Frankfurt am Main
18 September 2014

ESMA Consultation Paper on Clearing Obligation under EMIR (no.2, ESMA/2014/800)

BVI[1] gladly takes the opportunity to present its views on the consultation on the clearing obligation under EMIR (no 2).

We would like to make the following comments:

Question 1: Do you have any comment on the clearing obligation procedure described in Section 1?

We agree with ESMA`s proposal to group, to the extent possible, the analysis of the notified classes of OTC derivatives in a minimal set of consultation papers.

As mentioned in our previous positions to the clearing obligation under EMIR, it is crucial that Central Counterparties authorized by the National Competent Authority (NCA) have to offer at least one segregation model which allows all market participants (e.g. UCITS/AIF) to clear OTC products without breaching European investment fund law regulation (please see also our answer to question 6).

Question 2: Do you consider that the proposed structure for the untranched index CDS classes enables counterparties to identify which contracts are subject to the clearing obligation as well as allows international convergence? Please explain.

We agree in principal with the proposed structure for the untranched index CDS classes enabling counterparties (UCITS/AIFs) to identify the classes which are subject to the clearing obligation.

According to the European investment fund regulation (UCITS directive (2009/65/EG)), UCITS using a CDS contract are not allowed to receive a loan in a case of a credit event by a CCP (as a consequence of a credit event for which neither an auction settlement nor a cash settlement takes place). Loan delivery is not acceptable for UCITS as loans are not eligible assets.

The investment fund management company acting on behalf of the contractual UCITS has to agree with the counterparty on a provision which is different from the ISDA Credit Derivatives Definitions before concluding a CDS contract. In case of physical settlement the ISDA rules provide only a loan as a deliverable obligation. In order to avoid a delivery of a loan, cash settlement should be available to a UCITS. ISDA published “Additional Provisions”[2] which shall apply to UCITS for which the parties have agreed via a side letter.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 82 members manage assets in excess of EUR 2.2 trillion in retail funds, institutional funds and asset management mandates. As such, BVI is committed to improving the overall conditions for investors, while at the same time promoting a level playing field for all investors across all financial markets. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. (BVI’s ID number in the EU Transparency Register is 96816064173-47). For more information, please visit www.bvi.de.

[2] ISDA developed the „Additional Provisions relating to Credit Derivatives Transactions entered into between a Restricted Delivery Party and a Market Counterparty where Physical Settlement” applies: http://www2.isda.org/search?headerSearch=1&keyword=Additional+provisions

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Furthermore, we propose that ESMA clarifies with the NCAs that UCITS are allowed to apply a physical settlement as deliverable loan obligation.

If the UCITS acts as protection seller, it is obliged under the physical settlement provision to pay the agreed notional and to accept from the protection buyer a loan initially granted by a third party to the underlying of the CDS. The UCITS manager can either sell the loan or could file the claims under the insolvency proceeding related to the underlying. In both cases the UCITS would face a similar situation to a cash settlement.

It is unlikely that UCITS will seek protection against the default of an entity where loans are the only deliverable obligations in case of a fallback physical settlement. In the case that UCITS would be obliged to purchase a loan for a delivery to the protection seller, UCITS would not participate in the performance of the loans as it is to be delivered directly to the protection seller.

The alternative of a separate CDS-subclass for clearing could hinder investment fund management companies to access and clear CDS contracts in an efficient way. We fear that a CCP would clear CDS contracts which do not provide for special settlement terms which apply to only one of the counterparties within the clearing value chain.

Furthermore, ESMA should take into account the prevailing market standards for untranched index CDS applied by CCPs. The current market structure for untranched index CDS classes is also used by the confirmation platforms. The usage of the current market standards will guarantee that the introduction of a new contract within a class will be considered by all relevant market participants (UCITS/AIF) in the same way, avoiding any misinterpretation and mishandling of those contracts.

Question 3: In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to credit OTC derivatives? Given the systemic risk associated to single name CDS, would you argue that they should be a priority for the first determination as well? Please include relevant data or information where applicable.

We agree with the proposed approach.

Question 4: Do you have any comment on the analysis presented in Section 4.1?

We support the analyses made by ESMA. However, the client clearing offerings provided both on the level of the CCPs and of the clearing members are not sufficiently broad enough in comparison to the infrastructure of the interest rate derivative market. We fear that the limited client clearing offerings could cause bottleneck situations as all clients (UCITS/AIF) need to set up legal and operational arrangements with the CCPs and the clearing members at the same time.

Therefore, CCPs and clearing members offering client clearing arrangements should be capable to establish and set up the new clearing links to the investment fund management companies over time. The buy side has to rely on the willingness and the capability of the clearing members and the CCPs to set up the clearing arrangements in time, particularly in cases where only one CCP or a small number of clearing members offering client clearing models.

Question 5: Do you agree with the proposal to keep the same definition of the categories of counterparties for the credit and the interest rate asset classes? Please explain why and possible alternatives.

Yes, we agree with the assessment.

Question 6: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

We strongly agree with ESMA`s proposal that the date of the application for Category 2 (e.g. UCITS/AIF) should be set at eighteen months from the entry into force of the RTS on the clearing obligation. The phase-in period could be extended to further six months. Regulated investment funds need sufficient time to set up new legal and operational arrangements with the clearing members and the CCPs.

For example, the assessment and the implementation of the segregation requirements for regulated investment funds take additional time as fund managers have to analyze the complex and different clearing framework agreements by the CCPs, including whether the agreements comply with the European investment fund law. The terms “individual client segregation” and “omnibus client segregation” are not clearly defined which leads to the consequence that each CCP develops, interprets and offers its own segregation model to the financial industry.

Question 7: Do you consider that the proposed approach on frontloading ensures that the uncertainty related to this requirement is sufficiently mitigated, while allowing a meaningful set of contracts to be captured? Please explain why and possible alternatives compatible with EMIR.

We agree with ESMA`s proposal that only contracts entered into during Period B should be subject to frontloading under some conditions. However, ESMA should develop a balanced approach considering an efficient phase-in approach for Category 2 (UCITS/AIF) and a reasonable implementation time for the frontloading requirement. Furthermore, we would expect that contracts concluded and terminated between on or after the publication in the Official Journal of the RTS and the date on which the clearing obligation takes effect (the date of application) do not need to be frontloaded in a CCP due to that fact they do not create any counterparty or systemic risk.

Question 8: Please indicate your comments on the draft RTS other than those already made in the previous questions.
Question 9: Please indicate your comments on the Impact Assessment.

We have no comments.