November 6, 2014

Via Electronic Submission

European Securities and Markets Authority
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07, France

Re: Consultation Paper on the Clearing Obligation under EMIR (no.3)

Dear Sir or Madam:

Managed Funds Association (“MFA”)\(^1\) welcomes the opportunity to provide comments to the European Securities and Markets Authority (“ESMA”) on its Consultation Paper on the Clearing Obligation under EMIR (no.3), the amended version of which is dated 10 October 2014\(^2\) (“Consultation Paper”).

MFA strongly supports the goals and efforts of European policymakers to reduce systemic risk in the derivatives market, a core aspect of which is transitioning the over-the-counter (“OTC”) derivatives market to greater central clearing. MFA supports a thoughtful approach to central clearing that ensures that only appropriate products are subject to the clearing obligation. We believe that such an approach to mandatory clearing will: (i) increase transparency of the derivatives market; (ii) reduce counterparty and operational risk in trading; and (iii) enhance market integrity and oversight.

MFA supports ESMA’s proposals with respect to the European Market Infrastructure Regulation (“EMIR”) to move appropriate OTC derivative contracts to mandatory clearing in the European Union (“EU”) in a timely fashion. Accordingly, MFA has responded to ESMA’s previous consultations proposing the mandatory clearing of certain OTC interest rate derivative contracts\(^3\) and certain OTC credit derivative contracts\(^4\). In general, MFA has

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\(^1\) 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, the Americas, Australia and many other regions where MFA members are market participants.

\(^2\) Available at: [http://www.esma.europa.eu/content/Consultation-Paper-clearing-obligation-under-EMIR-No3](http://www.esma.europa.eu/content/Consultation-Paper-clearing-obligation-under-EMIR-No3)


been supportive of the proposed scope of the clearing obligation suggested in these consultation papers.\(^5\)

MFA, however, has concerns with ESMA proposing to subject any OTC foreign exchange ("FX") non-deliverable forward transactions ("NDFs") to mandatory clearing under EMIR at this time. MFA’s concerns in this regard are discussed in our response to Question 5 of the Consultation Paper. First, MFA does not believe that there is currently international convergence as to whether NDFs should be subject to a clearing mandate or the scope of such a mandate. Therefore, we are concerned that premature imposition of an NDF clearing obligation in the EU would result in markets being bifurcated along jurisdictional lines. Second, MFA is concerned that NDF clearing is in its infancy, with the inevitable consequence that certain market participants would find it difficult to access NDFs were ESMA to subject them to the EMIR clearing obligation. Lastly, MFA is concerned that the costs involved in implementing mandatory clearing with respect to NDFs and the associated impact on liquidity outweigh any limited reduction in systemic risk that would be achieved by introducing an NDF clearing obligation.

Therefore, MFA does not think it would be prudent for ESMA to impose a clearing obligation on NDFs at this time. Instead, we believe that ESMA should continue to monitor the NDF markets and engage in discussions with the regulators in third country jurisdictions, in particular, the U.S. Commodity Futures and Trading Commission, prior to imposing an NDF clearing obligation in the EU. We are of the view that this approach will ensure that ESMA imposes a clearing mandate on NDFs only when the concerns that we highlight in this response have been addressed and there is international consensus on both the need for NDFs to be subject to a clearing mandate and the scope of such a mandate.

Although, for the reasons set out above and in Question 5 of our response to the Consultation Paper, MFA does not support the introduction of a clearing obligation in respect of any class of NDF at this time, we have provided comments in our response to Question 6 of the Consultation Paper on the phase-in approach proposed in the Consultation Paper. The phase-in provisions will be of relevance to the extent the issues that we have highlighted with respect to the clearing of NDFs are addressed at a later date, and in this regard, MFA urges ESMA:

1. Not to apply the EUR 8 billion threshold, and instead to merge ESMA’s proposed Categories 2 and 3, such that the financial counterparties ("FCs") and alternative investment funds that are non-financial counterparties exceeding EMIR’s clearing threshold and not in Category 1 would be in the same category for purposes of the EMIR phase-in ("Combined Category 2");

2. To provide a 12-month phase-in period for Combined Category 2; and

3. To eliminate the frontloading obligation for FCs in Combined Category 2.

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

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director &
General Counsel
Reply form for the Consultation Paper
On the Clearing Obligation under EMIR (no. 3)
Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Consultation Paper - Clearing Obligation under EMIR (no. 3), published on the ESMA website.

Responses are most helpful:

i. if they respond to the question stated;

ii. contain a clear rationale, including on any related costs and benefits; and

iii. describe any alternatives that ESMA should consider

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

Responses must reach us by 6 November 2014.

All contributions should be submitted online at www.esma.europa.eu under the heading ‘Your input/Consultations’.

Instructions

Please note that, in order to facilitate the analysis of the responses, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

i. use this form and send your responses in Word format;

ii. do not remove the tags of type < ESMA_CA3_QUESTION_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and

iii. if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

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Information on data protection can be found at www.esma.europa.eu under the heading ‘Disclaimer’.
**General information about respondent**

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Introduction

Please make your introductory comments below:

<ESMA_CO3_COMMENT_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, the Americas, Australia and many other regions where MFA members are market participants.

MFA welcomes the opportunity to provide comments to the European Securities and Markets Authority ("ESMA") on its Consultation Paper on the Clearing Obligation under EMIR (no.3), the amended version of which is dated 10 October 2014 ("Consultation Paper"). MFA strongly supports the goals and efforts of European policymakers to reduce systemic risk in the derivatives market, a core aspect of which is transitioning the over-the-counter ("OTC") derivatives market to greater central clearing. MFA supports a thoughtful approach to central clearing that ensures that only appropriate products are subject to the clearing obligation. We believe that such an approach to mandatory clearing will: (i) increase transparency of the derivatives market; (ii) reduce counterparty and operational risk in trading; and (iii) enhance market integrity and oversight.

MFA, however, has concerns with ESMA proposing to subject any OTC foreign exchange ("FX") non-deliverable forward transactions ("NDFs") to mandatory clearing under EMIR at this time. MFA’s concerns in this regard are discussed in our response to Question 5 below. First, MFA does not believe that there is currently international convergence as to whether NDFs should be subject to a clearing mandate or the scope of such a mandate. Therefore, we are concerned that premature imposition of an NDF clearing obligation in the EU would result in markets being bifurcated along jurisdictional lines. Second, MFA is concerned that NDF clearing is in its infancy, with the inevitable consequence that certain market participants would find it difficult to access NDFs were ESMA to subject them to the EMIR clearing obligation. Lastly, MFA is concerned that the costs involved in implementing mandatory clearing with respect to NDFs and the associated impact on liquidity outweigh any limited reduction in systemic risk that would be achieved by introducing an NDF clearing obligation.

Therefore, MFA does not think it would be prudent for ESMA to impose a clearing obligation on NDFs at this time. Instead, we believe that ESMA should continue to monitor the NDF markets and engage in discussions with the regulators in third country jurisdictions, in particular, the U.S. Commodity Futures and Trading Commission ("CFTC"), prior to imposing an NDF clearing obligation in the EU. We are of the view that this approach will ensure that ESMA imposes a clearing mandate on NDFs only when the concerns that we highlight in this response have been addressed and there is international consensus on both the need for NDFs to be subject to a clearing mandate and the scope of such a mandate.

Although, for the reasons set out above and in Question 5, MFA does not support the introduction of a clearing obligation in respect of any class of NDF at this time, we have provided comments at Question 6 below on the phase-in approach proposed in the Consultation Paper. The phase-in provisions will be of relevance to the extent the issues that we have highlighted with respect to the clearing of NDFs are addressed at a later date, and in this regard, MFA urges ESMA:

1. Not to apply the EUR 8 billion threshold, and instead to merge ESMA’s proposed Categories 2 and 3, such that the financial counterparties ("FCs") and alternative investment funds ("AIFs") that are non-financial counterparties exceeding EMIR’s clearing threshold ("NFC+ AIFs") and not in Category 1 would be in the same category for purposes of the EMIR phase-in ("Combined Category 2");

2. To provide a 12-month phase-in period for Combined Category 2; and

3. To eliminate the frontloading obligation for FCs in Combined Category 2.
1. The clearing obligation procedure

Q1: Do you have any comment on the clearing obligation procedure described in Section 1?

<ESMA_CO3_QUESTION_1>
TYPE YOUR TEXT HERE
<ESMA_CO3_QUESTION_1>
2. Structure of the non-deliverable forward derivatives classes

Q2: Do you consider that the proposed structure for the FX NDF classes enables counterparties to identify which contracts are subject to the clearing obligation?

<ESMA_CO3_QUESTION_2>
Please see the discussion at Question 5.
<ESMA_CO3_QUESTION_2>
3. Determination of the classes of OTC derivatives to be subject to the clearing obligation

Q3: In view of the criteria set in Article 5(4) of EMIR, do you consider that the determination of this class addresses appropriately the objective of reduction of the systemic risk associated to NDF derivatives?

Q4: For the currency pairs proposed for the clearing obligation on the NDF class, do you consider there are risks to include longer maturities, up to the 2 year tenor?
4. Determination of the dates on which the obligation applies and the categories of counterparties

Q5: Do you have any comment on the analysis presented in Section Error! Reference source not found.?

Although, as noted in our introductory comments, MFA strongly supports the efforts made by ESMA to transition the OTC derivatives market to greater central clearing, MFA does not believe the introduction of a mandatory clearing obligation in respect of any class of NDF is appropriate at this time. MFA considers that, at a minimum, the following matters should be addressed before a clearing mandate in respect of NDFs should commence:

1. There is not currently international convergence as to whether NDFs should be subject to mandatory clearing and a harmonized approach on this issue is necessary to prevent markets becoming fractured along jurisdictional lines;

2. NDF clearing has developed relatively recently in the interdealer market and MFA is concerned that there is not a sufficiently robust offering of NDF clearing available to all market participants that will be subject to the EMIR clearing obligation; and

3. MFA is concerned that the costs involved in implementing mandatory clearing with respect to NDFs and the associated impact on liquidity outweigh any limited reduction in systemic risk that would be achieved by introducing an NDF clearing obligation.

I. Need for Clear International Convergence

MFA believes that, for the sake of preserving the global market for derivatives (instead of fracturing the markets along jurisdictional lines), it is important that the categories of derivatives subject to mandatory clearing in the EU and other jurisdictions be as similar as possible. In contrast to the treatment of IRS and CDS (in respect of which the CFTC has already introduced a clearing mandate), at present, no other jurisdiction has imposed a clearing obligation on NDFs. In addition, a robust discussion continues to take place among regulators and market participants as to: (i) whether it is appropriate or necessary to subject NDFs to mandatory clearing; and, if so, (ii) which currency pairs, maturities, or tenors should fall within the scope of such mandatory clearing obligation. Although the CFTC is also currently considering whether to mandate clearing of NDFs in the U.S., it has not yet issued rules proposing to extend clearing to include this product, as it is still thinking through the costs, effects and benefits of such clearing.

MFA believes that it would not be prudent for ESMA to impose a clearing obligation on NDFs in the EU at the current time. Instead, we recommend that ESMA continue to engage in a dialogue, and align timing of NDF clearing in the EU, with U.S. regulators to ensure that a con-
sistent, global approach is taken towards the treatment of NDFs in the U.S. and EU markets. We believe that, although it may prove appropriate to impose a clearing obligation on NDFs at a later date, a hasty decision to mandate NDF clearing could result in bifurcated markets, which could, in turn, prevent many market participants from using NDFs as a source of liquidity and lead to an increase in bid/ask costs. Further, given that many market participants frequently use NDFs as a tool for hedging their other exposures, MFA is concerned that a premature NDF clearing mandate could result in the accumulation of unhedged currency risk in (potentially volatile) emerging market currencies.

II. Relative Immaturity of the Cleared NDF Markets, Extent of CCP NDF Offering and Client Access to Clearing

MFA does not believe that the clearing infrastructure for the NDF market is sufficiently developed to warrant the imposition of a clearing obligation at the current time. In addition, we are concerned that not all market participants that would be subject to the clearing obligation would have access to NDF clearing through an authorized or recognized central counterparty ("CCP"). We believe that such access issues will arise because of the limited number of CCPs available to clear NDFs and because of the currently restricted client clearing offerings in relation to NDFs.

A. Infancy of the Cleared NDF Markets

In the case of IRS, clearing has existed since 1999 (see paragraph 150 of the IRS Consultation), and the data gathered at the time of the IRS Consultation shows that, in 2013, 35% of all swaps and 57% of all forward rate agreements were being centrally cleared (as set out in paragraph 102 of the IRS Consultation). In contrast, as ESMA notes in paragraph 97 of the Consultation Paper, the market for cleared NDF is still in its infancy. LCH.Clearnet Ltd ("LCH"), which is the only CCP with a live NDF clearing offering in the EU, launched its NDF clearing offering in 2012. Furthermore, the cleared NDF market is merely between 1% and 3% of the total NDF market, depending on the currencies involved (see paragraph 72 of the Consultation Paper). Given the small percentage of NDFs that are presently cleared, MFA questions whether it is appropriate for ESMA to prioritize an NDF clearing mandate.

B. Number of CCPs Available to Clear NDFs

At the time of the IRS Consultation, two (and in some cases three) CCPs were available to clear the IRS proposed to be subject to a clearing mandate. Moreover, the IRS Consultation did not take account of CME Clearing Europe, which clears all the relevant IRS, and which has since been authorized under EMIR (see paragraphs 147 to 148 of the IRS Consultation). The position is very different with respect to NDFs, where only LCH has a live NDF clearing offering in the EU. ESMA has pointed out at paragraph 95 of the Consultation Paper that three additional EU CCPs (i.e., CME Clearing Europe, ICE Clearing Europe, and Nasdaq OMX Clearing) expect to start offering NDF clearing. However, none of these CCPs has launched such an offering to date. Further,
even if such CCPs launch their offerings, there can be no certainty that the offerings will cover all classes of NDFs that ESMA proposes to make subject to the clearing obligation.

MFA appreciates that, as ESMA notes in paragraph 96 of the Consultation Paper, three CCPs established in third country jurisdictions currently clear NDFs and that “upon recognition” as third-country CCPs, such CCPs will also be available to market participants. MFA also welcomes the statement by ESMA that it expects to grant recognition to such third country CCPs in the near future. For example, we note the recent adoption by the European Commission (“EC”) of equivalence decisions with respect to the regulatory regimes of CCPs in Australia, Hong Kong, Japan, and Singapore. We believe these equivalence decisions represent an important step towards ESMA granting recognition to the Singapore Exchange Derivatives Clearing and OTC Clearing Hong Kong (i.e., two of the three non-EU CCPs which ESMA notes in the Consultation Paper currently clear NDFs) as third-country CCPs.

However, notwithstanding the equivalence decisions referred to above, given the importance of many U.S. CCPs to the global financial markets, we believe it is particularly important in the context of NDF clearing, as well as clearing generally, that the EC adopts an equivalence decision with respect to the U.S. CCP regulatory regime so that ESMA may recognize U.S. CCPs. In our responses to ESMA’s previous consultations on the clearing obligation, we have highlighted the challenges that market participants would face due to a delay in the EC granting recognition to third country CCPs and such challenges will continue to apply to a large proportion of market participants until ESMA grants recognition to U.S. CCPs. We are aware that recognition of U.S. CCPs is a goal that ESMA and the CFTC are working to achieve. In particular, CFTC Chairman Timothy G. Massad recently stated that “to facilitate the Europeans’ recognition of our clearing-houses, we have agreed to look at whether we can further harmonize our rules, and we are continuing to work on these issues with the Europeans” (see Chairman Massad speech before MFA, available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-2). Accordingly, MFA urges ESMA not to impose a clearing obligation on any category of derivative contract prior to when the EC adopts an equivalence decision with respect to the U.S. regulations and ESMA grants recognition to U.S. CCPs.

However, notwithstanding potential future recognition of third country CCPs, in MFA’s view, the fact that LCH is the only CCP currently available to clear NDFs in the EU could result in significant systemic risk if a situation arose where LCH were unable to cope with the demand for NDF clearing services. We believe that there is also a risk that imposing an NDF clearing obligation where only one CCP is available to clear it could result in a single CCP dominating the cleared NDF market, which would create a monopoly, artificially raise prices, and increase systemic risk in the event of that CCP’s failure. Accordingly, MFA urges ESMA not to impose a clearing obligation on any category of NDF unless there is more than one CCP available in the EU to clear such class of NDF.

C. Client Access to Clearing NDFs

ESMA noted in the IRS Consultation that there are 110 clearing members clearing IRS and that 42 of those clearing members offer a client clearing service (see paragraph 157 of the IRS Con-
sultation). By comparison, ESMA states (at paragraph 100 of the Consultation Paper) that only two of the twenty clearing members at LCH currently offer a client clearing service with respect to NDFs. Therefore, a substantial difference exists in the availability of client clearing as between IRS and NDFs. Most clients do not have the resources available to become clearing members themselves, and thus, will necessarily rely on the availability of client clearing services offered by clearing members to comply with EMIR’s clearing mandate. As a result, it is critical that clearing members make such client clearing services available to ensure that clients have fair and equal access to CCPs. For the EMIR clearing obligation to function as ESMA intends, it is extremely important that ESMA ensure that clients that are subject to the EMIR clearing obligation have robust and viable access to CCPs. Therefore, MFA urges ESMA not to subject any class of NDF to the EMIR clearing obligation until multiple clearing members are offering client clearing services with respect to that class of NDF.

III. Limited Reduction in Systemic Risk Balanced against Increased Costs and Reduction in Liquidity

In MFA’s view, the disadvantages of an uncertain cost structure and potential consequent reduction in liquidity arising from a premature imposition of an NDF clearing obligation outweigh any limited reduction in systemic risk that would be gained from imposing such a clearing obligation.

As noted in paragraph 74 of the Consultation Paper, Bank for International Settlements (“BIS”) data shows that turnover in the outright forward category (which includes NDFs) is concentrated in contracts with a maturity below 1 year and that forward contracts with longer tenors account for only 4.7% of the average turnover. DTCC data examined by ESMA (relating to NDFs only) shows that only 1% of the contracts in the sample had a maturity above 1 year (with the exception of Chinese Yuan, where the figure is 2.8%). These data show that the trading volume in NDFs with a maturity above 1 year is low and accounts for a very small portion of the total number of NDFs traded. Indeed, the data shows that the majority of NDFs have a maturity below 3 months (paragraph 76 of the Consultation Paper). In MFA’s view, the short-dated nature of most NDFs means that they do not currently create a substantial systemic risk, such that ESMA should impose an NDF clearing mandate at this time.

In addition, MFA believes that balanced against such insignificant reductions of systemic risk, the costs involved in mandatory clearing of NDFs (notably for end-users and clients) will be high. In particular, we believe that it will be more expensive to maintain a cleared NDF portfolio than it is currently to maintain an uncleared NDF portfolio for the following reasons:

1. Clearing and settling NDFs will cost significantly more for end-users than current FX prime brokerage arrangements because of CCP margin requirements and the inability of end-users to rely upon the cross collateralization of various different types of arrangements under an FX prime brokerage agreement. In particular, the ticket fees (i.e., the fees charged per lot or per ticket applied to each transaction) imposed by CCPs are substantially more than any ticket charges arising from non-centrally cleared NDFs.
2. Operational costs for end-users will increase because they will be required to maintain an FX prime brokerage arrangement for their deliverable FX contracts, while simultaneously being required to maintain clearing arrangements in respect of NDFs. Such additional costs may cause a reduction in liquidity in the NDF market and may result in a number of market participants leaving their currency exposures unhedged.

Q6: Do you agree with the proposal to keep the same definition of the categories of counterparties for the NDF classes than for the credit and the interest rate classes? Please explain why and possible alternatives.

As noted in our introductory comments, although MFA does not support the introduction of a clearing obligation in relation to any classes of NDF at this time, MFA welcomes the opportunity to comment on the proposed categories of counterparties and dates of application of the NDF clearing obligation. Because it may later become appropriate for ESMA to recommend mandatory clearing of NDFs, the issues that we identify in our response to Question 5 above must be addressed satisfactorily. At such point, MFA urges ESMA to consider the concerns and follow the proposals relating to the clearing phase-in set out below.

I. Background

At paragraph 186 of the IRS Consultation, ESMA proposed a phase-in approach where certain FCs and NFC+ AIFs would be included in Category 2 and would be subject to the clearing obligation beginning 18 months after entry into force of the regulatory technical standards (“RTS”). However, in its final report on “Draft technical standards on the Clearing Obligation – Interest Rate OTC Derivatives” dated 1 October 2014 (“Final Report”) (available at: http://www.esma.europa.eu/news/ESMA-defines-products-counterparties-and-starting-dates-clearing-interest-rate-swaps?t=579&o=page%2Fpost-trading), ESMA has proposed final draft RTS that meaningfully change its original proposed phase-in approach. In the Consultation Paper, ESMA suggests that it would adopt such altered approach in the context of the NDF clearing obligation. In particular, the RTS (Article 3(1)) divide previously proposed Category 2 into two separate categories (a modified Category 2 and new Category 3).

FCs and NFC+ AIFs that belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives, determined on the dates specified in the RTS, is above EUR 8 billion (“Notional Threshold”) would remain in Category 2, whereas FCs and NFC+ AIFs at or below the Notional Threshold would be included in a separate Category 3.

The regulatory effect of ESMA employing a threshold-based approach and splitting FCs and NFC+ AIFs into two different categories is that FCs and NFC+ AIFs in Category 2 would be subject to the clearing obligation beginning 12 months after entry into force of the final RTS. In addition, FCs in Category 2 would be subject to the frontloading obligation with respect to contracts concluded during “Period B” (i.e., the period between the publication of the RTS and the date on
which the clearing obligation begins to apply). In contrast, FCs and NFC + AIFs in Category 3 would be subject to the clearing obligation beginning 18 months after entry into force of the final RTS, and the FCs within this category that would otherwise be subject to frontloading would be excluded from the frontloading obligation altogether (paragraph 145 of the Final Report).

II. Practical Issues with Notional Threshold Approach

By using the Notional Threshold to divide FCs and NFC + AIFs into two categories, ESMA has created a number of practical issues that will make it difficult for some market participants to:

1. Begin the necessary calculations to determine their Category 2 or 3 status prior to publication of the final RTS, and

2. Complete the necessary Category 2 or 3 calculations following publication of the final RTS but prior to the frontloading obligation coming into effect as contemplated by ESMA in the Consultation Paper.

MFA believes that the unnecessary practical difficulties, complexities, and ambiguities created by employing the Notional Threshold justify its elimination and reversion to ESMA’s prior three-category approach, as discussed in Section IV below.

A. Ambiguity of “Group” and Product-Level Calculations

As mentioned, in the Consultation Paper, ESMA proposes to require market participants to calculate the Notional Threshold on a “group” basis. However, neither the Consultation Paper nor the Final Report clarifies what constitutes a “group”. This ambiguity is problematic. For example, in the case of AIFs, the concept of a “group” is not a well-established concept such that an alternative investment fund manager knows which AIFs form part of a “group” for purposes of performing the Notional Threshold calculation. In fact, in other contexts (e.g., in recital (5) to the European Supervisory Authorities (“ESAs”) consultation paper on “Draft regulatory technical standards on risk mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012” dated 14 April 2014 (“Margin Consultation”), available at: https://www.eba.europa.eu/regulation-and-policy/market-infrastructures/draft-regulatory-technical-standards-on-risk-mitigation-techniques-for-otc-derivatives-not-cleared-by-a-central-counterparty-ccp), ESMA has expressly determined that in the case of AIFs, similar calculations should be performed not on a “group” basis but on a fund-by-fund basis. We have no doubt that ESMA intends for AIFs to apply the same fund-by-fund analysis in this context as well. Therefore, if despite our recommendations herein, ESMA retains the Notional Threshold approach, we request that ESMA expressly confirm that AIFs perform such calculations on a fund-by-fund basis.
Further, MFA is concerned that ESMA has not issued sufficient guidance on the manner in which market participants should measure their “notional amount of certain non-centrally cleared OTC derivative contracts” for purposes of the Notional Threshold. In particular, market participants need more detailed guidance from ESMA as to how to determine the notional amount for non-centrally cleared option contracts. In the case of option contracts, in the ordinary course, market participants may calculate notional amounts in different ways. Therefore, to ensure that market participants perform the necessary Notional Threshold calculation in a consistent manner, it is important for ESMA to provide guidance as to the calculation methodology that it wants market participants to use for different OTC derivative contracts.

If ESMA retains the Notional Threshold approach, it would be necessary for ESMA to clarify both of the foregoing issues before market participants can begin to determine whether they fall within Category 2 or 3. Depending on the timing of ESMA providing this guidance, it likely would not give market participants sufficient time to complete the necessary calculation before the frontloading obligation comes into effect. In contrast, eliminating the Notional Threshold would also result in the elimination of these ambiguities and would provide for a smooth and more prompt transition to EU clearing.

B. Unknown Calculation Period

At paragraph 105 of the Consultation Paper, ESMA explains that a market participant exceeds the Notional Threshold if the “notional amount of non-centrally cleared derivatives for [November 2014, December 2014 and January 2015] is above EUR 8 billion”. As ESMA acknowledges in the Consultation Paper (paragraphs 112–113), the relevant calculation period remains unknown (although it is proposed that it should be the same as for IRS transactions that the Final Report proposes to subject to the clearing obligation). Rather, ESMA used the three-month period from November 2014 to January 2015 as a placeholder based on its assumption (at paragraph 107 of the Final Report) that the final RTS in relation to the IRS clearing obligation will enter into force during the month of February 2015. However, if that assumption is incorrect, ESMA will have to adjust the relevant calculation period. Therefore, by retaining the Notional Threshold approach, ambiguity would remain until publication of the final RTS in relation to the IRS clearing obligation as to the relevant calculation period(s) to determine their Category 2 or 3 status.

C. Timing and Costs of Notional Threshold Calculation

MFA is also concerned that proceeding with the Notional Threshold approach might also extend the timing needed by some market participants to complete the Notional Threshold calculation once they: (i) have clarity on what constitutes a “group”; (ii) have guidance on how to determine the notional amount of certain OTC derivative contracts; and (iii) know the relevant calculation period(s).
As a preliminary matter, some market participants do not have experience performing such calculations. As a result, the time necessary for some market participants to determine whether they exceed the Notional Threshold may be longer than contemplated by the Consultation Paper. As mentioned, use of the Notional Threshold is a new construct that affected market participants became aware of upon ESMA’s issuance of the Consultation Paper and the Final Report. Although certain NFC+s may have had to perform a similar calculation to determine whether they fell above or below the clearing threshold, FCs and many NFC+s never had to make such an assessment. In addition, while the Margin Consultation contemplates use of similar thresholds, those RTS are not final, and thus, market participants have not begun calculating those thresholds. Indeed, since the applicable margin RTS may change before they enter into force, it is possible that such calculation will not even be required.

In addition, once ESMA clarifies what constitutes a “group” for purposes of the Notional Threshold calculation, some market participants (in particular, some FCs) will need to establish arrangements with legal entities within that group to access their position-level information to complete the Category 2 or 3 calculation. This process could be time-consuming on a legal and operational level, and it is possible that the necessary data will not be readily accessible prior to expiration of the implementation timeframe.

MFA’s understanding is that market participants that have experience with such “group” assessments in the NFC+ context suggest that this task is not a straightforward task. Therefore, we believe the costs of calculating and applying the Notional Threshold could be burdensome for some market participants. In the Final Report, ESMA contends that the costs should be minimal due to “the quantitative threshold being aligned with the threshold agreed at international level related to margin requirements for non-centrally cleared derivatives” (Recital (9) of the IRS RTS). However, only certain dealers that expect to be among the first category of market participants subject to the ESAs’ final margin requirements have begun thinking about how to calculate the similar margin thresholds. Moreover, many of these dealers may also be clearing members that will fall within Category 1, and therefore, are not required to make such calculations for purposes of the clearing obligation. As discussed above, with respect to Category 2 and 3 entities, this approach is new and it would not be a straightforward or mechanical process for some Category 2 and 3 entities to complete. Therefore, MFA believes the costs of adopting the Notional Threshold approach could be material and potentially substantial.

III. Lack of Opportunity for Public Comment

Although ESMA has discussed applying the Notional Threshold with respect to other entirely unrelated EMIR requirements (e.g., the requirement in the Margin Consultation to post initial margin in respect of non-centrally cleared OTC derivative contracts), in its previous consultation papers on the clearing obligation, ESMA did not discuss using such a threshold-based approach to create separate categories of FCs and NFC+ AIFs (see the discussion at paragraphs 158 – 162 of the IRS Consultation). Specifically, in paragraph 127 of its discussion paper on “The Clearing
Obligation under EMIR”, dated 12 July 2013 (available at: http://www.esma.europa.eu/system/files/2013-925_discussion_paper_-_the_clearing_obligation_under_emir_0.pdf), ESMA considered dividing counterparties into categories “depending on the volume of OTC derivatives contract” to which they are a party. However, in the IRS Consultation, ESMA affirmatively dismissed using this activity-level approach, and instead proceeded with the three-category approach because it has “the benefit of limiting the number of categories to enable a simplified and pragmatic implementation period”.

The addition of the Notional Threshold with respect to the phase-in approach and frontloading obligation is a significant substantive change, and as discussed above, it creates a number of ambiguities and complexities that could make the prompt commencement of clearing difficult for some market participants. Since ESMA did not reissue the IRS RTS with the Notional Threshold for public comment prior to submission to the EC for its approval, we have not had the opportunity to share our reservations with this approach previously. Therefore, we welcome the opportunity to do so in the context of our response to the Consultation Paper. Accordingly, MFA respectfully requests that ESMA revise its approach consistent with our below recommendation. We have also written to the EC on this issue, in a letter dated 21 October 2014 (available at: http://www.managedfunds.org/issues-policy/mfa-comment-letters/mfa-submits-letter-european-commission-emir-clearing-phase-frontloading-obligation/).

IV. Recommended Solution

Due to the foregoing, MFA believes that the Notional Threshold approach introduces too much complexity and uncertainty into the phase-in approach and frontloading obligation. Below is our recommended solution, which we believe eliminates such complexity and uncertainty and supports ESMA’s aim (as stated at Recital (5) of the IRS RTS) of ensuring an orderly and timely implementation of the clearing obligation, once it is appropriate to impose such a clearing obligation on NDFs.

A. Combine Categories 2 and 3 Subject to a 12-Month Phase-In Period

MFA urges ESMA to revert to its previously proposed approach (at paragraph 186 of the IRS Consultation) by combining Category 2 and 3 into a single Combined Category 2 for purposes of the phase-in. In response to the IRS Consultation, MFA supported ESMA’s determination to include all relevant AIFs in Category 2 (see pp.16-7 of our response, a link to which is included at Section II of our response to Question 5 above). Because some AIFs will be FCs and other AIFs will be NFC+s, we thought (and still think) that ensuring that all AIFs begin mandatory clearing under EMIR at the same time is appropriate. In addition, we believe that returning to that approach and combining Category 2 and 3 entities will eliminate the practical issues with the Notional Threshold approach discussed herein, and simplify the application of the phase-approach and the frontloading obligation for all FCs and, as applicable, NFC+ AIFs not in Category 1.
MFA would also recommend that ESMA retain the shortened 12-month phase-in period for Combined Category 2. We do not believe that applying the shorter 12-month phase-in period for all Combined Category 2 entities would be unduly burdensome for less active FCs and NFC+ AIFs. In response to the IRS Consultation, we expressed that we considered the proposed 18-month phase-in period following entry into force of the RTS for Category 2 entities excessively long, and urged ESMA to introduce a shorter, 6-month phase-in period following entry into force of the RTS for such entities. At the time, our view was (and our view remains) that such a 6-month period, together with the additional time that will pass prior to the entry into force of the RTS, will give Category 2 entities sufficient time to put in place arrangements to clear under EMIR.

Although MFA continues to believe that entities in Combined Category 2 would be able to comply with the clearing obligation within 6 months from entry into force of the RTS, we appreciate that, in the Final Report and the Consultation Paper, ESMA reduced the proposed phase-in period for Category 2 entities to 12 months. Therefore, we think it reasonable to apply the proposed 12 month phase-in period to all entities in Combined Category 2.

However, MFA does not think a longer 18-month phase-in period is necessary for any FCs or AIFs that are NFC+s. A number of Combined Category 2 entities are already subject to a clearing obligation in other jurisdictions, and thus, already have connectivity with CCPs and appropriate clearing documentation in place. Moreover, such shorter implementation period will incentivize CCPs to give sufficient consideration of the requirements and timing applicable to Category 2 entities when finalizing their clearing offerings. We are concerned that if 18 months were to elapse after the application of the clearing obligation to Category 1 entities before Combined Category 2 entities were subject to a clearing obligation, competitive distortions would result from such a split phase-in period. Therefore, MFA believes that a 12-month implementation period is appropriate for all Combined Category 2 entities because only a short time will elapse between the application of the clearing obligation with respect to Category 1 entities and the application of the clearing obligation with respect to Combined Category 2 entities.

V. Eliminate Frontloading Obligation

MFA believes that our recommended approach of combining Category 2 and 3 and reducing the phase-in period for Combined Category 2 to 12 months supports elimination of the frontloading obligation for all FCs in Combined Category 2.

As discussed above, although ESMA’s draft RTS propose to eliminate the Period B frontloading obligation for Category 3 entities, ESMA retained the Period B frontloading obligation for FCs in Category 2. At paragraph 144 of the Final Report, ESMA reasoned that “frontloading may turn out to be a strong incentive for counterparties to start central clearing as soon as possible to minimise the number of contracts subject to frontloading.”
MFA does not see any justification for applying the frontloading obligation to FCs that exceed the Notional Threshold differently than to FCs at or below the Notional Threshold. However, regardless of whether ESMA adopts our recommended approach of creating a Combined Category 2, we have concerns with applying the frontloading obligation to any FCs within such category for contracts concluded during Period B.

Although parties will have legal certainty as to which contracts will ultimately be subject to the frontloading obligation, such contracts will be priced for a certain period of time as non-centrally cleared trades, and then, upon commencement of the clearing obligation for such trades, would have to be priced as cleared trades. MFA is concerned that, accordingly, the frontloading obligation in Period B will result in fractured markets and a troubling lack of transparent pricing being available during such interim period. ESMA acknowledges these pricing concerns at paragraph 142 in the Final Report, but determines only to provide relief to FCs that are at or below the Notional Threshold.

As a result, MFA urges ESMA to modify its approach to contracts concluded by FCs that are Combined Category 2 entities during Period B, and treat the minimum remaining maturity of contracts concluded during this period in the same way as in “Period A” (i.e., the period between the relevant notification of the classes of derivatives to ESMA and the publication of the final RTS). Taking such a position would effectively result in no contracts being subject to frontloading for Combined Category 2 entities.

MFA considers this solution appropriate in light of MFA’s support for reducing the phase-in period for Combined Category 2 above. Due to our concerns about the impact of frontloading on pricing of derivatives contracts and the resulting market disruption, we believe that accelerating the timeframe for phase in of the clearing obligation, rather than requiring frontloading during Period B, is a more appropriate way to ensure clearing of the proposed IRS and (if appropriate, in due course) NDF transactions. Such an approach would have the benefit of: (i) eliminating the difficulties associated with frontloading, as described above; (ii) ensuring that all in-scope AIFs are subject to the same treatment with respect to all aspects of the clearing obligation; and (iii) result in the clearing obligation applying to all entities in ESMA’s proposed Category 3 at an earlier date.

Q7: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

Please see our response to Question 6 above in this regard.
5. Remaining maturity and frontloading

Q8: Do you have comments on the minimum remaining maturities for NDF?

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Annex I - Draft Regulatory Technical Standards on the Clearing Obligation

Q9: Please indicate your comments on the draft RTS other than those already made in the previous questions.

<ESMA_CO3_QUESTION_9>

As noted above, MFA does not believe that frontloading should apply to any category of market participant. However, should ESMA retain the draft RTS in the proposed form, irrespective of the comments we have made above, MFA respectfully requests that ESMA amend the recitals to the draft RTS set out in the Consultation Paper so as to clarify that the frontloading obligation will not apply to any NFC+s. At present, the language in parenthesis in Recital (22) suggests that only NFC+s in Category 4 will not be subject to frontloading, whereas the proposal in the Consultation Paper is that frontloading will not apply to any NFC+s (including NFC+ AIFs).

<ESMA_CO3_QUESTION_9>
Annex II – Impact assessment

Q10: Please indicate your comments on the Impact Assessment.

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