DRAFT TECHNICAL STANDARDS FOR

THE REGULATION ON OTC DERIVATIVES, CCPs AND TRADE REPOSITORIES

An ESMA Discussion Paper

A response by the Futures and Options Association

March 2012

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1. Introduction

1.1 This response is submitted on behalf of the Futures and Options Association ("the FOA"), which is the principal European industry association for 160 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1).

1.2 The FOA welcomes this opportunity to comment on ESMA's proposals for developing regulatory and implementing technical standards in support of ESMA.

1.3 For confirmation, the FOA supports the CPSS-IOSCO Recommendations for Central Counterparties (November 2004) and the related CPSS-IOSCO Guidance on those Recommendations (May 2010). The FOA anticipates that ESMA, like the Commission, will look to correlate its proposals closely with these Recommendations and avoid super-equivalence in carrying out its intention to introduce more granular requirements, because of:

(a) the adverse consequences for the global competitiveness of EU institutions;

(b) the need to facilitate regulatory recognition, particularly with the US; and

(c) to better harmonise the approach towards EU CCPs within the overarching international recommendations, standards and guidance.

In this context, the FOA notes ESMA's intention (para 7, page 6) to rely also on reports issued by the Financial Stability Board, IOSCO and the Basel Committee on Banking Supervision.

It is critical therefore that ESMA reviews its final proposals and any subsequent changes introduced to them to ensure that consistency with the Recommendations is maintained.

1.4 The FOA would reiterate its general support for OTC regulatory reform and, in particular, the need for:

(a) close supervision of markets and dealers;

(b) CCP clearing of "eligible" OTC contracts, but is mindful also of the need to avoid undue exacerbation in the risk profile of CCPs or undermining (other than where necessary) the underlying economics of market functioning, particularly for financial and non-financial end-users;

(c) improved and authentically risk-based, but not punitive, capital treatment of non-CCP cleared OTC contracts;

(d) comprehensive reporting of all OTC transactions to trade repositories, through CCPs or otherwise to the relevant regulatory authority, but would emphasise also the importance of a proportionate approach, particularly in the case of uniquely tailored OTC contracts;

(e) more extensive transparency of OTC transactions which is proportionate to need and sensitive to market differentiation and user trading confidentiality;

(f) closer regulation of CCPs, including the imposition of risk-based capital rules, reliance on proportionate CCP "skin-in-the-game", risk/volume-based default funds and robust standards covering conduct of business, organisational requirements, conflicts of interest management and systems, controls and processes for managing risk;

(g) fairness and transparency in addressing rights of OTC clearing access to CCPs and the pricing of CCP services;

(h) close regulation of trade repositories, including gathering and secure retention of trade data, maintaining confidentiality and appropriate public disclosure of aggregated data.

We realise that a number of these elements will not fall to ESMA for decision, but we felt it would be helpful to set them out insofar as they represent our view as regards overarching policy for regulatory repair set by EMIR.

1.5 In general terms, the FOA represents the listed derivative markets, and we very much support the current drive to make the OTC markets safer, bearing in mind their interconnected nature, their size and the fact that, in the EU, they were under-regulated before the crisis and, in the US, not regulated at all. We also note that part of the programme of reducing the risk of these markets includes introducing some of the benefits of trading in the listed derivatives markets to OTC markets, eg closer supervision of dealings, enhanced and improved post-trade processing, new and better risk-based prudential requirements and, where eligible, CCP clearing and, where the contracts are sufficiently developed and liquid, multilateral execution.

On the other hand, it is equally important that ESMA bears in mind that the OTC markets – which are complementary markets to the listed derivatives markets – are not unduly constrained by ESMA's technical standards to the point where they are not able to fulfil their diversified role in terms of:

(a) acting as an economically viable "birthpool" for introducing new contracts insofar as, once a market has developed over-the-counter, it is easier for the exchanges to then develop a standardised contract that is suitable for multilateral execution (NB. By way of contrast, exchanges have launched many new contracts which were eligible for CCP clearing, but inappropriate and insufficiently developed to be capable of multilateral execution and which then failed);

(b) facilitating dealings in small specialist markets, where participation is too small for the purpose of being traded multilaterally on an economically viable basis;

(c) enabling fund managers, corporate treasurers and other institutional end-users to enter into tailored bilateral risk management transactions to address their unique and sometimes complex underlying business risks.

In putting this forward, the FOA would emphasise that this is not intended to suggest that exposures in OTC markets should not be (a) properly capitalised and, of course, it is generally recognised that they were under-regulated and under-capitalised in the past; or (b) adequately collateralised.

1.6 The FOA recognises the advantages of multi-lateral netting / offsets, robust risk management systems and controls, post-trade processing efficiencies and the mutualisation of losses offered by CCPs for addressing the credit risk of standardised OTC contracts. At the same time, it is important to sustain an accessible and economically-viable OTC market and to preserve the role of bilaterally-cleared "bespoke" contracts in meeting the often diverse and sometimes complex risk management needs of both financial and non-financial end-users.

As it was put in the IMF Global Financial Stability Report "Meeting New Challenges to Stability and Building a Safer System" (April 2010), "*many end-users continue to prefer OTC bilateral arrangements in order to meet their specific hedging requirements and hence have a desire for customised contracts*" (Chapter 3, page 10). In line with this recognition of the preference of end-users, the Commission in its Communication "Ensuring efficient, safe and sound derivatives markets: Future policy actions" (COM 2009 563/4) recognised the importance of risk management and emphasised that it "*does not want to limit the economic terms of derivatives contracts, neither to prohibit the use of customised contracts nor to make them excessively costly for non-financial institutions*".

The FOA would urge ESMA to bear these underlying policy approaches in mind in developing its technical standards in support of EMIR.

1.7 The FOA notes ESMA's intention to undertake an analysis of the cost and benefits of its proposed measures and its recognition of the length of time needed by the industry to implement those new measures. The FOA agrees that increased costs are an inevitable result of the drive for more effective regulation and supervision. However, it continues to be important that an effective balance is struck between delivering regulatory repair and sustaining, where achievable, the economics of market functionality, particularly regarding market participation by both financial and non-financial end-users.

The FOA notes in para 4 on page 5 of the ESMA DP that it is inviting respondents to provide "information on cost and benefits and timing for implementation" and to accompany their responses "with quantitative evidence". The FOA does not believe that this is possible within the timescale set by ESMA, namely, to submit responses to its DP by 19th March. Nevertheless, it will look at the feasibility of trying to deliver that

kind of analysis in a few areas, but anticipates that it may not be possible to complete such an analysis until at least May.

1.8 The FOA supports the criteria-driven approach in ESMA's DP, as against reliance on prescriptive lists and detailed formulae, but believes that ESMA should ensure that the national supervisors of the CCPs monitor the interpretation and application of all criteria (and compare and monitor the risk models employed by CCPs), to ensure that there is a consistent approach (which need not be exactly the same) adopted by all CCPs, reflecting the increasing importance of like rules being applied to like markets and of CCPs to the integrity of the financial system. At the same time, the criteria must allow for the tailored treatment of differentiated risk, which will vary from contract to contract and asset to asset.

1.9 The FOA notes that ESMA puts forward a number of prescriptive proposals which, in certain areas, could restrict CCP discretion and hamper its ability to dynamically manage risk, particularly in times of market stress, e.g.:

- there is a need to avoid any presumption that systems and controls deemed appropriate for one class of contract are necessarily appropriate for all classes of contract;

- the importance of avoiding a "tick-box" approach, which is a natural consequence of thresholds and standards, insofar as it could constrain a more judgemental approach in the dynamic management of risk.

1.10 It is important to bear in mind that the best execution obligation, which is owed to retail customers and those other customers who require best execution, includes not just price but the quality and robustness of the clearing of transactions executed on their behalf. It is important therefore that intermediaries have sufficient information provided to them by the CCP to enable them to assess the quality of the clearing guarantee and meet, therefore, the fiduciary obligation owed to customers with confidence. While it is not intended to require a CCP to disclose information which is, for example, commercially or strategically sensitive or which would undermine the security of systemic integrity of the CCP or the marketplace generally, ESMA needs to have these constraints in mind as it determines what classes of information should be made available for disclosure purposes and to whom – and this does arise in several sections through the DP.

1.11 With regard to collateral, the FOA would urge ESMA to be as non-prescriptive as possible, in order to take account of the fact that significant numbers of end-users that traditionally used the OTC markets will now be expected to not only meet more exacting and frequent margin calls in respect of their exposures, but will have to provide highly liquid collateral in support of this exposures. The FOA anticipates that there will be a shortfall of "highly liquid" assets capable of being recognised as eligible collateral and that, in any event, this will constitute a major add-on cost for end-users. The prospect of a collateral "crunch" cannot be discounted.

1.12 The FOA notes that ESMA has no authority to introduce Level 2 standards in relation to portability in the event of a default and would only emphasise that, bearing in mind its importance and the experiences gained to date, this seems an unusual omission.

1.13 The FOA would urge ESMA to take account of the fact that it is the credit clearing members that underwrite the integrity of the CCP structure and that their interests and concerns need to be taken carefully into account in developing proposals to support EMIR.

1.14 The FOA would make two further general observations, namely:

(a) The obligation placed upon CCPs is to provide choice as to client segregation models, which would enable end-users to determine the risk/cost ratio that suits them, insofar as absolute protection will come at a very high cost and there will be many end-users who would prefer to keep the costs down and have less protection, albeit still within segregation. The FOA does not believe it is appropriate to directly or indirectly incentivise the adoption of individually-segregated accounts, because of the significant cost that this will place upon clearing members and customers

(b) The FOA would urge ESMA to consider, where practical and feasible, ensuring that the industry code of practice that was developed for the clearing of cash equities under the auspices of the European Commission apply to the contracts which are the subject of these proposals, in terms of fees transparency, fees apportionment between execution and clearing, service transparency and separate accounting.

2. FOA response to specific questions in the ESMA Discussion Paper

Q.1 In your views, how should ESMA specify contracts that are considered to have a direct, substantial and foreseeable effect within the EU?

2.1 The FOA is concerned that third country entities will have to clear OTC derivative contracts that have a "direct, substantial and foreseeable effect within the EU" or where they would involve "evasion of any provision of EMIR", which raises the same concerns expressed by the EU over the basis of US extra-territorial application of US rules to non-US entities.

2.2 The FOA believes that there are considerable risks in ESMA's proposal to specify those contracts (presumably high-volume contracts with an EU underlying) that it believes will have a "direct, substantial and foreseeable effect within the EU", firstly, because that effect will vary significantly from time to time and from contract to contract and will depend largely upon volumes, continuing eligibility for EU clearing (which may fluctuate – see response to Q6), volatility and a continuing high degree of economic connectivity.

2.3 The FOA believes that the only practical approach to addressing this issue is for ESMA to reconcile the development of its technical standards for determining "eligibility" as closely as possible to those of the Dodd-Frank Act, the SEC and the CFTC, so as to establish a common EU/US approach. While this may be difficult to achieve in the context of a significant number of jurisdictions, this would help to (a) avoid unnecessary EU/US regulatory complexity / legal risk; (b) reduce the conflicting application of different rules applied extraterritorially; and (c) facilitate regulatory recognition of CCPs and the related rules and regulations governing the clearing obligation in jurisdictions which demonstrate comparable regulatory standards, outcomes and objectives.

In this context, it is worth noting that CFTC extraterritoriality is exacerbating the cost and burden of clearing in the EU by requiring that clearing members clearing for US customers must become CFTC-regulated FCMs.

In this context, the FOA would refer to the Recommendations in the recently-issued Requirements for Mandatory Clearing, issued by IOSCO's Technical Committee (February 2012) and, in particular, Recommendation 15, which urges authorities to *"closely co-operate to identify overlaps, conflicts and gaps between regimes, with respect to cross-border application of the clearing obligation"* and Recommendation 16, which urges supervisory authorities to *"give due consideration to allowing the use of third-country CCPs to meet mandatory clearing obligations"*.

Q.2 In your view, how should ESMA specify cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR for contracts entered into between counterparties located in a third country?

2.4 The FOA believes, once again, this is an extraordinarily difficult requirement for ESMA to address in a way that avoids regulatory conflict and enables counterparties to be able to reasonably predict the consequences of their actions. The FOA assumes that this is not intended to impair the ability of regulated firms to operate their businesses to the maximum benefit of their customers through lawful "avoidance" of onerous rules, and that a proper distinction will be maintained between "evasion" and "avoidance".

Insofar as both counterparties are non-EU branches of EU-licensed firms, the issue of evasion may be easier to identify, but, if they are non-EU affiliates of EU-licensed firms regulated by that third country and they fulfil the requirements of that country's domestic comparable clearing obligation, then it will be much more difficult (and, arguably, unfair) to seek to allege evasion.

2.5 The FOA is extremely concerned over the legal risk and regulatory conflict that will arise in relation to ESMA's response to Q1 and Q2 and would urge approximation in approach between ESMA, the SEC and the CFTC to mitigate the legal risk consequences of these provisions.

Q.3 In your views, what should be the characteristics of these indirect contractual arrangements?

2.6 The FOA welcomes ESMA's recognition of the value of indirect clearing, which will enable financial institutions, particularly relevant for SMEs, to secure the benefits of clearing for their own clients, without having to incur the costs of becoming clearing members.

2.7 The FOA assumes that those institutions that offer indirect clearing to their customers will be able to offer exactly the same degree of optionality in terms of segregation and the right of portability in the event of default, as would be made available by the relevant CCP.

For confirmation, we note the options for indirect clearing as set out in ISDA's response and, for the reasons given, support its conclusion that the preferred model is the agency model.

Q.4 What are your views on the required information? Do you have specific recommendations of specific information useful for any of the criteria? Would you recommend considering other information?

2.8 The FOA agrees with ESMA's approach, but would urge ESMA to pursue, as indicated in para 12, the adoption of a "more granular approach" as soon as possible to avoid the application of the clearing obligation applying to all contracts within a class, but with exceptions in the case of those contracts within the class which would fail the test of eligibility (e.g. uniquely long-dated contracts within the class). The FOA has emphasised in past responses that the tests will not apply evenly to each OTC derivative, but will vary significantly in terms of each derivative contract within a given class.

It is recognised that it is neither practical nor feasible to apply the test of eligibility on a contract-by-contract basis, nor to monitor eligibility on an on-going basis in this way, but an exceptions approach will be necessary and should provide a more practical basis for determining eligibility. Perhaps this could be applied on the basis of, once a class of contract is deemed eligible for CCP clearing, the "burden of proof" will shift in such a way that a specific case must be made to evidence that any particular contract or contracts within that class is/are not eligible for CCP clearing.

The FOA also recognises that it will be difficult to determine the definition of a "class" in this context which, presumably, would have to be based on a given degree of close correlation in terms of the pricing, historic volatility, quality and the economics of the underlying financial instrument or asset. This may prove to be difficult in the case of, for example, commodities or individually-tailored contracts such as individually-named CDSs.

2.9 In terms of the provision of information, the FOA believes that the notification from the competent authority will inevitably be tailored to the characteristics and risks of the market in question, but it should include, in addition to the information identified, sufficient information to enable ESMA:

- to determine the systemic importance of the relevant contract, where, for example, central clearing may have serious economic consequences for the viability of the contract (noting that financial end-users do not have the benefit of an exemption from the clearing obligation) to the point where liquidity will decline to an unacceptable degree;

- to gain a clear understanding of the underlying value at risk in a relevant derivative or class of derivatives, including the liquidity of that underlying instrument or asset;

- to take account of the impact of contract maturity and the denominated currency;

- to assess the depth of clearing member support for the CCP's default fund(s) and default management processes as regards the relevant derivative or class of derivatives;

- to assess CCP capability of clearing the relevant derivative or class of derivatives;

- to be aware of the outcome of public consultations (and, in the view of the FOA, this should be the subject of a specific obligation placed on the competent authority, rather than the less strict, almost discretionary approach, envisaged in para 19);

- to determine the merits (or otherwise) of any "front-loading" proposals for a particular derivative or class of derivatives.

The FOA believes that it is critically important for ESMA to have all the relevant material made available to it for the purposes of reaching a decision, and that the views of other "stakeholders" affected by ESMA's decision should be required to be submitted to ESMA. In this context, the FOA would refer to the Recommendations in the Requirements for Mandatory Clearing (referred to in para 2.3 above), namely Recommendation 4, which proposes that a determining authority "should consider information from a range of sources, including trade repositories" when assessing a mandatory clearing obligation; and Recommendation 9, which recommends consultation with stakeholders as part of the decision-making process, "to allow stakeholders to provide input on whether a product may be appropriate for a mandatory clearing obligation".

2.10 In defining liquidity, factors to be taken into account include pricing transparency and reliability and tradability at times of market stress (particularly important in the event of a default).

2.11 The FOA believes that notifications received by ESMA from a competent authority should be published on receipt, so that market participants can anticipate the economic and other consequences of likely changes to existing clearing arrangements for particular contracts; and that sufficient time should be allowed between confirmation of eligibility and implementation for market participants to prepare for transition to CCP clearing.

2.12 Clearly, changes in the liquidity of a CCP-cleared contract may mean that it is more difficult to clear or that it simply becomes uneconomic to be centrally cleared, and this will require, inevitably, the provision of further information to ESMA as and where relevant and a dynamic approach to monitoring eligibility for CCP clearing.

Q.5 For a reasonable assessment by ESMA on the basis the information provided in a later notification, what period of time should this historical data cover?

2.13 See FOA response to Q35, in which it expresses the view that, while its preferred approach is for a look-back period that covers a relatively long time to ensure that margins are appropriately risk-based, it believes this is an assessment that should be made by a CCP subject to monitoring for consistency by its licensing authority.

Q.6 What are your views on the review process following an indicative assessment?

2.14 The FOA would emphasise the importance of ensuring that fluctuations in liquidity, volume and other criteria do not result in contracts migrating in and out of eligibility for CCP clearing. This would have a destabilising effect and cause significant complications in terms of the practical management of counterparty risk. The FOA would urge ESMA, therefore, to consider carefully how and where appropriate thresholds are set for the relevant criteria.

2.15 The FOA would emphasise the importance of reasonable time limits and full recognition being given to the views of all "stakeholders" in reviewing that assessment and not just those of the competent authority or the CCP. Put another way, ESMA needs to be very careful to be all inclusive when considering the possibility of overturning a previous negative assessment of eligibility for CCP clearing of a class of derivative contracts or a contract within that class.

Q.7 What are your views regarding the specification for assessing standardisation, volume and liquidity, and availability of pricing information?

2.16 The FOA agrees the approach of ESMA, but would refer again to the importance of an assessment of the systemic importance of the contract or class of contract or class of contract under review. The macro-economic importance of requiring a contract or class of contracts to be CCP-cleared is particularly relevant where there is some lack of certainty as to whether or not that contract or class of contracts meets the criteria of "eligibility", i.e. if there is a potential exacerbation in risk for the CCP and there is no systemic importance in the contract or class of contracts in question, then the prudent consequence would be not to require those contracts to be CCP-cleared.

The FOA believes that the economic consequences of CCP clearing are particularly relevant for financial end-users which do not have the option of a clearing exemption. The FOA believes, nevertheless, that the reasons why non-financial counterparties are not subject to the clearing obligation (subject to the ESMA thresholds) are relevant to

reviewing the economic consequences of the clearing obligation on financial end-users.

2.17 ESMA, in considering the issue of standardisation, should distinguish carefully between legal standardisation, economic standardisation and process standardisation.

2.18 The FOA notes that factors such as volume, liquidity and availability of pricing information may vary over time and that this will require constant monitoring and the provision of further information to ESMA as may be appropriate, particularly in relation to the continuing eligibility of a contract to be CCP-cleared.

Q.8 What are your views regarding the details to be included in the ESMA register of classes of derivatives subject to the clearing obligation?

2.19 The FOA believes that the details are sufficient, but, pursuant to its earlier observations in para 2.7 about the application of the clearing obligation to a whole class of derivatives, it anticipates that there may be some exempted derivatives contracts within a class. This should be emphasised in the public register to avoid confusion.

Q.9 Do you consider that the data sufficiently identifies a class of derivatives subject to the clearing obligation and the CCPs authorised or recognised to clear the classes of derivatives subject to the clearing obligation?

2.20 In general terms, yes, subject to our response to Q4.

Q.10 In your view, does the above definition appropriately capture the derivative contracts that are objectively measurable as reducing risk directly related to the commercial treasury financing activity?

2.21 The FOA believes that paras 28 and 29 cover the broad variety of risks related to the kind of commercial activities or treasury financing activities of non-financial counterparties, but believes that they should also include:

- the activity of “refining” in (a);

- in (b), after the word “liabilities”, the words “and other economic inputs”; and after the words “foreign exchange rates”, the words “and other money rates or indices” for the sake of completeness and to cover future unexpected risk classes that need to be managed through the use of derivatives;

- hedging of future anticipated risks, i.e. anticipatory hedging; and we note that partial hedging is recognised through the words “reducing risks”;

- managing cash-flow risk generated by, for example, fluctuating levels of customer consumption and tensions in supply and demand;

- hedging the risks of other affiliates within the group and not just own proprietary risk.

NB. The FOA questions, bearing in mind that the exemption is restricted to non-financial institutions, whether or not they should have further enlargement to the definition of hedging to incorporate "investment activity" alongside "commercial activity".

It is important to bear in mind that large institutions with large mixed portfolios tend to hedge their exposure on a portfolio or "book" basis and not necessarily on a transaction-by-transaction basis to avoid hedging complexity and to secure the significant cost benefits of portfolio hedging.

Finally, the FOA notes the ESMA prohibition on "investing" or "trading" in a derivative in para 31. However, it should be borne in mind that risk management activity does involve "investing" in or "trading" in a correlated derivative to manage risk (and the FOA would point out the terminology used in Q53, which asks for comments on whether or not a CCP should be allowed to "invest in derivatives for hedging purposes"!). The FOA understands the purpose of the prohibition in terms of closing any possible "loophole", but the reality is that, in order to risk-manage an underlying, a derivative contract has to be traded and that could be construed as investing in the derivative, albeit for the purpose of risk management (i.e. the prohibition needs to be qualified in such a way as to make the point that "investing" or "trading" is prohibited unless it is for the purpose of risk management.

2.22 The FOA supports the view in para 30 that consideration should be given to accounting treatment in terms of defining whether or not a derivative is reducing risks, but would emphasise that derivatives can be used to reduce risk partially (and this may not be sufficient for hedge accounting treatment because the element of basis risk may still may still be too significant). Further, it should be noted that undue regulatory incentivisation to use multilaterally-executed standardised contracts may force increased basis risk on end-users and the use of partial hedging techniques to manage their underlying risks.

Q.11 In your views, do the above considerations allow an appropriate setting of the clearing threshold or should other criteria be considered? In particular, do you agree that the broad definition of the activity directly reducing commercial risks or treasury financing activity balances a clearing threshold set at a low level?

2.23 While the FOA welcomes the fact that ESMA has adopted a business-sensitive approach to defining the use of OTC derivatives in terms of reducing commercial risks or treasury financing activity, it is unclear as to why ESMA considers that this justifies a clearing threshold for non-hedging transactions. The FOA believes that the Level 1 intention was to allow non-financial participants to engage in a degree of non-systemically important, non-hedging trading activity. It was not to accommodate purely peripheral hedging activities. The FOA believes, therefore, that this is a fundamentally

incorrect interpretation of and an *ultra vires* limitation on the overarching ESMA requirement.

2.24 The FOA believes that the basis for setting the appropriate threshold is by relevance to the quantum of traded contracts in relation to the overall level of trading activity, to the extent that they are neither margined nor collateralised, i.e. to address the issue of credit risk and systemic risk posed by the relevant trading activity. It does not therefore believe that the appropriate measure for determining the risk of exposure or its systemic importance should be determined by notional value, but, if that is felt to be the appropriate test, it is important that this:

(a) is set in the same context of relativity to overall exposure; and

(b) pursuant to Article 5(4)(b) EMIR, takes into account the impact of netting and, as the FOA would argue, also the risk mitigation effect of collateralisation.

The FOA does agree, however, that determining what would be the appropriate clearing threshold requires further market analysis and the obtaining of more data (as suggested in para 36).

2.25 The FOA believes that the clearing threshold should be calculated at the group level because commodity and treasury risks are usually managed by a single legal entity on behalf of a group, but:

- if a threshold is breached solely because of the trading activity of a single legal entity within the group, there should be sufficient flexibility in the application of the threshold to ensure that not all the legal entities in the group will lose the intended benefit of the exemption and will be compelled to CCP clear all their exposures;

- it is presumed that intra-group transactions will not be subject to the clearing obligation and therefore not to any thresholds.

The FOA recognises that this is a difficult issue and would urge ESMA to undertake an informal round of consultation with a representative group of large-size and small non-financial market participants to determine how the eventual threshold should be applied.

Q.12 What are your views regarding the timing for the confirmation of the differentiated criteria? Is a transaction that is electronically executed, electronically processed or confirmed generally able to be confirmed more quickly than one that is not?

2.26 The FOA welcomes the requirement to provide confirmations via electronic means "where available", which acknowledges that a significant percentage of counterparties continue to use manual confirmations. Inevitably, the latter usually involves confirmation of individually-tailored contracts and, in any event, will nearly always take more time to confirm than the former. This, taken together with the fact that there may be unavoidable processing problems, suggests some latitude should be afforded,

particularly for transactions executed at the end of the business day. Perhaps the approach should be one of "comply or explain".

ESMA should also consider the fact that certain required information to be included in the confirmation will not always be available at the time of execution and this may be a case of setting a time limit which includes the words "or as soon as possible thereafter.

Q.13 What period of time should we consider for reporting unconfirmed OTC derivatives for competent authorities?

2.27 The FOA believes that this question is best answered by ISDA.

Q.14 In your views, is the definition of market conditions preventing market-to-market complete? How should European accounting rules be used for this purpose?

Q.15 Do you think additional criteria for marking-to-market model should be added?

2.28 In response to Qs 14 and 15, the FOA generally agrees with ESMA's approach, but would point out that it is not just market conditions that could prevent marking-to-market, but the unique nature/complexity of particular OTC contracts where the mark-to-market model would not be the most appropriate course.

Q.16 What are your views regarding the frequency of the reconciliation? What should be the size of the portfolio for each reconciliation frequency?

2.29 The FOA agrees with ESMA's approach to portfolio reconciliation.

Q.17 What are your views regarding the threshold to mandate portfolio compression and the frequency of performing portfolio compression?

2.30 The FOA believes this question is best answered by ISDA, which has played a key role in developing portfolio compression.

Q.18 What are your views regarding the procedures counterparties shall have in place for resolving disputes?

2.31 The FOA believes that ISDA is best-placed to address the dispute resolution of OTC contracts.

The FOA is of the view, however, that ESMA has, in general terms, established the correct criteria in relation to dispute resolution, but questions whether it is entirely fair that a counterparty should be given no more than five business days to resolve a dispute before formal procedures are applied. This is particularly the case with complex contracts, which may require significant analysis and protracted periods of negotiation.

Q.19 Do you consider that legal settlement, third party arbitration and/or a market polling mechanism are sufficient to manage disputes?

2.32 The FOA believes that the mechanisms for dispute resolution identified by ESMA are appropriate, but they may not be the only forms of dispute resolution and the FOA believes, therefore, that it should not be assumed that they will necessarily be "sufficient", firstly, because there may be new mechanisms for dispute resolution that may emerge and, secondly, because the parties to a contract should be free to agree any other mechanism for resolving a dispute between them.

Q.20 What are your views regarding thresholds to report a dispute to the competent authority?

2.33 In general terms, these thresholds seem reasonable, but, again, the FOA believes that this is a question best answered by ISDA.

Q.21 In your views, what are the details of the interim group transactions that should be included in the notifications to the competent authority?

Q.22 In your views, what details of the interim group transactions should be included in the information to be publically disclosed by counterparty of exempted intra-group transactions?

2.34 In response to Qs 21 and 22, the FOA believes that these are best addressed by ISDA, but would only point out that, so far as public disclosure is concerned, all that should be sufficient is disclosure of the names of the parties and the type or class of contract entered into between them in order to prevent any breach in trading confidentiality.

Q.23 What are your views on notion of liquidity fragmentation?

2.35 Defining "liquidity" in the context of whether or not its fragmentation will, in real terms, constitute an unacceptable threat to the smooth and orderly functioning of markets to the point where it justifies denying access to a CCP by an execution venue, will be extremely difficult and controversial. Further, it is not entirely clear how this test will operate in the context of bilaterally-executed OTC contracts. For your information, the FOA is intending to undertake further analytical work for the purposes of determining how "liquidity" should be measured for this purpose.

Q.24 What are your views on the possible requirements that CCP governance arrangements should specify? In particular, what is your view on the need to clearly name a chief risk officer, a chief technology officer and a chief compliance officer?

2.36 With regard to para 67 (b), the FOA believes that the organisation and structure should not only be "well documented" but also be both transparent and readily accessible.

Otherwise, the FOA agrees with the broad proposals as to the matters that should be specified in a CCP's organisational structure.

The FOA agrees that the roles of chief risk officer, chief technology officer and chief compliance officer are critically important and they should be readily contactable and therefore identifiable as indicated.

Risk management is critical to the role of a CCP and it should not be compromised by the new business growth opportunities of clearing eligible OTC contracts. It is particularly important therefore to ensure that the issue of governance of risk and the systems and controls for risk management cover specifically its identification, mitigation, monitoring and reporting (see also the FOA response to Q25).

Q.25 Potential conflicts of interests inherent to the organisation of CCPs appropriately addressed?

2.37 The FOA believes that conflicts of interest management is critical to the proper functioning of a CCP, bearing in mind the confidential nature of the data held by it and the tensions between competing for market share and preserving the independence and integrity of the risk management process, particularly with regard to the setting of margins, "haircuts" and offsets and classifying the types of assets that would constitute eligible collateral.

In addition, there is a potential tension for CCPs between, on the one hand, maintaining their role in terms of delivering on market integrity and fulfilling their regulatory obligations and, on the other hand, managing pressures to preserve or grow their business in an increasingly competitive market environment.

The FOA was strongly of the view that a CCP should be allowed to outsource its functionality – even in key areas – on the basis of the CCP retaining overall responsibility in the selection of third-party providers and monitoring constantly the outsourced function to ensure that it is meeting the required standard. Clearly, the more critical the outsourced function, the higher level of due diligence that will be required of a CCP.

Finally, in managing conflicts of interest, a CCP should bear in mind its duty of care to the clearing members and the commitments made by the clearing members to support the CCP in times of market stress. It is their funds and those of their customers that are at risk, and this is a key factor that should be taken into account in terms of the management of conflicts of interest.

The FOA would emphasise again the importance of clarity around clearing fees, separation between execution and clearing fees and clarity around the pricing of CCP services.

Q.26 Do the reporting lines – as required – appropriately complement the organisation of the CCP so as to promote its sound and prudent management?

2.38 Yes, and this is particularly the case with the risk management function which, as pointed out, must be independent of the business area. However, if the risk management committee (which is intended to be independent) has a full and regular reporting function to the Board, the FOA questions whether there needs to be a separate reporting line as envisaged here. That said, the internal audit function should be independent from other functions and should have a direct reporting line to the Board.

Q.27 Do the criteria to be applied in the CCP remuneration policy promote sound and prudent risk management? Which additional criteria should be applied, in particular, for risk managers, senior management and board members?

2.39 The FOA agrees with ESMA that the CCP remuneration policy should preserve sound and prudent risk management, but welcomes the assurance also that the design of the remuneration policy "lies with the Board". This should equally be the case with regard to the setting of specific remuneration, which would be subject to the oversight of a remuneration committee, which, for its part, will prioritise the need for remuneration not to undermine, in any way, the sound prudent management of the CCP.

The issue of performance-based remuneration should take fully into account the risk-averse responsibilities of the CCP to the system and the duty of care owed to its various "stakeholders", including clearing members and their customers.

The scope of entitlement to performance-based remuneration should include staff engaged in compliance, risk management and internal audit, bearing in mind particularly that risk management is critical to the soundness of a CCP.

Q.28 What are your views of the organisational requirements described above? What are the potential costs involved for implementing such requirements?

2.40 The FOA is not in a position to comment on the cost implications of implementing the requirements set out in paras 74 and 75, but believes that they are appropriate, save as follows:

- in para (d), the FOA is not convinced that it is necessary to refer to the option of obtaining an independent legal opinion, insofar as the obligation on the CCP should be to identify and analyse potential conflicts of law issues and it should be entirely a matter for the CCP as to whether or not it requires an independent or an in-house legal opinion;

- with regard to (f), the FOA is not convinced that it is necessary for a CCP to disclose its commercial strategies as suggested in sub-para (i).

Q.29 Should a principle of full disclosure to the public of all information necessary to be able it to understand whether and how the CCP meets its legal obligations will be included in the RTS? If yes, which should be the exceptions of such disclosure requirements? Has the information CCP should disclose to clearing members be appropriately identified? Should clients, when known about the CCP, receive the same level of information?

2.41 Subject to issues of confidentiality (e.g. business growth strategies, CCP security, systemic stability, member confidentiality, etc.), the importance of a CCP to the financial system and its dependency on the clearing members means that sufficient disclosure, particularly to clearing members, should be made with regard to its financial robustness, the strength of the clearing guarantee, margin formulae and levels, collateral eligibility, "haircuts" and the CCP's capability to withstand market stress – as well as default management processes. Further, much of this information should be made available to clients as well as clearing members, where necessary and appropriate. Inevitably, such information would include the financial resources available to it and, subject to the issues of confidentiality mentioned above, the broad outcome of back-testing / stress-testing, the formulae for calculating margin, etc. (see FOA responses to Qs 57 to 65).

2.42 The FOA believes that it is critically important that sufficient information is made available to clearing members, firstly, so that they can assess their own risk arising out of their support and relationship with a CCP, secondly, because the soundness and safety of a CCP is information that they should be able to provide to their customers as and where appropriate and, thirdly, the quality of clearing is a key part of the quality of execution.

Q.30 What are your views on the possible records CCPs might be required to maintain?

2.43 No comment.

Q.31 What are your views on the modality of maintaining available the above records? How does the modality of making available records impact the costs of record-keeping?

2.44 The FOA welcomes the readiness of ESMA to differentiate the modality (and duration) of record-keeping requirements to keep them in line with varying degrees of importance of the records in question and the need for them to be instantly accessible. The FOA questions, however, whether the proposal that they might have to be kept for a period of ten years is necessary for any particular set of records.

Q.32 What are your plans on the possible requirements for the business continuity and disaster recovery plan and in particular on the requirements for the secondary site? Will it be appropriate to mandate the establishment of a third processing site, at least when the conditions described above apply? What are the potential costs and time necessary for the establishment of a third processing site with immediate access to a secondary business site?

2.45 The systemic importance of CCPs means that they must have business continuity and disaster recovery plans in place to deal with "extreme but plausible" scenarios which are practical, effective and capable of being put in place in a timely fashion.

As ESMA will know, the establishment and maintenance of alternative disaster recovery sites is extremely expensive in terms of initial set-up and on-going operational costs. The FOA does not believe that the cost/benefit of establishing a second alternative site is justifiable if the first alternative site has – as envisaged in para 88(b) – "a geographically distinct risk profile from the primary site" and the CCP can demonstrate that it has remote access working arrangements and that its transport, communications, power and systems infrastructure is independent from the primary site, sufficient to ensure the maintenance of business continuity.

Q33 Is the two hours maximum recovery time for critical functions proportionate to requirement? What are the potential costs associated with that requirement?

2.46 Yes, but recovery time for certain functions will vary depending on their criticality and the nature of the function, so the requirement should perhaps be phrased on the basis of "as soon as possible, but, in any event, within two hours". The FOA believes that further analysis may be necessary here to ensure that recovering times are deliverable and proportionate.

Q.34 Are the criteria outlined above appropriate to ensure that the adequate percentage above 99% is applied in CCP's margin models? Should a criteria-based approach be complemented to an approach based on fixed percentages? If so, which percentages should be mandated and for which instruments?

2.47 So far as Qs 34 to 37 are concerned, the confidence interval, look-back period and liquidation period are the most important parameters to include in a CCP's margining model, but a CCP should have some flexibility in terms of taking into account other elements relevant to the setting of margin, particularly where the model produces margin levels that are inconsistent with expectations of future price movements (generated, for example, by increased economic or political risks).

2.48 The level of confidence interval is a key aspect to defining the relationship between a default fund ("survivor pays") and the level of applicable margin ("defaulter pays"). The FOA supports the preference for a "defaulter pays" approach, which places less reliance on the default fund and the contingent liability of clearing members, but an appropriate balance must be struck in the relationship between the default fund and margin.

While the FOA is not expert in this area, it is noted that there does appear to be a general view that a confidence level greater than 99% may be appropriate. This would allow for sudden erosion of margin held by a CCP in times of unexpected market stress and therefore facilitate portability.

2.49 The FOA notes that ESMA will be looking at limiting pro-cyclicality in the setting of margins – and the FOA understands the need to avoid the adverse effects of pro-cyclicality – but is concerned to ensure that margins, while robustly set and called, are still authentically risk-based and do not become, in any way, punitive. However, this will obviously depend upon – as it is put in para 127 – what is meant by requiring that margins should be "calculated in a conservative manner". This may call for further research and analysis to ensure that the right balance is struck.

2.50 The FOA believes that there is potential significant duplication in terms of requiring an extensive look-back period for data analysis, imposing additional financial "cushions" on margin calculations and more frequent intra-day calls for margin. This is where what could become a "belt and braces" approach to systems and controls for managing risk in a CCP need to be measured carefully against the cost consequences for market users. As ESMA will be aware, there have been many successive crises which affect the level and frequency of margin calls, and the FOA would be interested to know on what basis ESMA now feels that it would be important for margins to be subjected to any form of "top-up" buffer, bearing in mind also the impact that this may have on clearing economics for end-users – a concern which is reflected in the "cons" of setting a higher confidence level than 99%.

2.51 The FOA prefers a criteria-based approach than one which is based on fixed percentages, but it is important that CCPs are monitored as to how they implement those criteria to ensure that there are comparable outcomes in respect of comparable classes of financial instrument cleared by each CCP.

Q.35 Taking into account both the avoidance of pro-cyclicality affects and the need to ensure a balanced distribution of financial resources of the CCP disposal, what in your view is the preferred option for the calculation of the look-back period?

2.52 The FOA instinctively prefers a look-back period that covers a relatively long time to ensure that margins are appropriately risk-based and have taken into account stressed market conditions. However, it may be appropriate to weight more recent crises over earlier crises, insofar as the possibility of any reoccurrence of an earlier crisis may have been mitigated as a result of post-crisis regulatory and structural changes. At the same time, the FOA sees the value in Option C, which also allows margins to be calculated on the basis of "both stable and stressed market conditions".

The use of a long look-back period should obviate the need for "buffers" because margins will then be set at a conservative manner and will be effectively risk-based. Clearly, in the case of new(ish) contracts, a long look-back period may not be possible and additional calculations may be needed for the purpose of setting an appropriate level of margin, but they should take into account realistic and not fanciful market stress conditions.

Q.36 Is in your view the approach described above for the calculation of the liquidation period the appropriate one? Should a table with the exact number of days be included

in the technical standards? Should other criteria for determining the liquidation period be considered?

Q.37 Is pro-cyclicality duly taken into account in the definition of the margin requirements?

2.53 The FOA, in responding to Qs 36 and 37, agrees that the factors outlined in para 100(a) and (b) are necessary for the determining of the liquidation period, but this has to be read in the context of characteristics of the relevant cleared contract and of the position to be liquidated. The FOA questions whether a specific table is required at this stage, rather than simply requiring specific holding periods to be set by each CCP for each market cleared by it, but which will be monitored for consistency by the relevant licensing authority.

Q.*38 What is your view of the elements to be included in the framework for the definition of extreme but plausible market conditions?*

2.54 The FOA supports the use of the words "extreme but plausible" (but would emphasise that this should take account of CCP failure and its consequences for the market).

Q.39 Do you believe that the elements outlined above would rightly outline the framework for managing CCPs' liquidity risk?

2.55 Yes. Mitigation of liquidity risk is essential to the effective and efficient management of defaults and avoiding a "domino" effect, particularly for other market participants (see further the FOA's response to Q44).

Q.40 Do you consider that the liquid financial resources have been rightly identified? Should ESMA consider other types of assets, such as time deposits or money market funds? If so please provide evidence of their liquidity and minimum market credit risk.

2.56 The FOA believes that money market funds should be the subject of further consideration as to whether or not they would constitute eligible assets for this purpose, but they should meet certain conditions, such as same-day accessibility and not be subject to redemption caps.

Q.41 Should the CCP maintain a minimum amount of liquid assets in cash? If so, how this minimum should be calculated?

2.57 The FOA questions whether it is necessary to mandate an obligation for a CCP to maintain a minimum amount of liquid assets in cash, insofar as it will be under a stringent obligation to maintain liquid financial resources, as envisaged elsewhere in the ESMA DP; and how the CCP will meet that obligation will be the subject of close on-going monitoring by its licensing authority. The FOA is aware of other views which do believe that it would be appropriate for a CCP to maintain a minimum amount of liquid assets in cash.

Q.42 What is your preferred option for the determination of the quantum of dedicated own resources of CCPs in the default waterfall? What is the appropriate percentage for the chosen option? Should in option (a) the margin or the default fund have a different weight? If so how? Should different criteria or a combination of the above criteria be considered?

2.58 The FOA supports the concept of a CCP having "skin in the game" as a first-call priority after the utilisation of margin, which will incentivise prudent management of risk, but believes that it should be proportionate to the resources available to the CCP, but calculable as a measure of margins.

Q.43 What should be the appropriate frequency of calculation and adaptation of the skin in the game?

2.59 Presumably, any CCP "skin in the game" would have to be recalculated to accord with any change in the CCP's capital and monitored carefully (e.g. monthly) to ensure that it does not fall below the required regulatory minimum.

Q.44 Do you consider that financial instruments which are highly liquid have been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of cash of financial instruments? Do you consider that the bank guarantees or gold which is highly liquid has been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of bank guarantees or gold?

2.60 The FOA believes that ESMA's approach is helpful, but unduly prescriptive. It also believes that as many asset classes as prudently possible (and using haircuts as necessary) should be deemed eligible to be provided as collateral. End-users will be meeting margin calls on a wide variety of contracts which were not previously the subject of margin calls (which will be called more frequently and are likely, in a number of cases, to be set at a higher level). The provision of highly-liquid collateral in relation to those margin calls will also be a major additional cost to them (and the prospect of a collateral "crunch", particularly in this climate, should not be discounted). This could disincentivise trading activity, including particularly the execution of risk management transactions (e.g. end-users could factor in their risk assessment to the pricing of products for their customers, rather than manage the risk of those products in the markets). For this reason, the FOA would invite ESMA to consider (to the extent permitted under Level 1) adopting a criteria-driven approach, but giving examples of the categories of assets that will be deemed eligible collateral (subject to risk/liquidity review) and to consider the following observations:

(a) allowing the use of assets which are closely correlated with the underlying exposures that are the subject of margining (which is particularly important for end-users with inventory);

(b) allowing the use of highly liquid corporate bonds (and a minimum BBB rating has been suggested);

(c) the imposition of “haircuts” should mean that assets that are not, in themselves, “highly liquid”, will become more liquid because of the “haircut” on their value, which should make them more rapidly sellable (but the owner of the asset must understand that this provision may mean that such assets are sold at below value);

(d) the possibility of some illiquid assets (presumably up to a limit) owned by well-rated non-financial counterparties being covered by an insurance policy where the premium is based largely on the asset’s illiquidity in return for which the company would agree to make an unconditional and guaranteed payout within a given period of time and so correct the illiquid nature of the underlying asset (and it is the understanding of the FOA that this form of collateral transformation might be achievable, but it would also have to be economically viable).

Q.45 In respect of the proposed criteria regarding a CCP not accepting as collateral financial instruments issued by the clearing member seeking to lodge those financial instruments, is it appropriate to accept covered bonds as collateral issued by the clearing member?

2.61 A CCP should manage strictly its wrong-way risk and, provided those risks are adequately managed, covered bonds should also be considered as acceptable collateral.

Q.46 Do you consider that the proposed criteria regarding the currency of cash, financial instruments or bank guarantees accepted by CCPs have been rightly identified in the context of defining highly liquid collateral? Should ESMA consider other elements in defining the currency of cash, financial instruments or bank guarantees accepted by CCPs as collateral? Please justify your answer.

2.62 The issue of defining highly-liquid collateral will depend largely upon the degree of price volatility and the actual liquidity of the collateral in question, and the correlation between the value of the collateral and the underlying position (which reflects the view of the FOA expressed in response to Q44 that assets which are closely correlated in this way should be regarded as eligible collateral).

The FOA is not entirely clear why the liquidity of cash, financial instruments or bank guarantees is dependent on them being denominated in the currency of the jurisdiction where the CCP is established, as against the currencies of other well-rated jurisdictions.

Clearly, FX haircuts should be applied, where appropriate, to mitigate any currency risk arising from accepting collateral in a different currency to that of the underlying exposure (or the risk could be addressed through the use of derivatives).

Q.47 Do you consider that the elements outlined above would rightly outline the framework for determining haircuts? Should ESMA consider other elements?

2.63 In general terms, yes, but the applied haircut should reflect the characteristics of the asset in question and the other factors, including issue size and liquidity, identified in para 128.

It should be borne in mind that, if haircuts are set too high, particularly for high-quality collateral, it may not be attractive for clearing members to deposit that collateral with a CCP, but to use it for other purposes, where its value can be taken into better account.

Q.48 Do you believe that the elements outlined above would rightly outline the framework for assessing the adequacy of haircuts? Should ESMA consider other elements?

2.64 The FOA believes that the other elements identified by ESMA are correct, but it is important that ESMA monitors the setting of haircuts to ensure that CCPs are adopting a comparable approach and that this does not become a competitive issue between clearing houses. Additional risks that might need to be covered is legal risk where the collateral in question is outside the jurisdiction of the CCP.

Q.49 Do you consider that the elements outlined above would rightly outline the framework for determining concentration limits? Should ESMA consider other elements?

2.65 The FOA agrees the importance of diversification – and believes that this will be further enhanced through allowing additional asset classes as suggested in para 2.40 in this response (given that concerns over liquidity can be addressed). Undue concentration may require the application of an additional haircut (or other measures such as limits or additional margin), but this should only be considered where the CCP regards the normal risk measures as inadequate.

Q.50 Should a CCP require that a minimum percentage of collateral received from a clearing member is provided in the form of cash? If yes, what factors should ESMA take into account in defining that minimum percentage? What would be the potential cost of that requirement?

2.66 This should be a matter for the exercise of CCP discretion (see also the FOA's response to Q41).

Q.51 Do you consider that financial instruments and cash-equivalent financial instruments which are highly liquid with minimal market and credit risk have been rightly identified? Should ESMA consider other elements in defining highly liquid financial instruments with minimal market and credit risk? What should be the timeframe for the maximum average duration of debt instrument investments?

2.67 The FOA supports the proposed criteria-based approach to the CCP's investment policy, but it should be transparent, deliverable and monitored to ensure a broadly consistent, if not exactly the same, approach is being adopted by different CCPs. Any list of eligible assets should be transparent and subject to periodic review and fast-track amendment in the case of stressful market conditions.

2.68 The FOA agrees that criteria for defining liquidity with minimal market and credit risk should be more restrictive in terms of a CCP's investment policy than the criteria for defining the highly-liquid collateral that can be accepted by a CCP for the reasons given. It is essential that a CCP's financial reserves are liquid and instantly available in the event of a default.

Q.52 Do you think there should be limits on the amount of cash placed on an unsecured basis?

2.69 Yes, limits should be placed on unsecured cash held with commercial counterparties to ensure adequate risk diversification.

Q.53 Do you consider that a CCP should be allowed to invest in derivatives for hedging purposes? If so, under what conditions and limitations?

2.70 The FOA does not agree that CCPs should "not be allowed to invest in derivatives to hedge their interest rate, currency or other exposures". Their ability to manage risk is critically important and on the basis that they are using derivatives only to manage risk where necessary, the assumption that "investment in derivatives would expose the CCP to additional risks which are not typical of the clearing activity" is incorrect and any such prohibition could actually enhance the risk profile of a CCP. The FOA notes that some consideration is being given to their use "in exceptional situations", but believes that this limitation is inappropriate and the option of using derivatives for risk-reduction purposes as and where necessary, is a fundamental part of the systems and controls of any organisation for managing their underlying risks.

Q.54 Do you consider that the proposed criteria regarding the currency of financial instruments in which a CCP invests has been rightly identified in the context of defining highly liquid financial instruments with minimal market and credit risk? Should ESMA consider other elements in defining the currency of highly liquid financial instruments with minimal market and credit risk? Please justify your answer.

2.71 Yes. The FOA has no issue with a criteria-based approach, but, given that the CCP can only take financial instruments that are denominated in a currency where the CCP is able to manage the risks of that currency and that it meets the test of being able to demonstrate sufficient liquidity, it is not clear why emphasis is placed on (i) and (iii). There needs to be a high level of confidence that the CCP is able to manage the risks on the currency and that it has minimal market and credit risk surely points to the use of derivatives (which appears to be embargoed by ESMA).

Q.55 Do you consider that the elements outlined above would rightly outline the framework for determining the highly secured arrangements in respect of which financial instruments lodged by clearing members should be deposited? Should ESMA consider other elements? Please justify your answer.

2.72 Yes. The obligation that collateral should be held in such a way as to afford full protection to the assets/instruments comprising that collateral is not solely in the interests of the CCP, but also in the best interests of the clearing members and the customers.

Q.56 Do you consider that the elements outlined above would rightly outline the appropriate framework for determining concentration limits? Should ESMA consider other elements? Please justify your answer.

2.73 Yes, but the FOA questions why the factors required to be taken into account in relation to types of issuer are not also factors to be taken into account in terms of addressing concentration risk as regards assets.

In general terms, while it is right for the CCP to be able to select the models most appropriate to its risk management needs, the FOA notes and supports ESMA's intention to specify the testing requirements and that the model will be subject to a process of validation "by a qualified and independent party prior to application" (see the response to Q58). The FOA also believes it is important that the supervising authority of a CCP reviews the overall process and model selection to ensure it is fit for purpose.

Q.57 What are your views on the definitions of back and stress testing?

2.74 The FOA believes that these are appropriate definitions, but questions why standard back testing is focussed only on credit and liquidity risk. Should it not also cover market risk?

Q.58 What are your views on the possible requirements for a CCP's validation process?

2.75 The FOA believes that it is important that the validation process, as suggested by ESMA, is comprehensively documented, and that the process itself is an end-to-end assessment of the fitness-for-purpose of the CCP's risk-management model. It also agrees that such a process could be undertaken internally provided, as it is put by ESMA, the party conducting the validation is not in any way part of the business unit which is involved in the development or operation of the models and has an appropriate high-level and independent reporting line.

At the same time, the supervising authority of a CCP should ensure that the validation process is comprehensive and independent and that any issues identified through that process are addressed comprehensively and in a timely fashion.

Finally, subject to any material confidentiality issues, the outcome of the validation process should be made available, at least in general terms, to at least the clearing members who have a direct interest in the robustness of the CCPs risk management models.

Q.59 What are your views on the possible back testing requirements?

2.76 These seem appropriate.

Q.60 Would it be appropriate to mandate the disclosure of back testing results and analysis to clients if they request to see such information?

2.77 Subject to the confidentiality issues mentioned earlier in this response (which are important) and that the information is couched in general terms, yes, bearing in mind the increased systemic importance of CCPs and that this goes to the robustness of the CCP and is information that should be taken into account in terms of the obligation to give best execution (which includes the quality of CCP clearing).

Q.61 Should the time horizons for back tests specified under 144(e) be more granular? If so, what should the minimum time horizon be? Should this be different for different classes of financial instruments?

Q.62 What are your views on the possible stress testing requirements?

2.78 No comment, other than to point out that full-scale industry testing will not always be necessary or appropriate, bearing in mind particularly the extensive cost and burdensome nature of this kind of testing. The FOA believes that, in general terms, testing can be safely restricted to clearing members, other than in the most extreme circumstances.

Q.63 Would it be appropriate to mandate the disclosure of stress testing results and analysis to clients if they request to see such information?

2.79 Yes, to clearing members, and subject to the response given to Q60.

Q.64 What are your views on the possible requirements for reverse stress tests? What impact do you think such requirements would have on industry?

2.80 The FOA recognises the value of reverse stress tests and notes that they are aimed at identifying the scenarios and market conditions which “go beyond extreme but plausible market conditions”. It believes that they will be helpful to a CCP, but the FOA notes that, in para 158(a), the expectation is that the CCP will use its testing results “to determine the amount of additional margin it may need to collect”. Does this not undermine, in practical terms, the constraint of risk management parameters focussing on “extreme but plausible” market conditions, and will this not further exacerbate the cost implications using CCP clearing for end-users?

Q.65 Should there be any other parties involved in the definition and review of tests? Please justify your answer and explain the extent to which suggested parties should be involved.

2.81 No comment.

Q.66 Should the testing of default procedures involve a simulation process?

2.82 No comment.

Q.67 Are the frequencies specified above appropriate? Please justify your answer.

2.83 No comment.

Q.68 In your view, what key information regarding CCP risk management models and assumptions adopted to perform stress tests should be publicly disclosed?

2.84 No comment, but the FOA would refer to the qualifications in its responses to Qs 60 to 63.

Q.69 What is your view on the need to ensure consistency between different transaction reporting mechanisms and the best ways to address it, having in mind any specific items to be reported where particular challenges could be anticipated?

2.85 Maintaining consistency between different transaction reporting mechanisms is essential to ensure costs of regulatory compliance are kept to a minimum. Consolidating data effectively requires consistency in (a) the exact fields required; (b) the exact technical format specified for reporting data per field; and (c) the exact definition of the data to be included in the field. This means that ESMA should provide explicit data on how data should be reported per field for various classes of derivative; and in the event of any reportable post-execution life cycle events. We would also emphasise the importance of harmonising reporting mechanisms between EMIR and MiFID II to avoid duplication of reporting capabilities.

The FOA agrees that ESMA needs to establish greater granularity than is provided by the CPSS-IOSCO Principles, but any additional requirements will need to be consistent with those principles in order to ensure that, so far as possible, there is a consistent global, as well as internal EU approach to transaction reporting.

In terms of the deals outlined at Annex II Tables 1 & 2, they appear comprehensive, but alignment with Dodd-Frank in this area is important.

Q.70 Are the possible fields included in the attached table, under Parties to the Contract, sufficient to accurately identify counterparties for the purposes listed above? What other fields or formats could be considered?

2.86 A number of the fields included the Counterparty Data are scheduled to be included in the scope of the LEI and would not therefore require separate reporting, particularly since the LEI reference data should provide better quality data than these duplicative fields. The FOA would only question whether too much detail is being sought and it is important to avoid requiring the provision of duplicative or repetitive reference data, such as repeating all the details of each counterparty in every report (e.g. location of registered office).

Q.71 How should beneficiaries be identified for the purpose of reporting to a TR, notably in the case of long chains of beneficiaries?

2.87 The FOA is concerned over the requirement to identify the economic beneficiary, because it is difficult to prove in practice, in particularly where natural persons are involved, and it is inconsistent with the reporting infrastructure the industry is building to support the Dodd-Frank reporting requirements. The FOA would argue that this data may be of limited use to regulators and, noting the particular difficulties in terms of funds and structured products, not to mention the problems of local law restrictions and the commercial sensitivities of the ultimate economic beneficiary, the FOA would urge the adoption of a more flexibility definition of beneficiaries to be identified.

Q.72 What are the main challenges and possible solutions associated to counterparty codes? Do you consider that a better identifier than a client code could be used for the purpose of identifying individuals?

2.88 While the FOA is not directly involved in the development of an LEI for identifying counterparties, it remains strongly supportive of the initiative, but it may be necessary for ESMA to introduce transitional arrangements to enable what is a complex global standard to be implemented.

The FOA would cross-refer any responses to this question with its responses to Q71 and would only emphasise that, during the transitional period, firms should be permitted to use the hierarchy of counterparty code reporting approved by their lead regulator for MiFID transaction reporting, as this data is already deemed suitable for consumption and aggregation by national competent authorities.

Q.73 What taxonomy and codes should be used for identifying derivatives products when reporting to TRs, particularly as regards commodities or other assets for which ISIN cannot be used? In which circumstances should baskets be flagged as such, or should their composition be identified as well and how? Is there any particular aspect to be considered as regards a possible UPI?

2.89 The FOA is not involved in the work currently being undertaken by the industry in this regard, other than in the context of working closely with the British Bankers' Association in the context of transaction reporting. The FOA supports the work currently being undertaken, which is now part of the FpML standard for TR reporting.

In general terms, the FOA would emphasise that taxonomy and codes should be set according to a global standard and aligned with current industry initiatives, particularly in the area of OTC derivatives (e.g. in the allocation of ISINs and other approved product identifiers).

Q.74 How complex would it be for counterparties to agree on a trade ID to be communicated to the TR for bilaterally executed transactions? If such a procedure is unfeasible, what would the best solution be to generate the trade ID?

2.90 The FOA believes this question is best answered by ISDA, but for listed derivatives, there is also a trade ID (e.g. for exchanges) that could be used separately by both counterparties and CCPs to identify a unique transaction.

Q.75 Would information about fees incorporated into pricing of trades be feasible to extract, in your view?

2.91 The FOA does not see the benefit to ESMA of providing this information and believes that there could be significant difficulties in extracting and providing fee data, insofar as fees are incorporated within the spread price, so extraction is simply not feasible.

Q.76 What is your view of the granularity level of the information to be requested under these fields and in particular the format as suggested in the attached table?

2.92 The FOA would emphasise that, where information is available from a reference data source, particularly in respect of the LEI code, this should be used rather than requiring submission through trade reports.

Q.77 Are the elements in the attached table appropriate in number and scope for each of these classes? Would there be any additional class-specific elements that should be considered, particularly as regards credit, equity and commodity derivatives? As regards format, comments are welcome on the possible codes listed in the table.

2.93 Here again, consistency with the work being undertake as a result of the Dodd-Frank requirements is important.

Q.78 Given that daily mark-to-market valuations are required to be calculated by counterparties under [Article 6/8] of EMIR, how complex would it be to report data on exposures and how could this be made possible, particularly in the case of bilateral trades, and in which implementation timeline? Would the same arguments also apply to the reporting of collateral?

2.94 Once again, as with many of these particular responses, ISDA is best-placed to deal with this question, but the FOA understands that collateral reporting was removed from Dodd-Frank as there were large overheads to firms in including it.

Assessing exposures at the portfolio level, rather than at the transaction level is more useful in terms of establishing the financial stability of an institution and the inclusion of mark-to-market values will significantly increase the flow of reports being submitted to the trade repository and that will impact on the cost and burden of the reporting process. This is further exacerbated by the fact that many OTC transactions are valued on the basis of mark-to-model rather than mark-to-market.

Q.79 Do you agree with this proposed approach? What are in your view the main challenges in third party reporting and the best ways to address them?

2.95 Once again, we would emphasise the importance of alignment with Dodd-Frank and note that this differentiates between registered infrastructures such as SEFs and third-party service providers, such as MarkitWire.

Q.80 Do you envisage any issues in providing the information/documentation as outlined above? In particular:

(a) what would be the appropriate timeline over which ESMA should be requesting business plans (e.g. 1, 3, 5 years)?

(b) what would be the appropriate and prudent length of time for which a TR must have sufficient financial resources enabling it to cover its operating costs (e.g. 6 months / 1 year)?

2.96 The FOA believes that the information sought appears appropriate, but:

- providing specific remuneration details of employees who are not directors or senior management seems inappropriate and excessive;

- a three-year business plan would be appropriate;

- a six-month resource funding requirement should be sufficient for business to be transferred across to other competitors or alternative trade repositories;

- the information should include arrangements for ensuring data security, the reviewing of critical systems and controls and the management of conflicts of interest.

Q.81 What is your view on these concerns and the ways proposed to address them? Would there be any other concerns to be addressed under the application for registration and tools that could be used?

2.97 The FOA agrees with the approach of ESMA.

Q.82 What level of aggregation should be considered for data being disclosed to the public?

2.98 As ESMA will appreciate, this is a particularly sensitive issue and, in line with the response to previous consultations, the FOA believes that the information disclosed to

the public should be anonymous and provided on an aggregated basis to preserve full trading confidentiality, and it is important that ESMA monitors the process to ensure that every step is taken to avoid any inadvertent disclosure of confidential information, either directly or indirectly.

So far as the provision of information to competent authorities is concerned, the FOA believes that there should be no constraint on the provision of relevant transaction information made available to them, but it remains important that the information provided to them is for the purpose of fulfilling their regulatory responsibilities, and that those authorities do not disclose it to other authorities with whom they may have memoranda of understanding without being provided with a clear statement of reasons as to why the information is being sought and being satisfied that it is for a regulatory and not for any other purpose.

It is also important that regulators that have rights to be able to access such transactional information are identified and approved as eligible to receive it.

Q.81 What should the frequency of public disclosure be (weekly? monthly?); and should it vary depending on the class of derivatives or liquidity impact concerns; if yes, how?

2.99 Clearly, it is important that the data which will be the subject of disclosure is accurate and reliable, and that it is made available on an even-handed basis in a way that does not give any individuals, organisations or sectors any informational advantage, i.e. disclosure could be simply web-based.

APPENDIX 1

LIST OF FOA MEMBERS

FINANCIAL INSTITUTIONS
ABN AMRO Clearing Bank N.V.
ADM Investor Services International Ltd
Altura Markets S.A./S.V
AMT Futures Limited
Jefferies Bache Limited
Banco Santander
Bank of America Merrill Lynch
Banca IMI S.p.A.
Barclays Capital
Berkeley Futures Ltd
BGC International
BHF Aktiengesellschaft
BNP Paribas Commodity Futures Limited
BNY Mellon Clearing International Limited
Capital Spreads
Citadel Derivatives Group (Europe) Limited
Citigroup
City Index Limited
CMC Group Plc
Commerzbank AG
Crédit Agricole CIB
Credit Suisse Securities (Europe) Limited
Deutsche Bank AG
ETX Capital
FOREX.COM UK Limited
FXCM Securities Limited
GFI Securities Limited
GFT Global Markets UK Ltd
Goldman Sachs International
HSBC Bank Plc
ICAP Securities Limited
IG Group Holdings Plc
International FC Stone Group
JP Morgan Securities Ltd
Liquid Capital Markets Ltd
Macquarie Bank Limited
Mako Global Derivatives Limited
Marex Spectron
Mitsubishi UFJ Securities International Plc
Mizuho Securities USA, Inc London
Monument Securities Limited
Morgan Stanley & Co International Limited
Newedge Group (UK Branch)
Nomura International Plc
Rabobank International
RBC Europe Limited
Saxo Bank A/S
Scotia Bank
S E B Futures
Schneider Trading Associates Limited
S G London
Standard Bank Plc
Standard Chartered Bank (SCB)
Starmark Trading Limited
State Street GMBH London Branch
The Kyte Group Limited
The RBS
UBS Limited
Vantage Capital Markets LLP
Wells Fargo Securities
WorldSpreads Limited

EXCHANGE/CLEARING HOUSES
APX Group
CME Group, Inc.
Dalian Commodity Exchange
European Energy Exchange AG
Global Board of Trade Ltd
ICE Futures Europe
LCH.Clearnet Group
MCX Stock Exchange
MEFF RV
Nasdaq OMX
Nord Pool Spot AS
NYSE Liffe
Powernext SA
RTS Stock Exchange
Shanghai Futures Exchange
Singapore Exchange Limited
Singapore Mercantile Exchange
The London Metal Exchange
The South African Futures Exchange
Turquoise Global Holdings Limited

SPECIALIST COMMODITY HOUSES
Amalgamated Metal Trading Ltd
Cargill Plc
ED & F Man Capital Markets Ltd
Engelhard International Limited
Glencore Commodities Ltd
Koch Metals Trading Ltd
Metdist Trading Limited
Mitsui Bussan Commodities Limited
Natixis Commodity Markets Limited
Noble Clean Fuels Limited
Phibro GMBH
J.P. Morgan Metals Ltd
Sucden Financial Limited
Toyota Tsusho Metals Ltd
Triland Metals Ltd
Vitol SA

ENERGY COMPANIES
BP Oil International Limited
Centrica Energy Limited
ChevronTexaco
ConocoPhillips Limited
E.ON EnergyTrading SE
EDF Energy
EDF Trading Ltd
International Power plc
National Grid Electricity Transmission Plc
RWE Trading GMBH
Scottish Power Energy Trading Ltd
Shell International Trading & Shipping Co Ltd
SmartestEnergy Limited

PROFESSIONAL SERVICE COMPANIES
Ashurst LLP
ATEO Ltd
Baker & McKenzie
Berwin Leighton Paisner LLP
BDO Stoy Hayward
Clifford Chance
Clyde & Co
CMS Cameron McKenna
Deloitte
Dewey & LeBoeuf LLP
FfastFill
Fidessa Plc
Freshfields Bruckhaus Deringer
Herbert Smith LLP
ION Trading Group
JLT Risk Solutions Ltd
Katten Muchin Rosenman LLP
Linklaters LLP
Kinetic Partners LLP
KPMG
Mpac Consultancy LLP
Norton Rose LLP
Options Industry Council
Orrick, Herrington & Sutcliffe (Europe) LLP
PA Consulting Group
R3D Systems Ltd
Reed Smith LLP
Rostron Parry Ltd
RTS Realtime Systems Ltd
Sidley Austin LLP
Simmons & Simmons
SJ Berwin & Company
SmartStream Techologies Ltd
SNR Denton UK LLP
Speechly Bircham LLP
Stellar Trading Systems
SunGard Futures Systems
Swiss Futures and Options Association
Traiana Inc
Travers Smith LLP
Trayport Limited