5 EMIR if this consultation starts shortly after the notification of the competent authority has been received by ESMA.

3. OTC derivatives for hedging purposes and clearing threshold (provisions III.V, Annex VII –).

Art. 1 NFC criteria for establishing which OTC derivative contracts are objectively reducing risks

To prevent confusion and for making a clear distinction of responsibilities of non financial parties and their financial counterparties, we would prefer a paragraph clearly stating that it is the non financial party's responsibility to monitor its derivatives positions (for example on whether these are hedge positions or not) and whether the non financial party exceeds (one of thesix) thresholds.

Art. 2 NFC Clearing threshold

e. EUR 3 billion in notional value for commodity derivative contracts and other OTC derivative contract not defined under (a) to (d)

new text proposal

e. EUR 3 billion in notional value for commodity derivative contracts
f. EUR 3 billion in notional value for other OTC derivative contract not defined under (a) to (e)

Explanation : there is clear definition for a commodity derivative contract so don't mix this with other not defined derivative contracts.

4. Timely confirmation (provisions III.VI, Annex II Ch VIII – art. 1 RM).

The time required for a confirmation can differ considerably depending on the type of transaction and market participants involved. In particular small and medium sized market participants (which would include a significant portion of market participants falling under the definition of financial counterparty, in particular small and medium sized banks) will have a significantly less developed infrastructure (human resources, system capacity, etc.) for the processing of transactions and thus will generally require more time for processing transactions.

Furthermore, small financial and non-financial counterparties with a limited range of derivative exposure should not be forced to implement and perform a confirmation process through electronic platforms. In any event, the benchmarks set by highly sophisticated market participants and in relation to simpler transactions should not set the standard for all confirmations (electronic or non-electronic).

Lastly, the time limit proposed under Article 1 RM para. 2 appears to be based on benchmarks set by these highly sophisticated market participants and in relation to simple transactions and thus cannot be applied to all market participants and in relation to all types of transactions (in particular bespoke transactions). Against this background, a limit of 5 days would be more realistic and ensure higher quality and efficiency of the confirmation process with regard to non-electronic confirmation of less sophisticated market participants. We therefore suggest the following amendment of Article 1 RM para 2 (addition in bold and italic):

2. An OTC derivative contract concluded with a financial counterparty or a nonfinancial counterparty that meets the conditions referred to in Article 10(1)(b) of Regulation (EU) No xxxx/2012 [EMIR] and which is not cleared by a CCP shall be confirmed, where available via electronic means, as soon as possible and at the latest by the end of the same business day. ***In case of non-electronic confirmation the OTC derivative contract should be confirmed at the latest by the end of the fourth business day following the business day of the transaction.***

5. Intragroup exemption (provisions III.VI, Annex II.VIII – art. 7 RM)

Intra-group transactions are often used for central monitoring of the risks related to the derivatives transactions (back to back transactions). It is important that the requirements for using the intra-group exemption don't hamper this important function.
Many experts expect that as a result of non-compatible regulatory regimes (for example based on Dodd Frank or EMIR) many financial institutions will split their present global derivatives business in regional centres of competence (subsidiaries). In that case, the importance of back-to-back transactions as an instrument for central risk management will even increase.

Often group entities work on a consolidated basis and are guaranteed subsidiaries. No exchange of collateral takes place in relation to the back to back transactions. We assume that regarding the conditions these transactions have to comply with, the very internal (Group) character of these transactions will be taken into account.
Regarding the public disclosure requirement of an intra-group exemption we don't understand article 8 under d (page 78). The notional aggregate amount of the OTC derivative contracts under the intra-group exemption will vary in the course of time related to the development of the derivatives business. We assume that we do not have to constantly publish the new notional aggregate amount. This wouldn't have added value.
We also assume that this paragraph doesn't mean that there will be a maximum notional aggregate amount for which the intra-group transaction exemption applies.

Section IV – CCP Requirements

1. outsourcing & organisational requirements (provisions IV.III)

According to provision 133, a CCP should maintain its own human resources for all of the CCPs functions. However, outsourcing arrangements are possible provided the CCP retains full control over the outsourced function and manages conflicts of interest (art 1 ORG).

We are questioning whether the outsourcing applies to technical requirements only or also extends to staff / human resources.

Also, a start-up CCP will be put at a competitive disadvantage compared to already established CCPs if it is required to establish a full-blown organisation structure from the start.

It is not clear to us what the purpose is of "a CCP shall provide incentives to its clearing members to manage and contain the risks they pose to the CCP" (*Section IV organisational requirements, article 2 Risk management and internal control mechanisms (page 93) par).*
What kind of incentives shall be needed (fees?) and what principles (ratings?) should be used in order to implement these incentives.

2. margin requirements (provisions IV.VI, Annex III Ch 7/11)

- Article 1 COL, paragraph 1 in conjunction with paragraph 3 (b) (i) and paragraph 3 (b) (ii) seems to imply that e.g. stocks cannot be accepted as collateral, whereas this could be allowed according to paragraph 2 of Article 46 of EMIR. This is also in line with current practices at many CCPs.

- Article 1 MAR, 1.: It is not clear why there are different confidence intervals for OTC derivatives and other financial instruments. The 99% should also be used for OTC derivatives, because depending on the definition of 'OTC derivatives' it would be feasible that derivatives traded OTC and centrally cleared by the CCP that are also identical and fungible with derivatives traded on-exchange would be treated differently. This would not make sense because such position can be traded out on exchange.

- Article 2 MAR, 1. The detailed prescription of historical volatility seems inappropriate for the following reason:
a) The inclusion of the most stressed market conditions during the last 30 years in (b) means effectively that the latest 6 months in (a) can be neglected;
b) The inclusion of the most stressed market conditions during the last 30 years in (b) means that stress testing and its results becomes far less important.

- Article 3 MAR 1.: It is not clear why there are different time horizons for OTC derivatives and for other financial instruments. Also, depending on the market covered by the CCP, the positions of the defaulting clearing member etc. it is feasible that the liquidation period can even be 1 day.

- Article 4 MAR
This article is not understandable. Furthermore, a detailed prescription of percentages as given would lead, together with other MAR articles, to very similar models used by CCP thus increasing systemic risk.

- Article 5 MAR
This article as well as Article 3 COL, 3. seems to imply that in some way margin requirements are to be somehow limited from above (i.e. some sort of maximum), instead of from below. Rather e.g. one should select a minimum price movement for the underlying of a stock option also in less volatile times so that the increase in more volatile times will be less extreme. Capping margin requirements from above for derivatives could rather be dangerous.

In summary, in our view the technical standards should not prescribe the input of the margin requirement calculation models, but rather define minimum standards for the output. i.e. prescribing confidence intervals and time horizons for the liquidation period and the calculation of historical volatility should be sufficient.

3. default waterfall (provisions IV.IX)

Under EMIR a CCP needs to use first its own financial resources before an application to the clearing fund can be made. We oppose to hold separately in its balance sheet, an amount of dedicated own resources for the purpose set out in Article 45(4) of Regulation (EU) No xx/xxxx [EMIR]. It will endanger the proper functioning of the CCP in a likely distressed period and it is unsure whether a CCP would be still regarded as a credible institution knowing that it needs to recapitalise itself for more capital resources with its shareholders. Also, the article does not foresee in measures if shareholders are unwilling or unable to make additional capital contributions to the CCP during that time.

4. capital requirements CCP (provisions IV.IX, Annex III – art. 1DW)

Article 1 DW prescribes that the amount of a CCP's own dedicated resources to be used before the default fund contributions of the non-defaulting clearing members must be at least 50% of the capital including retained earnings and reserves.

This percentage seems unnecessary high and can potentially result in destabilising an otherwise well-functioning CCP. Please note also shareholders cannot be forced to pay in more capital whereas default fund contributions can be prescribed by the CCP rules.

What do we want, higher margins or higher default fund contribution (page 30).
Page 31, point 96, page 105. Confidence interval of OTC derivatives should at least be 99,5% and 99% for other products (also see article 41, paragraph 1 of EMIR). Is that acceptable for us?

5. Collateral requirements.

If there a possibility of the use of central bank guarantees, to our opinion this should be accepted by CCP's and clearing members for fulfilling collateral and default fund obligations or even be preferable. The Central Bank will issue a guarantee for the obligations of the clearing member or (direct or indirect) client of a clearing member. The beneficiary will issue a counter guarantee secured by collateral deposited with the Central Bank.
Important advantages of using central bank guarantees are adequate segregation of assets (deposited with the Central Bank), better safeguards for portability, mitigating concentration risks on clearing members and CCP's and efficient use

of collateral because of the pooling of this collateral with the Central Bank.
We would appreciate ESMA specifying in the proposed standards its view regarding the use Central Bank guarantees.

Section V - Trade repositories

1. reporting obligation (provisions V.I)

Regarding page 46, under provision 259, clarification would be needed regarding the determination if a contract is crossing the clearing threshold resulting in an obligation to centrally clear.

The consultation paper clarifies that transactions, eligible for central clearing, between financial institutions will be mandatory centrally cleared without any need to consider thresholds. However transactions eligible for central clearing between financial institutions with non-financial institutions will only be mandated to be novated into CCPs if the clearing threshold related to the non-financial counterparty is crossed (while transactions are also not exempted because they are, provision 56 (section III.V), page 14, "objectively measurable as reducing risks related to the commercial activity...").

If crossing the threshold is to be calculated by aggregating transactions in the same asset class it has to be noticed that the financial institution as the counterparty of the non-financial institution is not able to do this aggregation because 1. The non-financial counterparty can have entered into similar trades with other financial institutions or 2. The non-financial counterparty can be part of a holding structure with other legal entities also engaged in similar trades. The responsibility to evaluate whether there is an obligation to centrally clear the transaction can therefore only be with non-financial counterparty.

More clarification would be needed regarding the calculation method for deciding if a threshold is crossed; which transactions (of which time-period) within the same asset class have to be aggregated and does the threshold have to be applied towards a single non-financial counterparty or is the threshold to be applied to the aggregated trades of all counterparties belonging to the same group.

annex II draft regulatory technical standards on OTC derivatives

Chapter I Articles 2 definitions (1)

(1) indirect client means the client of a client of a clearing member

new text proposal

(1) indirect client means an undertaking with a contractual relationship with a client of a clearing member

explanation : the new text is full in line with the definition of client

Annex V Draft regulatory technical standards on trade repositories

Annex 1 to regulatory technical standard on the details to be reported to trade repositories Article 9 of EMIR

Table 1 Counterparty Data

row 2 field C/P ID the reporting counterparty shall be identified by a unique code or, in the case of individuals , by a client code

Please give a definition of individuals and include this definition in Article 2 Definitions of Annex V