MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

August 5, 2012

Via Electronic Submission: www.esma.europa.eu

European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris France

Re: ESMA Consultation Paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

Dear Sir or Madam:

Managed Funds Association[1] welcomes the opportunity to provide comments to the European Securities and Markets Authority ("**ESMA**") in response to its Consultation Paper on "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories" (the "**Consultation Paper**").[2] MFA strongly supports the final Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivative transactions, central counterparties and trade repositories ("**EMIR**") as an important step towards central clearing of over-the-counter ("**OTC**") derivatives, increasing market transparency and reducing systemic risk. In particular, we applaud the mandatory inclusion of client representatives on central counterparty ("**CCP**") risk committees[3] and the requirement that CCPs offer both "omnibus" and "individual client" collateral segregation arrangements.[4] We also appreciate ESMA's efforts in the Consultation Paper to draft regulatory technical standards ("**RTS**") that further these objectives and mandates. In this spirit, MFA is providing comments on the Consultation Paper in this letter and in an accompanying letter on straight-through processing ("**MFA STP Letter**") in the hope of assisting ESMA in finalising RTS ("**Final RTS**") that will: (i) enhance CCPs' operation and governance; (ii) increase clearing certainty and the protections and information provided to clients; (ii) ensure consistent and effective global regulation of the OTC derivatives markets; and (iv) facilitate EMIR's implementation in an efficient and workable manner.

[1] Managed Funds Association ("**MFA**") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

[2] Available at: http://www.esma.europa.eu/system/files/2012-379.pdf.

[3] *See* Article 28(1) of EMIR.

[4] *See id*., Article 39.

I. Client Representation on CCP Governing Bodies

MFA strongly believes that clients[5] should have affirmative representation on CCP governing bodies. Clients are crucial stakeholders in the derivatives markets in that they: (i) collectively represent, for most derivatives asset classes, a significant portion of the outstanding risk and open interest; (ii) have interests that are highly aligned with the EMIR core goals of mitigating systemic risk conjoined with increasing transparency, efficiency and competition; (iii) have sophisticated derivatives product and risk management expertise; (iv) have significant knowledge about the issues market participants encounter when seeking direct and indirect clearing membership and access to best execution; and (v) can act as a counterbalance to historically aligned and concentrated dealer interests. Thus, MFA strongly supports the EMIR provisions that: (i) promote CCP accountability and transparency;[6] (ii) require participation of clients in the risk committees of CCPs;[7] (iii) affirmatively limit the representation of any group on CCP committees to a percentage lower than a controlling majority;[8] and (iv) require CCPs to invite client representatives to meetings of the CCP's board of directors ("**Board**") for matters relating to transparency, segregation and portability.[9]

As a result, MFA applauds ESMA's efforts to improve client protections and we support the RTS that require CCP governance arrangements to include processes for ensuring accountability to stakeholders.[10] We believe that the Final RTS should secure these protections by including the anti-circumvention measures described below.

First, to ensure that the EMIR transparency requirements apply where necessary, the Final RTS should include a broad anti-circumvention provision[11] that obliges the Board and other CCP governing bodies to refrain from making decisions regarding CCP governance and

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[5] By "clients", we mean those entities that undertake a contractual relationship with a clearing member that enables them to clear transactions with the relevant CCP.

[6] *See* Article 26(7) of EMIR, which requires CCPs to, *inter alia*, make their governance arrangements available to the public free of charge.

[7] *See id.*, Article 28(1), which requires CCP risk committees to include representatives of clients as well as clearing member representatives and independent directors.

[8] *See id.*, which provides that none of the groups represented on CCP risk committees will have a majority.

[9] *See id.*, Article 27(2), which requires client representatives to be invited to Board meetings for matters relevant to Articles 38 (Transparency) and 39 (Segregation and portability) of EMIR.

[10] *See* Consultation Paper at 92, Article 1(3) ORG (organizational requirements) of the Commission Delegated Regulation supplementing EMIR with regard to regulatory technical standards on requirements for central counterparties ("**CCP RTS**"), which requires a CCP to define its organizational structure and the policies, procedures and processes by which its Board and senior management operate, and which specifies that key components of CCP governance arrangements shall include processes for ensuring accountability to shareholders; and at 96, Article 4(2) ORG of the CCP RTS, which requires the Board to assume the responsibility for the accountability to the shareholders, owners, employees, clearing members, clients and other relevant stakeholders.

[11] This anti-circumvention provision should be similar to the provision in Article 11(12) of EMIR, which provides that the risk mitigation obligation under Article 11 shall apply to OTC derivative contracts entered into between third country entities that would be subject to those obligations if they were established in the EU where such obligation is necessary or appropriate to prevent the evasion of any provision of EMIR.

operations with the intention of circumventing any EMIR client protection or transparency requirement, and to actively consider the interests of all stakeholders, including clients, in providing clearing services and managing the CCP.

Second, MFA is concerned about the possibility that the Board or CCP risk committee may delegate its decision-making authority to one of their respective subcommittees that does not reflect the EMIR balanced governance provisions applicable to Boards[12] and risk committees.[13] As a result, we believe that amending and expanding the RTS, which currently states that "[b]oard approval shall be required for material decisions of its sub-committees that could have a significant impact on the risk profile of the CCP",[14] to provide expressly that the Board has the ability to review and overturn a decision of any CCP subcommittees on any subject matter, would provide protection against such risk and an appropriate general anti-circumvention mechanism. Such a provision would also be consistent with general corporate governance principles, the CPSS-IOSCO Principles[15] and other RTS.[16]

Third, the Final RTS should guard against circumvention of the EMIR transparency requirements by requiring CCPs to give client representatives and CCP independent directors rights to attend all meetings of all CCP governing bodies, including subcommittees, if such meetings deal with matters that directly affect clients' interests (*e.g.*, changes to margin valuation models or methodologies, material changes to a CCP's design or operation or changes to a CCP's risk profile, including changes to its risk management framework or default fund arrangements). Although we recognize that EMIR requires each CCP to act fairly and in the best interests of its clearing members and clients,[17] we are concerned that without such a mandate, the Board or a CCP committee (other than the risk committee) may nonetheless make material decisions without adequately taking into account clients' views. We submit that measures that enhance client representation and participation will foster the transparency of, and confidence in, CCPs, balance the decision-making process and help to mitigate and improve the effective resolution of conflicts of interest.

Fourth, although MFA thinks that it is implicit that all members of CCP governing bodies should have fiduciary duties to the CCP, applicable law or CCP constitutional documents may not provide for such fiduciary duties. Thus, we submit that ESMA should expressly set out the

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[12] *See* Article 27(2) of EMIR, which requires that at least a third of the Board shall be independent directors.

[13] *See* supra note 8.

[14] *See* Consultation Paper at 96, Article 4(4) ORG of the CCP RTS.

[15] *See* "Principles for Financial Market Infrastructures" by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions, April 2012 ("**CPSS-IOSCO Principles**"), at 30, available at http://www.bis.org/publ/cpss101a.pdf, which provide that Board approval should be required for material decisions, including the introduction of new products, implementation of new links, use of new crisis-management frameworks, adoption of processes and templates for reporting significant risk exposures, and adoption of processes for considering adherence to relevant market protocols.

[16] *See* Consultation Paper at 93, Article 2(3) ORG of the CCP RTS, which requires the Board to assume final responsibility and accountability for CCP risk management.

[17] *See* Article 36(1) of EMIR.

existence of these duties in the Final RTS to reinforce the alignment of interests between governing body members and the CCP and to further mitigate potential conflicts of interest. Such duties may include (but not be limited to) obligations: (i) to exercise independent judgment; (ii) to avoid conflicts of interest; (iii) not to accept benefits from third parties; and (iv) to disclose an interest in a proposed arrangement.

II. Transparency of CCP Governance and Operations

MFA strongly supports the RTS related to transparency, including the requirement that a CCP must publish, free of charge, information concerning its governance arrangements, rules, design and operations.[18] Such transparency is particularly important in light of the limited client representation within CCP governing bodies.

To ensure the Final RTS's efficacy, MFA recommends that ESMA expand the "processes for ensuring accountability to stakeholders".[19] First, ESMA should require a CCP to make publicly available minutes of its governing bodies' proceedings to the extent it would not be prejudicial to business secrets. Second, the Final RTS should oblige a CCP to disclose the identity of the members of its Board, other CCP governing bodies, the risk committee and other significant Board subcommittees. Lastly, we request that ESMA mandate disclosure of CCP ownership interests held by the CCP's directors, senior management and other CCP governing body members, including the members of any Board committee.

Since clients and other stakeholders will not have representation on all CCP governing bodies, such transparency is particularly important in respect of matters that may have a direct or indirect material effect on their respective interests. For clients, such matters include, for example, the selection of derivatives contracts for clearing as well as material changes to a CCP's design, operation,[20] margin models or methodologies, risk profile and arrangements with its clearing members.[21] More extensive disclosure is also necessary to ensure the transparency of any concealed bias in a CCP's decision-making process and to improve market participant's ability to identify and monitor interlocking governance arrangements[22] and conflicts of interest.

Given ESMA's desire to ensure consistent global regulation, we note that mandating the foregoing level of transparency is consistent with the CPSS-IOSCO Principles[23] as well as the

[18] *See* Consultation Paper at 98, Article 7(1) ORG of the CCP RTS, which requires, *inter alia*, public disclosure of a CCP's governance arrangements, rules and procedures, and of material changes to the same.

[19] *See id*. at 92, Article 1(3)(g) ORG of the CCP RTS, which provides that key components of the governance arrangements defined by the CCP shall include the processes for ensuring accountability to stakeholders.

[20] For example, changes to the CCP's risk management framework or default fund arrangements.

[21] For example, clearing members would likely pass on to clients, in whole or in part, both increased CCP charges in the form of higher clearing access costs and higher CCP margin requirements in the form of higher clearing member margin requirements.

[22] Interlocking governance arrangements include the participation of the same representatives in various governing bodies within or across one or more CCPs, trading venues and other significant market infrastructure providers.

[23] *See* CPSS-IOSCO Principles at 26, which require clear disclosure of major decisions to relevant stakeholders and, where there is a broad market impact, the public; at 27, which require clear documentation and disclosure of CCPs'

U.S. Commodity Futures Trading Commission's ("**CFTC**")[24] and the U.S. Securities Exchange Commission's ("**SEC**")[25] current proposed requirements.

III. Portfolio Margining

MFA commends ESMA for providing a framework for sound portfolio margining practices that permit offsets across correlated financial instruments,[26] with a single default fund covering all financial instruments under the same portfolio margining arrangements.[27] We recommend, however, that the Final RTS not prescribe the use of specific offsets or correlation levels because fixed limits for minimum correlation level and maximum permitted offset amounts are not appropriate and meaningful risk management tools with respect to many OTC derivative instruments.[28]

Instead, we believe that CCPs (specifically, CCP risk managers together with CCP risk committees) should be able to determine the permitted parameters of portfolio margining models for different products and asset classes, including offsets and risk correlation levels, subject to regulatory oversight. CCP risk managers have in-depth technical expertise and proximity to day-to-day market movements, as well as a thorough understanding of the capital needs of, and total resources available to, a CCP. Thus, CCP risk managers with risk committees are in the best

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governance arrangements, including key components, such as the role and composition of the Board and any subcommittees, senior management structure, reporting lines between management and the Board, ownership structure and design of risk management and internal controls, to the owners, authorities, participants, and at a more general level, the public; and at 31, which require a CCP to clearly and promptly inform its owners, participants, other users and, where appropriate, the broader public, of the outcome and explanation of major decisions.

[24] *See* CFTC Proposed Rules on "Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities", 76 Fed. Reg. 736 (January 6, 2011), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-31898a.pdf, which require public disclosure of: (i) summaries of significant decisions implicating the public interest, including open access and the acceptance or rejection of products for clearing; and (ii) the names of all Board members, all subcommittee members and the identities of all representatives of CCPs' customers.

[25] *See* SEC Proposed Rules on "Clearing Agency Standards for Operation and Governance", 76 Fed. Reg. 14538, 14539 (March 16, 2011), available at http://www.sec.gov/rules/proposed/2011/34-64017fr.pdf, which require CCPs to have governance arrangements that are clear and transparent and to provide market participants with sufficient information for them to identify and evaluate the risks associated with using a CCP's services.

[26] *See* Consultation Paper at 106, Article 4(1) MAR (margins) of the CCP RTS, which allows a CCP to offset or reduce the required margin across the financial instruments that it clears if the price risk of one financial instrument or a set of financial instruments is significantly and reliably negatively correlated with the price risk of other financial instruments.

[27] *See id*., Article 4(3) MAR of the CCP RTS.

[28] The key consideration in determining the scope and application of margin offsets to financial instruments is the type and degree of mutual correlation upon the collateral provider's default, which may differ significantly from the correlation assessed in normal market conditions. For example, the fixed 80% maximum permitted offset would result in significant over-collateralization of: (i) an in-the-money option that is delta-hedged with the underlying instrument; (ii) two identical (other than the fixed rate) offsetting swaps; or (iii) a CDS index hedged with single name CDS in all the underlying instruments.

position to determine, and adjust as market conditions evolve, the proper level of negative correlation and offset for different financial instruments, subject to regulatory supervision.

We believe greater flexibility would: (i) allow for a more efficient use of capital and lower trading costs; (ii) enhance liquidity in the OTC derivatives markets as it would avoid over-collateralization; (iii) enable CCPs to develop product-appropriate portfolio margining models without compromising CCP collateral levels; and (iv) ensure adequate and efficient regulatory oversight of, and transparency into, portfolio margining practices for purposes of effective monitoring of systemic risk. We believe that such flexibility would also reduce aggregate counterparty credit risk by encouraging clients that might be deterred by high transaction costs to seek to clear voluntarily. This more flexible approach would also be consistent with the CPSS-IOSCO Principles[29] and with the CFTC's regulations in the U.S. on CCP portfolio margining.[30]

IV. Straight-Through Processing

MFA strongly supports straight-through processing of OTC derivative contracts, which reduces counterparty credit risk and improves the efficiency of OTC derivatives markets. Please see the MFA STP Letter for MFA's detailed views on straight-through processing.

V. Segregation of Collateral

MFA applauds EMIR requiring CCPs to offer both "omnibus" and "individual client" collateral segregation with respect to direct and indirect clearing arrangements.[31] We also support the RTS that address the portability of an indirect client's collateral upon the default of a client providing indirect clearing services.[32] However, we note that although the RTS replicate and add detail to the EMIR segregation and portability provisions as regards "indirect" clearing arrangements, it contains no substantive detail on the segregation models and protections for direct or indirect clients. Therefore, we would appreciate the Final RTS clarifying: (i) the legal and operational characteristics of the "omnibus" and "individual client" segregation models; (ii)

[29] *See* CPSS-IOSCO Principles at 54, which provide that a CCP may allow offsets or reductions in required margin amounts between products if there is significant and reliable correlation in the risk for the products, and that a CCP should consider measures of dependence other than correlation, particularly for non-linear products.

[30] *See* CFTC Final Rules on "Derivatives Clearing Organization General Provisions and Core Principles", 76 Fed. Reg. 69432 (November 8, 2011) ("**CFTC Final CCP Rules**"), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-27536a.pdf, which require a CCP seeking to provide portfolio margining to submit the rules for implementing portfolio margining for CFTC's prior approval, but that do not prescribe specific limits or thresholds.

[31] Article 39 of EMIR.

[32] *See* Consultation Paper at 66-67, Article 4 ICA (indirect clearing arrangements) of the RTS on OTC derivatives, which requires a clearing member to have in place procedures to manage the default of a client that provides indirect clearing services, including procedures that allow the transfer of an indirect client's collateral and positions upon the direct client's default, and require the clearing member to hold directly the collateral and positions of the indirect client on reasonable commercial terms for at least 30 days, if the clearing member cannot successfully transfer collateral and positions of the indirect client to another client or clearing member.

whether a client should provide collateral on a principal[33] or agency[34] basis; and (iii) whether a clearing member's transfer of client collateral to the CCP should be on a gross[35] or net[36] basis.

MFA is aware that in Europe market participants currently post collateral on a principal basis, which increases a client's exposure to its clearing member's default because a client may not be able to retrieve from the CCP its posted collateral as the client lacks a contractual nexus with the CCP. In the event of such a default, even if the defaulted clearing member's records are accurate, and, in principle, a client should be able to retrieve its posted collateral, the client would have to request the return of the collateral from the CCP through the defaulted clearing member's administrator.[37] Further, a client whose collateral is segregated on an omnibus basis would also be exposed to the default of other clients whose collateral is held in the same omnibus account.

In light of this client exposure, MFA urges ESMA to require clearing members and CCPs to offer at least one recognised, effective segregation option[38] that: (i) protects client collateral upon the clearing member's default; (ii) more comprehensively addresses client risks associated with the loss of collateral upon such default; and (iii) is offered on fair and reasonable commercial terms. Furthermore, MFA notes that collateral transfers on a net basis may

[33] Providing collateral on a "principal basis" means that a client has no direct contractual relationship with a CCP and provides collateral to its clearing member, who in turn, provides equivalent (but not necessarily identical) collateral to the CCP under a separate contractual arrangement.

[34] Providing collateral on an "agency basis" means that a client has a direct contractual relationship with the CCP but the relevant clearing member guarantees the client's obligations to the CCP.

[35] Transferring collateral on a "gross basis" means that the client posts collateral to the clearing member without any offset or reduction against the client's other collateral on its other open positions with the clearing member. The clearing member in turn passes on equivalent collateral to the CCP without any reduction or offset against the collateral posted by its other clients or by it in connection with its proprietary trading positions.

[36] Transferring collateral on a "net basis" means that the client posts collateral to the clearing member without any offset against other collateral the client has posted on its other positions open with the client. However, the clearing member passes only "net" equivalent collateral on to the CCP (*i.e.*, the collateral is netted against the collateral requirements applicable to the clearing member's other clients and/or to its proprietary trading positions).

[37] We understand that European CCPs are developing different market options to address this risk and MFA supports the development of such options. LCH.Clearnet is developing a model that requires the client and the clearing member to enter into an English law deed of assignment ("**LCH Model**"), which effectively provides that LCH.Clearnet will transfer any remaining collateral and account balance to the client or a replacement clearing member upon the clearing member's default, allowing the client to circumvent the administrator of the clearing member's insolvent estate in order to recover its assets. Eurex is developing an individual segregation model ("**Eurex Model**") under which a clearing member grants a pledge in favour of a client over the clearing member's claims against Eurex upon Eurex's default and a similar pledge in favour of Eurex over the clearing member's claims against the client, allowing the parties to circumvent the administrator of the clearing member's insolvent estate in order to recover assets. Under a model CME is currently developing ("**CME Model**"), a third party custodian holds client collateral in an individually segregated account in the client's name. The CCP and the custodian exchange collateral and payments directly and the clearing member has a subordinated lien over the custody account for amounts due to it under transactions with the client.

[38] *See* supra note 37 for arrangements that could be effective segregation options.

compromise the portability of clearing arrangements.[39] Accordingly, we recommend that the Final RTS mandate that a clearing member must post client collateral to CCPs on a gross basis.

MFA commends the EMIR provisions[40] that require CCPs to facilitate the transfer of client assets and positions upon a clearing member's default, and the RTS[41] that require clearing members to facilitate the transfer of an indirect client's assets and positions upon the default of a client providing indirect clearing services. MFA believes that the Final RTS should include an explicit requirement that a CCP's governance requirements must take into account and facilitate the portability of client clearing arrangements. Further, ESMA should require CCPs and clearing members to establish client clearing arrangements that address the transfer of client assets and positions in the ordinary course of business and upon the default of a clearing member, which would be consistent with the final CFTC rules.[42] MFA strongly believes that allowing clients to freely transfer assets and positions between clearing members would permit clients to manage more effectively their exposures to clearing members, and encourage competition between clearing members, thereby reducing systemic risk associated with clearing member default and improving market conditions for clients and indirect clients.

In addition, MFA notes that, although the RTS address the protection of indirect clients' interests,[43] there are no equivalent RTS related to the protection of direct clients. MFA submits that the Final RTS should provide complete and identical protection to direct and indirect clients to ensure that clients entering into clearing arrangements on a direct basis are not disadvantaged and that the Final RTS do not create market asymmetries between clients and indirect clients where they would otherwise not exist. Also, to provide for the orderly and competitive operation of the derivatives markets, we request that, similar to the requirement on clearing members,[44] ESMA require CCPs, on a temporary basis, to hold directly a client's assets and positions upon a clearing member's default and mandate that the CCP and the client's clearing member(s) agree in advance to the terms of such temporary arrangement.

[39] Upon the default of its clearing member, a substitute clearing member may require the client to post additional collateral to compensate for any collateral shortfall due to the defaulted clearing member having posted collateral on a net basis, even if the client has posted adequate collateral through the defaulting clearing member.

[40] *See* Article 48(5) and 48(6) of EMIR, which provide that, at a minimum, a CCP shall contractually commit itself to trigger the procedures for the transfer of client assets and positions held by the clearing member to another clearing member as designated by the relevant client.

[41] *See* supra note 32.

[42] *See* CFTC Final CCP Rules at 69442, which require CCPs' rules to provide that, subject to the receiving clearing member's consent and certain other conditions, if a client instructs its clearing member to transfer its assets to another clearing member at the same CCP, the CCP will promptly transfer all or a portion of that client's requested positions and related funds without requiring the close-out and rebooking of the positions.

[43] *See* supra note 32.

[44] *See id.*

VI. Extraterritorial Application and Mutual Recognition

A. Generally

MFA notes the importance of ongoing supra-national work in determining the scope of the extraterritorial application of the clearing, risk mitigation and transparency obligations under EMIR, the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**") and Asian laws. We appreciate the need to encourage consistent global regulation and supervision, to prevent regulatory arbitrage and to ensure comprehensive application of the clearing obligation, risk mitigation and transparency requirements. Broadly harmonised and complementary regulatory requirements across different jurisdictions allow for efficient use of regulatory resources and are essential to regulate effectively the international OTC derivatives markets and to avoid conflicting clearing mandates from multiple regulators, which would render full compliance impossible for some market participants and undermine the effectiveness of the various regulations. Thus, MFA respectfully requests that ESMA coordinate closely the jurisdictional limits of the requirements with U.S. and other international regulators to ensure the consistency of regulatory reform to the extent possible and appropriate, and to address counterparty and systemic risk, while facilitating and encouraging access to, and competition among, CCPs organized in countries outside the European Union ("**EU**").[45]

In particular, MFA's view is that the Final RTS should also be consistent with the approach in the CPSS-IOSCO Principles[46] and with the standards set out in other international measures in order to avoid regulatory arbitrage in the OTC derivatives markets and to avoid duplicative or conflicting regulatory requirements applicable to the same transaction. We also believe that mutual recognition[47] is the preferred solution. Minimising extraterritorial application and permitting reliance on equivalent third country regulation is the most direct way to reduce conflicts of laws and unnecessary regulatory overlap, and to enable the effective global enforcement of regulatory requirements.

B. Direct, Substantial and Foreseeable Effects within the EU

In light of the strict G20 timeline, we urge ESMA to publish as soon as possible the consultation paper addressing the application of EMIR to transactions between non-European

[45] We note that, in the U.S., the CFTC has recently issued interpretive guidance as to the cross-border application of U.S. requirements and that the SEC expects to provide similar guidance in due course. *See* CFTC Proposed Interpretive Guidance and Policy Statement on "Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act", Fed. Reg. 77 41218-41222; 41235-41237 (July 12, 2012), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-16496a.pdf, which proposes to apply U.S. regulations to U.S. and non-U.S. persons that must register with the CFTC as swap dealers or major swap participants as well as certain of their U.S. and non-U.S. affiliates, subsidiaries, branches and agencies.

[46] *See* the CPSS-IOSCO Principles at 134, which state that regulatory authorities should cooperate with each other to reduce the probability of gaps in regulation, supervision and oversight that could arise if they did not coordinate, and to minimise the potential duplication of effort and the burden on the market participants.

[47] Mutual recognition is the principle that compliance with equivalent foreign regimes can appropriately substitute for compliance with national rules.

counterparties that have a direct, substantial and foreseeable effect within the EU[48] so as to allow stakeholders sufficient time to consider the proposals and submit considered comments. Due to the cross-border nature of derivatives markets, MFA strongly urges ESMA to draft technical standards setting out clearly and precisely the circumstances in which ESMA considers: (i) an OTC derivative contract to have a "direct, substantial and foreseeable effect within the EU"; and (ii) that it is necessary or appropriate to apply the clearing and risk mitigation obligations to contracts between third country counterparties in order to prevent the evasion of the requirements under EMIR. Without clear, comprehensive guidance, the application of the EMIR clearing obligation to market participants will be uncertain, making compliance with EMIR difficult for third country entities trading OTC derivatives in some circumstances.

In particular, we would appreciate it if ESMA took into consideration each of the following factors when consulting on and drafting the RTS: fund domicile, manager domicile, reference entity domicile, market location, reference security, underlying instrument and counterparty domicile. Specifically, the RTS should make it explicitly clear that transactions between two third country entities are not within the scope of EMIR simply because there is an EU reference security or other EU underlying instrument.

In the event ESMA subjects a contract between two third country parties to the EMIR clearing obligation due to the contract having an EU reference security or other EU underlier, MFA recommends that, for it to be deemed to have a "direct, substantial and foreseeable" effect within the EU, the contract, at a minimum, must meet all of the following characteristics:

(i) (a) for derivatives referencing a security, such as equity derivatives and credit default swaps ("**CDS**", or an index of such derivatives), the reference entity must be domiciled and have its principal place of business in the EU; (b) for foreign exchange derivatives, Euro or another currency of an EU member state must be one of the relevant currencies; or (c) for interest rate derivatives, the denomination must be in Euros or the currency of another EU member state;

(ii) the settlement currency of the contract must be in Euros or the currency of another EU member state; and

(iii) the notional amount of the contract must be substantial.

For an index or basket derivative, in addition to clauses (ii) and (iii) above, MFA believes the majority of the underlying reference entities must meet clause (i) above. Minimum standards such as those enumerated above will ensure an appropriate materiality threshold.

[48] *See* Consultation Paper at 22, Paragraphs 107-115 of the Introduction, where ESMA recognizes the significant implications of this requirement on the global nature of OTC derivatives, but considers that further work is required on this topic and determines to consult later on specific draft regulatory technical standards.

VII. Requirements for Recognition of Third Country CCPs

MFA supports the main criteria for ESMA's recognition of third country CCPs,[49] and appreciates supra-national efforts in this area. Further, MFA appreciates efforts to avoid duplicative or conflicting regulations, including ESMA's reporting on such rules as well as the monitoring of third country legal, supervisory and enforcement arrangements to ensure equitable and non-distortive application and enforcement.[50] However, MFA believes that it is most appropriate to use a non-prescriptive, outcomes-based approach to assess the effectiveness of third country supervisory and enforcement frameworks, equivalence of a similar recognition system, and the equivalence of the systems to combat money-laundering and terrorist financing. We believe that such a comprehensive approach will ensure effective regulation of the OTC derivatives markets and appropriately encourage expanded clearing of OTC derivatives globally.

VIII. Risk Mitigation Techniques for Non-Cleared Trades

A. Portfolio Compression

MFA fully supports ESMA's work on risk mitigation techniques in relation to non-cleared OTC derivatives.[51] However, we would appreciate clarification of the threshold at which counterparties are required to consider undertaking a portfolio compression exercise. We believe that the requirement to undertake, or assess whether to undertake, a portfolio compression exercise should apply only if counterparties have at least 500 non-cleared OTC derivative contracts outstanding in the same product category with each other (as opposed to a party having at least 500 non-cleared OTC derivatives contracts outstanding across all product categories and across all its counterparties). Such a requirement would ensure that market participants are not required to assess the feasibility of a portfolio compression exercise with such frequency and on such low notional values as to make the associated risk mitigation benefits negligible. It would

[49] *See id*. at 91-92, Article 1 3C (recognition of third country CCPs) of the CCP RTS, which sets out the requisite information and evidence a third country CCP must include in its application to ESMA for recognition under EMIR, including, *inter alia*, its rules and internal procedures with evidence of full compliance with applicable laws; details of its financial resources; details on the methodology for the calculation of margin and the default fund; list of the eligible collateral; classes of financial instruments cleared; identities of the shareholders or members with material holdings; and results of the stress tests and back tests performed during the preceding year preceding.

[50] *See* Article 13(1) of EMIR, which states that ESMA will assist the European Commission in monitoring and preparing reports on the international application of principles laid down in EMIR, in particular with regard to potential duplicative or conflicting requirements on market participants, and recommend possible action; and Article 85(3)(g), which requires ESMA to submit to the European Commission a report on the impact of the application of additional requirements by EU member states to third country CCPs by 30 September 2014.

[51] *See* Consultation Paper at 73-74, Articles 1-3 RM (risk mitigation techniques for OTC derivatives not cleared by a CCP) of the RTS on OTC derivatives, which require the timely confirmation of OTC derivatives trades, daily portfolio reconciliation for counterparties that have at least 500 OTC derivatives trades outstanding with each other (or weekly for counterparties with 300 to 499 OTC derivative contracts outstanding with each other, or monthly for counterparties with fewer than 300 OTC derivative contracts outstanding with each other), and an at least biannual assessment as to the possibility of carrying out a portfolio compression exercise, with a reasonable and valid explanation to the regulators if the party concludes that a portfolio compression exercise is not appropriate.

also be consistent with current practice in the bilateral markets and would lead to substantively similar policy outcomes as the CFTC's proposed portfolio compression requirements.[52]

Alternatively, given the minimal relative benefits of requiring portfolio compression to such a small portfolio and the substantial time and resources required to assess the possibility of portfolio compression,[53] it may be more appropriate to: (i) apply the requirement to a materially higher threshold of outstanding non-cleared OTC derivatives contracts; and/or (ii) allow any party that has at least 500 outstanding non-cleared OTC derivatives contracts to have the option (but not the obligation) to participate in any multilateral portfolio compression exercise initiated, offered or sponsored by a CCP, self-regulatory organization or self-regulatory association active in the OTC derivatives markets of which that party is a member.

B. Timing of Confirmation of OTC Derivative Contracts

MFA generally supports efforts to improve the efficiency and timing for confirming the terms of any contract not cleared by a CCP as it may reduce operational risk in the derivatives market.[54] However, we respectfully request that ESMA further consider the implications of its proposed timing requirements. Specifically, while we support the RTS that mandates confirmation of non-cleared OTC derivatives at the latest by the end of the same business day,[55] we are concerned that the RTS as proposed will modify current market practice, particularly where the parties do not confirm the terms of the OTC derivative transaction electronically.[56]

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[52] *See* CFTC Proposed Rules on "Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants", Fed. Reg. 75 81532 (December 28, 2010), available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-32264a.pdf ("**CFTC Proposed Portfolio Compression Rules**"), which require U.S. swap dealers or major swap participants to engage in a bilateral portfolio compression exercise for each swap in which the counterparty is also a swap dealer or major swap participant at least once per calendar year, subject to certain exemptions.

[53] As portfolio compression requires the replacement of a portfolio of existing trades with a smaller number of new trades that have the same cash flows and risk profile as the initial portfolio, it involves the combination of contractual terms of a number of separate trades and, as not all terms of such trades are identical, the exercise necessitates the comparative review of the derivative contracts overall, and not merely the key economic terms. This exercise is time consuming and elaborate, and requires adequate resources in order to carry it out with requisite care and to avoid inadvertent changes in contractual terms resulting in unintended changes in the economic outcome of the derivative contract.

[54] *See* MFA's comment letter to the CFTC on its proposed rulemaking on "Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants", dated February 28, 2011 ("**MFA Portfolio Compression Letter**"), available at: http://www.managedfunds.org/wp-content/uploads/2011/06/2.28.11-CFTC.Portfolio.Reconciliation-Compression.Rules_.Final_.MFA_.Letter.pdf.

[55] *See* Consultation Paper at 73, Article 1RM of the CCP RTS, on OTC derivatives.

[56] As a prefatory matter, we note that there is a fundamental distinction between bespoke, structured, bilateral OTC derivatives transactions that require flexible timing before the parties can fully confirm all non-economic terms, and fully standardized, centrally cleared OTC derivatives transactions that parties can confirm immediately. All derivatives that are currently centrally cleared are standardized and and the facilities for trade capture and straight-through processing are already currently available (*see* the MFA STP Letter for further detail).

Under current practice for bilateral non-cleared OTC derivatives transactions, parties executing a transaction other than under a master agreement execute with the expectation that they will negotiate certain non-economic terms after execution. The post-execution negotiation of non-economic terms is market practice particularly with respect to complex, customized or heavily negotiated OTC derivatives where the counterparties must negotiate the allocation of legal risks and rights. In practice, if the RTS timely confirmation requirement extends to all transaction terms, clients and other parties may be unable to enter into certain transactions if they cannot agree on terms in time, or may be forced to agree to unfavourable transaction terms, most often to the client's detriment, as the client likely would be compelled to sign a form of confirmation drafted by its dealer counterparty. Accordingly, the requirement to confirm all OTC transaction terms within the same business day may disadvantage clients and other entities with less negotiating power or that need to execute swaps promptly to avail themselves of market opportunities, and thus, may impede such entities from effectively hedging risk.

Therefore, MFA recommends that ESMA amend the proposed timing requirements to apply only to the delivery of a trade acknowledgment (*i.e.*, only the primary economic terms of the transaction, for example, upfront payment, floating rate payment, coupon and maturity). For non-economic terms (*e.g.*, dispute resolution provisions and termination events), we respectfully request that the Final RTS allow parties sufficient time to complete negotiation of those terms by permitting confirmation as soon as possible without mandating a strict deadline. Such flexibility is particularly important for bespoke or complex non-cleared trades in order to prevent penalization of parties where the delay in confirmation results from them carrying on negotiations of the transaction terms in good faith.

MFA recognizes that the proposed RTS tracks the CFTC's proposed requirements,[57] and that ESMA is concerned about harmonizing its technical standards with the regulations adopted by its U.S. counterparts. We note that MFA has submitted similar comments to the CFTC on its equivalent proposed rules and we await its response.[58] In addition, as ESMA is aware, the Dodd-Frank Act did not give the CFTC jurisdiction over all non-cleared, U.S. derivative products.[59] Rather, the SEC has jurisdiction over "security-based swaps", which include debt-security based swaps and other security-based swaps (*e.g.*, total return swaps based on securities, loans and indices of securities or loans). As of the date of this letter, the SEC has not proposed similar confirmation timing rules, and a number of bespoke and customized transactions for which market participants might need a longer time to confirm the non-economic terms would, in the

[57] *See* CFTC Proposed Portfolio Compression Rules at 81531, which require confirmation of: (i) electronically executed and/or processed derivatives transactions within 15-30 minutes of execution; (ii) derivatives transactions that cannot be processed electronically the same calendar day as execution; and (iii) confirmation of derivatives transactions entered into with non-financial counterparties no later than the next business day after execution.

[58] *See* MFA Portfolio Compression Letter.

[59] *See* SEC and CFTC Joint final rule; interpretations; request for comment on an interpretation on the "Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping". As of the date of this letter, the Federal Register has not published this joint final rule release, but the SEC and CFTC each approved it on July 10, 2012, and the draft final rule release is available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf.

U.S., be considered security-based swaps.[60] As a result, if not amended, it is possible that the effect of the Final RTS could exceed that of the current U.S. proposals because the Final RTS would apply to all derivatives contracts.

IX. Market Transparency and Data Availability

MFA believes that the RTS regarding transparency[61] do not adequately address the information needs of market participants. Public dissemination of information is important for purposes of promoting improved transparency in the markets, whereas limiting the availability of public data through the imposition of fees, subscription services or other barriers is unwarranted.

MFA believes that the costs of implementing increased transparency requirements should be relatively low, and thus, we recommend that ESMA require trading repositories to publish daily aggregate weighted average prices and end-of-day prices for each instrument as well as transaction volumes and open interest for all reasonably liquid traded instruments based on actual transaction data. The Final RTS should also require CCPs to publish free of charge end-of-day data including settlement prices, volumes and open positions. Such transparency is consistent with existing CFTC requirements for cleared OTC derivative contracts,[62] and consistent reporting and transparency across instruments would give market participants a broad and timely view of the market and would benefit central clearing and liquidity in the markets.

MFA believes that ESMA can accomplish the above transparency objectives in a manner that is consistent with ESMA's intention to require trade repositories both to ensure that the published data does not enable, by any means, the identification of individual counterparties or trades and to monitor the compliance with this obligation when supervising the public availability of trade repository data.[63] Therefore, MFA recommends that, in accordance with the EMIR requirements,[64] ESMA expressly prohibit trade repositories from publicly disseminating information that could identify any counterparty to an OTC derivatives contract. Specifically, the Final RTS should exempt thinly traded or customized instruments from the publication obligation (if appropriate) in order to protect the counterparties' identities from unauthorised disclosure. Such safeguards are necessary because MFA members employ a customized and proprietary trading strategy, and the disclosure of identifying information could, in practice, result in the disclosure of the specific trading strategy or positions.

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[60] *See id.*

[61] *See* Consultation Paper at 164, Article 2 of the RTS on trade repositories, which requires trade repositories to publish information on the derivative contracts reported to them on at least weekly basis, and requires the published data to include the type of derivative as well as the aggregate open positions by derivative type (*i.e.* credit, equities, interest rates, commodities and foreign exchange derivatives).

[62] *See* CFTC Final CCP Rules at 69446, which require CCPs to make public, *inter alia*, daily settlement prices, volume and open interest for each contract, agreement or transaction cleared or settled by the derivatives clearing organization no later than the business day following the day to which the information pertains.

[63] *See* Consultation Paper at 56, Paragraph 313 of the Introduction.

[64] *See* Article 81(5) of EMIR, which requires the relevant draft regulatory technical standards to aim to ensure that the information published by a trade repository is not capable of identifying any party to a contract.

With respect to the frequency of public disclosure, MFA reiterates its recommendation that the Final RTS specifically require trade repositories to establish disclosure timeframes tailored to specific products, where the liquidity of, or volume of trading activity with respect to, the type of OTC derivative contract warrants a more or less frequent disclosure requirement. Specifically, ESMA should mandate daily public disclosure for liquid OTC derivative contracts and should permit less frequent disclosure for illiquid OTC derivative contracts to avoid impairing liquidity.[65] Similarly, we recommend that the Final RTS include disclosure thresholds that are specific to each class or subclass of derivative, are set at levels or ranges that do not threaten to reduce market liquidity, and can adjust to reflect changing liquidity levels in the market over time. Lastly, MFA recommends phasing in such public disclosure by initially allowing longer reporting periods and reducing those periods over time if ESMA determines that liquidity issues do not materialise, subject to ESMA's reasonable discretion to provide exceptions to the disclosure regime on a product-by-product basis.

X. CCP Margin Models

A. Margin Model Transparency

MFA supports the RTS obliging CCPs to calculate initial margin for each product such that the margin covers the exposure movements of the financial instrument over a specified time period[66] and assumes a time horizon for the liquidation of the position.[67] MFA recommends, however, that to encourage transparency and ensure the ongoing appropriateness of a CCP's valuation model, the Final RTS should require CCPs to disclose details of the data and methodology used in the model to clients. This disclosure would allow clients to verify such data and methodology and to replicate the model as part of their risk estimation and management efforts.

B. Applicable Confidence Interval

MFA supports the flexibility afforded to CCPs in the RTS to determine when, if ever, to apply a confidence interval above the base level. As a general matter, MFA supports margin requirements that are risk-based and subject to regular review, as we believe that imposing margin requirements that are excessive relative to risk exposure adversely affects market liquidity and is inconsistent with the objective to move towards a wider market practice of

[65] *See* MFA's comment letter to ESMA on its Discussion Paper on "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories", dated March 19, 2012, at 15, available at: https://www.managedfunds.org/wp-content/uploads/2012/03/MFA.Response.ESMA_.EMIR_.Discussion.Paper_FinalLetter_03-19-2012.pdf.

[66] *See* Consultation Paper at 104-105, Article 1 MAR of the CCP RTS, which requires a CCP to ensure that initial margin for OTC derivatives covers at least a 99.5% confidence interval; and Article 2 MAR of the CCP RTS, which mandates calculation of historical volatility weighting equally: (i) the latest six months, and (ii) the six months reflecting the most stressed market conditions during the last 30 years or as long as reliable price data is available.

[67] *See id*. at 106, Article 3 MAR of the CCP RTS, which provides that the time horizon for OTC derivatives must be five business days and for other financial instruments must be two business days.

central clearing.[68] Therefore, we think it important that the Final RTS retain this flexibility so that margin criteria can evolve with the markets and allow ESMA to change the scope or provide exemptions for the applicable margin requirements or liquidation periods if they prove to be excessive based on future market conditions.

However, we urge ESMA to reduce the currently proposed 99.5% confidence interval to 99% (*i.e.*, the proposed level for financial instruments other than OTC derivatives),[69] but leave flexibility for CCPs to use a higher confidence interval, if it is necessary, based on current market conditions to ensure a proper balance between posted collateral and default fund contributions. We note that a number of CCPs currently use a 99% confidence interval for various cleared derivatives products,[70] and we are not aware of any evidence that indicates that current margin levels are insufficient to protect CCPs or the markets.[71] Moreover, we believe that a 99% baseline confidence interval would benefit the market by furthering incentivising central clearing and aligning the margin requirements for OTC derivatives with other financial instruments. A 99% baseline confidence interval would also be consistent with proposed CFTC rules[72], the CPSS-IOSCO Principles[73] and the most recent Basel-IOSCO proposals.[74]

While we agree that it is important to ensure that, if a clearing member or client defaults, CCPs have access to adequate and high quality resources, we are concerned that a 99.5%

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[68] *See* MFA comment letter to the CFTC on its proposed rules on "Risk Management Requirements for Derivatives Clearing Organizations", dated March 21, 2011, available at: http://www.managedfunds.org/wp-content/uploads/2011/06/3.21.11-CFTC.DCO_.Risk_.Management.Rules_.Final_.MFA_.Letter.pdf, where we note that, during the financial crisis, many customers used far less leverage and were more creditworthy than many regulated entities.

[69] *See* Consultation Paper at 104-105, Article 1 MAR of the CCP RTS.

[70] *See* CME's "*Cleared OTC Initiatives: Protecting OTC Market Participants Through the Security of Centralized Clearing*" (July 2011), available at http://www.cmegroup.com/trading/cds/files/cleared-otc-offerings-2011-07.pdf, which explains that CME's margin methodology for cleared OTC interest rate swaps uses a 99% confidence interval for a 5-day move. *See also* Stan Ivanov and Lee Underwood, "*CDS Clearing at ICE: A Unique Methodology*", Futures Industry, November 2011, available at: https://www.theice.com/publicdocs/ice_trust/FIA_magazine_CDS_risk_management_article.pdf, which describes that for CDS ICE's margin methodology uses a 99% confidence interval over a 5-day risk horizon.

[71] Indeed, in recent years, the issue was not that margin levels were insufficient, but rather that certain parties did not post any margin when their counterparties should have required them to do so. MFA members continue to post both initial and variation margin during the ordinary course of their business.

[72] *See* CFTC Final CCP Rules at 69438, which require a CCP to ensure that the actual coverage of the initial margin requirements produced by its models, along with projected measures of the models' performance, meet an established confidence level of at least 99% based on data from an appropriate historic time period.

[73] *See* CPSS-IOSCO Principles at 50, 161, which specify that initial margin should meet an established single-tailed confidence level of at least 99% with respect to the estimated distribution of future exposure.

[74] *See* "Margin Requirements for Non-Centrally-Cleared Derivatives" by the Basel Committee of Banking Supervision and IOSCO, July 2012, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf, at 17, which requires that, for the purposes of informing the initial margin baseline, the potential future exposure of a non-centrally-cleared derivative should reflect an extreme but plausible estimate of an increase in the value of the instrument that is consistent with a one-tailed 99% confidence interval over a 10-day horizon, based on historical data that incorporates a period of significant financial stress.

baseline will negatively affect clients, as many justifiably post lower margins to clearing members, and will impede the efficient and accurate collateralization of OTC derivatives. Therefore, MFA respectfully requests that ESMA consider current margin levels in the marketplace and the potential impact on liquidity and on trading costs and, to the extent it requires CCPs to use a confidence level higher than 99%: (i) explain why, in light of these concerns, such increased baseline margin is still necessary, and (ii) either allow CCPs to apply for exemptions for classes of derivatives in the event that market conditions prove that the application of the prescribed margin requirements is excessive, or require CCPs to review and consider reducing the interval at least on an annual basis.

Similarly, we believe the Final RTS should not be overly prescriptive as to the liquidation horizons used in CCP margin models, and instead, should preserve reasonable flexibility for ESMA to shorten the liquidation periods as markets evolve and liquidity in the cleared product increases. Substantial liquidity already exists in the most heavily traded and standardized interest rate swaps and CDS indices, and market participants broadly acknowledge the potential for these instruments to trade through electronic central limit order book facilities. Therefore, as it is possible that in the near term CCPs will be able to liquidate positions in these instruments in a default scenario in a shorter period than that currently indicated in the RTS, the liquidation horizon for these instruments should reflect such improved liquidity.[75]

XI. Criteria for the Determination of the Classes of OTC Derivative Contracts Subject to the Clearing Obligation

MFA agrees with the factors ESMA proposes to take into consideration with respect to the degree of standardization of the contractual terms and operational processes of the relevant class of OTC derivative contracts.[76] However, as the standardized industry documentation, such as ISDA documentation, developed with respect to bilateral OTC derivatives contracts, does not address matters relating to clearing, we request that ESMA not treat the existing derivatives trading documentation as providing a template for standardized clearing documentation. Rather, with a view to facilitating effective and orderly operation of the OTC derivatives markets, we believe that it is necessary to adopt a measured approach to determining the appropriate content for any standardized clearing documentation, as opposed to using potentially flawed or unsuitable existing documentation.

We further emphasize that a core objective of EMIR is to eliminate the risks of bilateral counterparty credit risk through clearing. As discussed in the MFA STP Letter, straight-through processing effectively eliminates counterparty credit risk between bilateral executing parties as well as the need for any form of execution documentation, such as an ISDA agreement. For this

[75] *See* Consultation Paper at 106, Article 3 MAR of the CCP RTS, which prescribes a 5-business day liquidation horizon for OTC derivatives.

[76] *See id.* at 69-70, Article 1 CRI (criteria to be assessed by ESMA) of the RTS on OTC derivatives, which states that ESMA will take into consideration whether the OTC derivatives contract's: (i) contractual terms of incorporate common legal documentation (*e.g.*, master netting agreements, definitions, standard terms and confirmations with commonly-used contract specifications); and (ii) operational processes are subject to automated post-trade processing and lifecycle events that are managed subject to a widely-agreed timetable.

reason, no established cleared derivatives market has execution documentation. Were such documentation required for cleared OTC derivatives, the process for clients to complete these agreements would represent a material hindrance to trading and clearing access, fragment liquidity for clients and impede clients' access to competitive pricing. As a result, for centrally cleared OTC derivatives, we believe that the sole documentation required to execute trades and access clearing should be the agreement negotiated between a client and its clearing member and the rules of the CCP, as applicable to the client. Accordingly, we respectfully request that the Final RTS provide guidance regarding the provisions that the agreement between a client and its clearing member should include (*e.g.*, access and transaction fees, chosen segregation option and associated costs, portability arrangements and default asset recovery procedures).

XII. CCP Recordkeeping

MFA commends ESMA's work on the CCP recordkeeping requirements, and we agree with requiring a CCP to ensure the safety and confidentiality of its records.[77] MFA's members operate highly customized and proprietary investment strategies, which form the foundation of their businesses. Disclosure of information that could reveal directly or indirectly a member's trading strategy or positions could result in material losses to it. Thus, to further strengthen the efficacy of ESMA's mandate, we believe in the Final RTS, ESMA should also explicitly require CCPs to: (i) protect effectively any strategic or commercially sensitive client information that the CCPs receive, including information arising at risk committee or Board meetings, against unauthorised or inadvertent disclosure; and (ii) disclose data (aggregated or not) only in a format that ensures that such disclosure will not reveal an individual client's positions, trading strategies or other sensitive proprietary information.

XIII. CCP Access to Trading Venues

MFA wishes to ensure that nothing unreasonably impedes CCPs' access to trading venues. The intention behind the EMIR non-discriminatory trading venue access provisions[78] is to eliminate vertical silos[79] in the derivatives markets, thereby creating competition and fostering innovation - objectives MFA strongly supports. However, we are concerned that the RTS, as currently drafted, raise the question as to whether a trading venue may deny a CCP access due to the potential that such access could give rise to "liquidity fragmentation",[80] even where no

[77] *See id.* at 129, Article 2(2) of the CCP RTS, which sets forth the format of the records that CCPs must maintain.

[78] *See* Article 8 of EMIR, which provides that, subject to the decision of the regulator of the trading venue or the CCP to the contrary, a trading venue must grant by a CCP access within three months of the CCP's request, but that access can only be granted if such access would not require interoperability or threaten the smooth and orderly functioning of markets, in particular due to liquidity fragmentation.

[79] By "vertical silos", we mean multiple affiliated market participants that have a significant or dominant market position as a result of their market presence at different phases or levels of the trading process (*e.g.*, the provision of one or more trading platforms as well as clearing and settlement services), which would allow them to influence the market generally and/or the actions of, or commercial outcomes for, specific market participants.

[80] *See* Consultation Paper at 71-72, Article 1 LF (liquidity fragmentation) of the RTS on OTC derivatives, which defines liquidity fragmentation as a situation in which a trading venue's participants are unable to conclude a transaction with one or more other venue participants because of the absence of clearing arrangements to which all

liquidity fragmentation exists, or where the impact of any liquidity fragmentation would be so minimal that it could not reasonably threaten the efficient and orderly functioning of the markets.

MFA is not aware that such "liquidity fragmentation" exists or is likely to exist. In addition, our understanding is that, before a market participant may participate in a trading venue, it must have access to at least one CCP and the trading venue must support the processing of trades to at least one CCP. In light of such preconditions, we strongly believe that market participants should be free to select with which CCP they clear their trades, based on pricing and other market attributes. Indeed, we are concerned that conflicts of interest motivations could result in "liquidity fragmentation" becoming a pretext for excluding a CCP from access to a trading venue. Market incentives for trading venues and clients should operate to ensure that trading venues and clients exert pressure on CCPs to enter into the necessary clearing arrangements. As we believe that liquidity fragmentation is unlikely to be a problem, the Final RTS should: (i) grant CCPs access, in the ordinary course of business; (ii) permit trading venues to refuse access to CCPs only in exceptional circumstances; (iii) require trading venues to process access requests within a reasonable time, and subject to commercially reasonable fees; and (iv) expressly require trading venues to grant access on fair, reasonable and non-discriminatory terms.

XIV. CCP Resources to be Used in the Default Waterfall

MFA endorses the RTS that requires a CCP to keep a minimum amount of capital for use in the default fund and revise such amount annually.[81] However, we are concerned about CCPs having a fixed minimum default capital requirement given the relatively low minimum capital requirements applicable to CCPs[82] and the size of potential losses arising on a clearing member or client default. Providing a quantitatively prescriptive minimum default fund amount, particularly one that is linked to a low minimum capital requirement, is not appropriate given that the purpose of the default fund is to protect the CCP in the event of a clearing member's default, and thus, to reduce the systemic risk of such default. Moreover, we believe it is likely that to comply with its obligations with respect to the default fund, CCPs would need to maintain capital in excess of the 50% minimum requirement even at an early stage of operations.

Therefore, we believe that the Final RTS should include a more flexible requirement that a CCP shall maintain highly loss absorbent[83] capital for use upon a clearing member or client default that is at least sufficient to cover the CCP's exposures with a high degree of confidence

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participants have access. A CCP's access to a trading venue that is already served by another CCP does not give rise to liquidity fragmentation within the trading venue if all participants to the trading venue have access, directly or indirectly, to at least one CCP in common or clearing arrangements established by the CCPs.

[81] *See id*. at 111, Article 1(1) DW (default waterfall) of the CCP RTS, which requires a CCP to keep, and indicate separately in its balance sheet, a dedicated amount of its own resources for use in a default fund at least equal to 50% of the CCP's capital, including retained earnings and reserves, and to revise this amount on a yearly basis.

[82] *See* Article 16(1) of EMIR, which requires a CCP to have permanent and available initial capital of €7.5 million in order to be authorised.

[83] For example, cash, short-term money market instruments and liquid high-grade debt instruments.

and to comply with its business continuity obligations. We also recommend that ESMA consider the related Basel III proposals for credit institutions[84] and the U.S. proposals for CCPs[85] when determining the applicable CCP capital requirements in the context of a default fund and otherwise to ensure global consistency.

XV. Review of CCP Models, Stress Testing and Back Testing

MFA strongly supports obligating CCPs to make available their back testing and stress testing results and analysis.[86] Sharing these results and analyses will help to ensure that clients have sufficient information to scrutinize CCPs properly. In order to ensure that clients receive the relevant test results, the Final RTS should require: (i) CCPs to inform clearing members or, where known, clients, that the detailed stress testing and back testing results for a client's portfolio are available and provide these directly to the client on request; and (ii) clearing members to make available to clients the stress testing and back testing results without request, as a client may not be aware that such results have become available.

We also would appreciate it if ESMA would specify what it means by a client being "known" to a CCP. We believe that, for the purposes of the Final RTS, a client should be deemed to be "known" to a CCP if the CCP has entered into any contractual arrangement with the client or received, within six months of the date of such stress or back testing result, a confirmation or record from a clearing member indicating that the client is a client of the clearing member. We believe this standard is reasonable because it indicates that the CCP has "actual" knowledge of the clients' status without requiring independent verification by the CCP.

In addition, we support ESMA mandating that a CCP disclose the general principles underlying its models and methodologies.[87] However, we respectfully suggest that ESMA explicitly require the public disclosure also to include the specific methodologies used by a CCP in stress and back tests. It is important that the Final RTS are comprehensive in this regard in order to foreclose any loopholes that might allow CCPs not to disclose important data to the market. We believe that public disclosure of the model methodologies would eliminate any loopholes by allowing continuous peer review, revealing weakness or inconsistency in the

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[84] *See* "Strengthening the resilience of the banking sector" by the Basel Committee of Banking Supervision, December 2009, available at http://www.bis.org/publ/bcbs164.pdf, at 4, 14-17, 28-30, which notes the importance of having a high quality capital base to back a bank's risk exposures and proposes measures to raise the quality, consistency and transparency of the regulatory capital base.

[85] *See* CFTC Final CCP Rules at 69435, which require a CCP to maintain financial resources sufficient to cover its exposures with a high degree of confidence (*i.e.*, the CCP must be able to meet its financial obligations notwithstanding a default by the clearing member creating the largest financial exposure for the CCP in extreme but plausible market conditions, and it must be able to cover its operating costs for a period of at least one year).

[86] *See* Consultation Paper at 120-122, Articles 3 and 5 of the CCP RTS, which require CCPs to make the results available to all clearing members and, where known to the CCP, clients. For other clients, the relevant clearing members shall make back testing results available on request. Such information shall be aggregated, and clearing members and clients shall only have access to detailed back testing results and analysis for their own portfolios.

[87] *See id*. at 126, Article 15 of the CCP RTS.

models or the underlying data and improving the reliability and accuracy of the models, in turn, reducing systemic risk and improving confidence in CCPs and the central clearing framework.

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MFA thanks ESMA for the opportunity to provide comments regarding the proposals in the Consultation Paper and we would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact Carlotta King or the undersigned at +1 (202) 730-2600 with any questions ESMA or its staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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