THE INVESTMENT ASSOCIATION

REPSONSE TO THE EUROPEAN COMMISSION EMIR REVIEW

Lobbying number: 5437826103-53

Introductory Comments

It is widely acknowledged that fulfilment of the G20 directive to mandate central clearing of derivatives where practicable has added to Central Counterparties (CCPs) systemic significance. (They can be thought of as *market infrastructure* Systemically Important Financial Institutions (SIFIs)). The Financial Stability Board and G20 policy-makers have rightly taken steps to address the risks to financial stability and other public policy objectives, should a SIFI get into difficulty and fail. Indeed, the Commission's work-plan for 2015 includes a legislative proposal on CCP recovery and resolution.

The Investment Association believes that there are two implications for the EMIR review. First, the review is an opportunity to develop the EU's capacity to deal with a threat to the viability of a CCP. Secondly, and more generally, it is important that the forthcoming legislative proposal on CCP recovery and resolution aligns with EMIR post any amendments resulting from this review (suggesting that the legislative proposal should not be made before the EMIR review is completed).

We believe that the power to suspend mandatory clearing at a CCP (or for a class of OTC derivatives mandated for clearing at that CCP) in emergency situations when clearing is no longer appropriate should be available to the authorities. Such a tool would most obviously be helpful to address a crisis threatening the viability of a CCP (and as a recovery and resolution tool), but should also be available for use in other extraordinary situations where clearing ceases to be appropriate. For example, suspension should be available to the authorities in the event that:

- a CCP notifies ESMA that the liquidity of a class (or contracts within a class) has deteriorated to such an extent that it is difficult for the CCP to manage the risk.

- the liquidity of the class (or contracts within a class) becomes materially less than the basis on which ESMA originally determined the relevant class subject to mandatory clearing.

Suspension of the clearing service for a class of OTC derivatives mandated for clearing at a CCP in an emergency situation (or, in worse crises, of all clearing at the affected CCP) might be essential to enable the market and the authorities to deal with the difficulties in question. There seems no obvious downside to giving the relevant EU authorities this power (e.g. through augmenting Article 24, emergency situations).

PART I

Questions on elements of EMIR to be reviewed according to Article 85(1)(a)-(e)

QUESTION 1.5: CCP Margins and Collateral
(a)
i. Is the spectrum of eligible collateral appropriate to strike the right balance between the liquidity needs of the CCP and its participants?
ii. If your answer to i. is no, for what reasons? How could it be improved?

No we do not consider the range of eligible collateral is sufficient to meet the liquidity needs of buy side market participants.

CCPs continue to demand only cash Variation Margin (VM), so the rationale for exempting Pension Scheme Arrangements (PSAs) from the clearing obligation – that it is inappropriate to oblige pension funds to post cash VM – remains valid. The Commission's recent report[1] on Article 89 concedes that it would be unreasonable to oblige PSAs to post cash VM and we endorse this conclusion. In particular, the report notes that the exemption was designed to avoid forcing PSAs to "*hold cash reserves instead of higher yielding assets*" and thereby reducing "*the total amount paid out by the PSAs as retirement income*".[2]

Ideally, non-cash VM should be permitted more generally, if "haircut" appropriately to the collateral posted, but we recognise the significant operational challenges this would pose to CCPs. Existing legislative restrictions on the ability of fund managers to convert fund assets to cash for use as VM make cash-only VM requirements even more challenging. For example, *ESMA's Guidelines on ETFs and other UCITS issues* has significantly impaired UCITS' ability to access cash via repurchase agreements (repos). Furthermore, as PSAs must use securities financing transactions (repo) to convert fund assets to cash for use as VM, the eventual VM requirement for PSAs must take into account the challenge to PSAs in times when SFT markets are stressed or malfunctioning.

Pension funds are typically fully invested and minimise their allocations to cash to reflect the long-term nature of their pension fund obligations and therefore to generate long-term returns. Mandatory clearing for pension funds would therefore introduce significant new liquidity and transformation risk as they would be forced to meet VM calls by either liquidating existing investments at very short notice (1 day) or attempting to repo their assets. This is a new risk for pension funds as they have previously been able to post VM in the form of high quality government bond securities.

Pension funds would not have the ability to manage this liquidity risk in stressed market conditions. This is exactly when central clearing is meant to provide stability to the financial system. Only central banks can provide the ability to mitigate liquidity risk in these

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[1] *REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL under Article 85(2) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, assessing the progress and effort made by CCPs in developing technical solutions for the transfer by pension scheme arrangements of non-cash collateral as variation margins, as well as the need for any measures to facilitate such solution (link), published on 3 February 2015*

[2] *Compare with page 11 of the EC report*

circumstances. Unlike banks, and to some extent CCPs with the recent developments, pension funds do not have access to central bank liquidity as the liquidity provider of last resort.
This new liquidity risk will potentially have wider market implications. It applies additional stress on a repo market that is already shrinking as a result of bank capital regulations. It potentially exacerbates downward pressure on falling asset prices in stressed market conditions as pension funds sell out of their physical assets (such as bonds and equities) in order to meet the cash VM calls. All this, we believe, conflicts with EMIR policymakers' objective of reducing risk and avoiding pro-cyclicality.

We, therefore, call for an extension of the exemption granted by Article 89 for a further three years (renewable) when the current exemption expires. Indeed, following the logic of the Report to the Commission would require that the exemption remain in place until such time as it ceased to be unreasonable to oblige PSAs to post cash VM – potentially indefinitely.

QUESTION 2.2

(b)(i) Are there any other significant ongoing impediments or unintended consequences with respect to preparing to meet clearing obligations generally in accordance with Article 4 of EMIR?

(b)(ii) If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Frontloading:

The frontloading requirement should be removed for all future classes of derivatives deemed subject to the clearing obligation

The Investment Association believes that the frontloading requirement creates significant pricing and market risk management challenges, particularly where bilateral collateral terms differ from CCP collateral terms, which can impact financial stability. It also creates significant challenges for EU counterparties pricing trades in the absence of counterparty classification information especially when trading with non-European counterparties. Thus we believe that the obligation should be removed for all future classes of derivatives declared subject to the clearing obligation.

We support the response by ISDA in relation to Frontloading under question 2.2 b ii.

Portfolio Compression:

We believe ESMA should exclude from the clearing obligation and the margining of uncleared derivatives any replacement trades and amendments to trades (which could include notional increases or decreases) that result from portfolio compression and other post-trade risk reduction exercises. As a starting point, ESMA could define 'portfolio compression' as contained in Article 2(47) of MIFIR, which states:

'portfolio compression' means a risk reduction service in which two or more counterparties wholly or partially terminate some or all of the derivatives submitted by those counterparties for inclusion in the portfolio compression and replace the terminated derivatives with another

derivative whose combined notional value is less than the combined notional value of the terminated derivatives.

It should be noted, however, that while compression can result in some derivative transactions being reduced and terminated or terminated and replaced, compression can also (i) result in fewer transactions, without any reduction in notional amounts, for example, in the case of a compression re-couponing exercise or, (ii) involve the addition of new trades, which reduce counterparty credit risk.

ESMA should also define 'other post-trade risk reduction services' such that components of non-price forming post-trade risk reduction services which reduce non-market risks in derivatives portfolios shall mean only components of a compound transaction where:

- the transaction is designed to be overall market risk neutral for each participant;
- the participants of the transaction do not submit bids and offers to enter into a specific position;
- the transaction is cycle-based and multilateral (e.g. including at least two participants), and must be accepted in full by all participants or it will not be effected; and
- the transaction is designed to reduce secondary risks emerging from existing derivatives transactions, such as counterparty credit risk, operational risk and/or basis risk.

We support the response by ISDA in relation to compression under Question 2.2 (b) (ii).

PART II

General Questions

QUESTION 2.3: TRADE REPORTING

i. Are there any significant ongoing impediments or unintended consequences with respect to meeting trade reporting obligations in accordance with Article 9 of EMIR?

ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

The Investment Association wishes to raise two issues that its members believe should be considered as part of the Commission's review - single-sided reporting and the backloading of historic closed trades. These are considered below in turn.

A. Single-Sided Reporting (SSR)

The key objective of the reporting obligation imposed by EMIR and derivatives reform legislation in other jurisdictions in response to G20 commitments to improve the transparency to regulators of derivatives trading and thereby enable better monitoring of risk in the financial system, both domestically and internationally.

Although the focus of the G20 commitments from 2009 with regard to derivatives was the OTC, with no mention of the respective merits of dual-sided or single-sided reporting, the regime imposed in Europe both extends to exchange-traded derivatives and requires both counterparties to report. We believe the primary motivation for Dual-Sided Reporting (DSR) is a perception that it improves data quality; we also understand that some competent authorities have suggested that it can assist with dispute identification and resolution.

We would suggest, however, that the present DSR regime has failed to deliver the anticipated data quality and, indeed, has produced a huge amount of data that regulators will struggle to aggregate in any meaningful way in order to achieve the goals of the G20. Indeed, this was evidenced in ESMA's December 2014 consultation paper on MiFID II/MiFIR (ESMA/2017/1570), in which it noted in paragraph 118 the poor quality of the data available from the trade repositories. Insofar as dispute identification and resolution is concerned, counterparties have other more effective means - trade confirmation and reconciliation (the latter being undertaken regardless of whether or not it is mandated). DSR has placed unnecessary and disproportionate demands on counterparties' resources to examine and resolve reconciliation breaks in the data reported to trade repositories when no dispute surrounds the actual outstanding trades.

Data Quality under the DSR Regime:

Under the present DSR regime, the reports from each counterparty need to be paired and matched in order that they are not double-counted. However, the current legislation leaves much to interpretation in terms of how to report various trade scenarios. In addition, the differing levels of sophistication among counterparties means that trade data can be captured and stored in different ways - in particular some counterparties' systems will capture the individual components of complex trades, while others do so in their bundled form; as such neither party is able easily to report in alignment with the other, although the trade economics and other details are agreed. Added to this, the present lack of a globally endorsed approach to the generation and exchange of unique trade identifiers continues to hinder the pairing of some counterparties' trades.

DSR at individual trade level also generates a huge number of reports, especially with exchange-traded derivatives in which end of day positions may reflect the execution of many individual trades during the day. The number of records generated has posed significant challenges to firms and trade repositories alike in the processing of such huge qualities of data, much of which is repetitive (two views of the same transaction) and arguably of limited value (intra-day position movements)

The explicit provision for delegated reporting was an attempt to ease some of the above challenges and, indeed, does overcome the UTI and many of the matching issues. Many Investment Association members have elected to delegate to the sell-side dealers the reporting they would otherwise undertake on behalf of their clients (the client being the actual trade counterparty). However, inconsistencies in the way different dealers report, either because of differing interpretations of the requirements or the ways in which their various systems capture and report the trades, has made it difficult and costly for investment managers to oversee and validate the reporting undertaken on their behalf.

Nonetheless, with delegated reporting the same economic trade data is submitted in both reports (albeit with certain information "flipped"), so ultimately does not improve the quality of the data held at the trade repository.

DSR as an Aid to Dispute Resolution:

As noted above, we understand that some competent authorities perceive that DSR can assist with dispute resolution. We believe, however, that at best it duplicates what is achieved by way of other EMIR obligations in relation to non-cleared trades (Article 11) and similar market practices employed for cleared trades; and at worst it adds unnecessarily to the reconciliation/resolution burden.

Switching to a SSR Regime:

The Investment Association believes strongly that adoption of a single-sided reporting (SSR) regime would:

(a) improve the quality and value of the data available to, and therefore reduce costs for, regulators as it would no longer require de-duplication of the data submitted by the two counterparties in order to understand the outstanding risk in the system;

(b) reduce the operational complexity of the current DSR regime for counterparties and trade repositories alike, thus reducing their costs; and

(c) release less sophisticated counterparties from the reporting burden altogether.

Although considerable cost has already been sunk in attempting to make DSR work, we believe significantly more would be necessary under DSR, both in systems development and oversight, still with no guarantee that the benefits envisaged by the regulators will accrue. We believe SSR can deliver the necessary data quality more cost effectively to both regulators and market participants and that the costs of switching to SSR would be considerably less than will be required to make DSR work effectively.

SSR Reporting Framework:

We recognise that a key question when considering SSR, under which one counterparty alone would have the obligation to report, is on which party that obligation should fall? In order to address this we have worked closely with a number of other trade associations[3] across the market to develop a blueprint for a reporting framework that avoids the obligation as far as possible for less sophisticated participants, such as buy-side clients and NFCs.

We take the opportunity to articulate the blueprint below, but please note that in the interests of simplicity we focus on how it would operate from the perspective of the asset management community that we represent and the clients, such as investment funds and pension schemes, on whose behalf they trade (and typically report under the current DSR regime). Note that we do not consider here in detail additional aspects that do not impact our members, but do support the representations made by our fellow trade associations which will be more detailed in those respects.

A. Cleared trades

In the case of cleared trades (both exchange-traded and OTC), the CCP alone would be obliged to report to trade between itself and the clearing member. The clearing member

[3] ISDA, MFA, AIMA, BBA, GFMA, FIA Europe and The Investment Association

similarly would have sole obligation to report the associated trade between itself and the client.

In a situation where the CCP or (in the case of the client-side trade) clearing member were located in a third country, the obligation would need to sit with the other counterparty that was subject to EMIR. It should still be possible for the reporting to be delegated to the non-EEA counterparty in these circumstances, albeit the EEA counterparty would retain accountability for the reporting undertaken on its behalf.

B. Non-cleared trades

- Step 1 - trading with a non-EEA counterparty

  In keeping with the recommendation above with regard to cleared trades, where only one counterparty is subject to EMIR, that counterparty would have the obligation to report.

  Again, it should be possible for the EEA counterparty to delegate the reporting activity to the non-EEA counterparty, while retaining accountability for the reporting undertaken on its behalf.

- Step 2 - bilateral agreement

  Where both counterparties are subject to EMIR, it should be possible to determine the reporting obligation by way a bilateral agreement between them to identify clearly that one would always be the reporting counterparty in any trade between them.

- Step 3 - clear seniority of one counterparty

  The obligation to reporting would be established in the first instance by the "seniority" of the counterparties, broadly as follows:

  ⇦⇦ More sophisticated------------Less sophisticated ⇨⇨

Investment Firms/ Credit Institutions	Other Financial Counterparties and portfolio managers*	Non-Financial Counterparties

  As such, where an investment firm or credit institution (A) traded with any other type of financial or non-financial counterparty, including another investment firm acting on behalf of a client in the course of portfolio management activity (i.e. an investment manager), "A" would always have the obligation to report.

  ** In the portfolio management scenario, the investment manager's client would be the actual counterparty to the trade and therefore the entity that is subject to EMIR. The client may itself be an investment firm or credit institution, but the obligation to report would still fall upon "A" under the above determination unless the client had agreed otherwise with A as described in step 2.*

- Step 4 - non-cleared trades between counterparties of similar status

  Investment managers represented by this Association would invariably be trading for their clients with investment firms or credit institutions and as such would not need to look beyond step 3 above. Nonetheless, further logic is proposed to address situations that will arise in the inter-dealer space, following based upon a "tie-breaker" system already established by ISDA to assist in other jurisdictions that have SSR regimes today.

As this additional logic would not impact our members, we leave it for ISDA and other associations to expand on the detail, which we support fully.

Regulator Assurance:

We are conscious that an additional objective of DSR beside the quality of the data reported for each trade might be to provide comfort (at least where both counterparties are subject to EMIR) that all trades have been reported. There is a fear among our member firms that any move to SSR would be associated with an obligation on the non-reporting counterparty to undertake a full daily reconciliation of their trades to what is reported by the other counterparty and resolve any differences identified. This would require a solution that was at least as complex as they have today, perhaps more so given that different counterparties might report to different trade repositories.

If such assurance is of genuine concern to regulators, we would welcome further discussion on potential solutions to deliver an appropriate level of comfort without imposing a disproportionate burden upon the non-reporting counterparty.

B. Backloading of Historic Closed Trades

Article 9 of EMIR determines the reporting obligation such that it extends to all trades open on or after entry into force (16 August 2012). As such, the current Level 1 text requires that backloading be addressed, and to that end the trade reporting Implementing Technical Standards (ITS) determine that where a trade had been open at any time while EMIR has been in force, but was closed before the reporting start date (RSD), it must be reported within 3 years of the RSD, i.e. before 12 February 2017.

The backloading obligation represents a significant challenge for reporting entities, given the availability of data to meet the reporting requirements (which, indeed, are likely to change before the 2017 deadline[4]). Moreover, that some counterparty entities may no longer exist and counterparties that remain will not have considered the allocation of common UTIs at the time of the trade will prevent any meaningful pairing and matching of the data submitted to trade repositories, thus limiting its value. Nor will it be comprehensive at trade level in view of the guidance provided by ESMA in its Q&A (response to TR Question 4) that where a counterparty reported at position level, it was expected to report only the position still outstanding at the RSD.

We do not believe competent authorities have any intention to use the data from backloaded trades and, indeed, suspect that with hindsight Article 9 might have been drafted differently today (we understand, for example, that the backloading obligation under the forthcoming Securities Financing Transactions Regulation will be limited to transactions that are outstanding at the RSD and have a minimum remaining maturity of more than six months).

We therefore propose that EMIR be revised so that the reporting obligation would apply only to trades outstanding on or after the RSD.

[4] ESMA consultation paper 2014/1352 - Review of the technical standards on reporting under Article 9 of EMIR

We recognise that it is unlikely any changes to EMIR could be brought about before the current backloading deadline in February 2017. However, we note that the present deadline is imposed by the ITS that ESMA has proposed to revise[4] with a view to implementation during 2016. We therefore propose as an interim measure that Article 5(4) of those ITS also be amended to extend the deadline for the backloading of closed trades sufficiently to allow time for the Level 1 text to be revised.

QUESTION 2.4: Risk Mitigation Techniques

i. Are there any significant ongoing impediments or unintended consequences with respect to meeting risk mitigation obligations in accordance with Articles 11(1) and (2) of EMIR?

ii. If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

We would also highlight some interpretive issues with obligation to mark to market under Article 11(2). The definitions of 'mark-to-market' and 'mark-to-model' are unclear in the Level 1 text, leading to further lack of clarity in Level 2. The apparent obligation on all FCs (regardless of size) to independently value positions or, if 3rd parties are employed, for the FC's board to independently approve 3rd party models, seems unrealistic. 3rd party valuation methodologies remain proprietary information, and developing methodologies in-house, particularly for complex derivatives, is disproportionately expensive. Whilst firms have sought clarification from relevant Member State regulators on this issue, and the Investment Association has developed Best Practice materials, we believe this process offers an opportunity to reconsider the language to ensure consistency across firms and jurisdictions.

QUESTION 2.6: Cross-Border Activity in the OTC derivatives markets

(a) With respect to activities involving counterparties established in third country jurisdictions; are there any provisions or definitions within EMIR that pose challenges for EU entities when transacting on a cross-border basis?

EU counterparties trading with non-EU counterparties established in, or subject to the rules of, an Article 13(2) equivalent jurisdiction should be able to elect which set of equivalent rules would apply to a particular trade between them. This flexible, pragmatic approach would allow for situations where EU firms entered into transactions with counterparties that are obliged to comply with another ruleset – for example, where an EU counterparty trades with an entity designated as a US person but also subject to EU rules, the entity would need the ability to choose to apply US rules.

The lack of substantive convergence between the rules of different jurisdictions and the absence of equivalence determinations will act as an incentive to market participants to focus their trading activity in their local markets and further catalyse market fragmentation. This will likely result in increased trading costs due to liquidity fragmentation, loss of market efficiencies and ultimately damage to the real economy. We do not believe this is an intended policy outcome and is not in the best interests of Europe's end-investors.