- The Chairman -	
European Commission Mr. Jonathan Faull Director General DG Internal Market and Services Rue de la Loi 200 B-1049 BRUXELLES	09 July 2010

Dear Sirs,

EFMLG letter regarding central counterparty (CCP) clearing of derivatives

The European Financial Markets Lawyers Group (EFMLG) is a group of senior legal experts in the field of wholesale, corporate and investment banking, who have their professional careers in the major credit institutions of the EU, and meet regularly to review and discuss issues that have an impact on EU financial market integration. Among its tasks, the EFMLG monitors and discusses from a legal perspective any changes and prospective changes in the legislative framework and its application affecting the business of such credit institutions. You may wish to read more about the EFMLG in its website: www.efmlg.org.

Ahead of the publication of proposed legislation on CCP requirements scheduled for September 2010, the EFMLG has again reviewed the proposals from the Commission to increase the proportion of OTC derivatives that are cleared by central counterparties ("**CCPs**") as set out in the public consultation paper on Derivatives and Market Infrastructures (the "**Consultation Paper**"), Communications (2009) 339 and 563, the Staff Working Paper SEC (2009) 905 (the "**Working Paper**") and with reference to standards set out in the CPSS/IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs (the "CPSS-**IOSCO Recommendations**").

The EFMLG is supportive of a balanced approach to clearing

1. We support the objectives the Commission is seeking to achieve with regards to CCPs and have a number of specific comments which we would like to submit for consideration. We note that the G20's promotion of mandatory clearing for standard derivatives is based on the assumption of reducing systemic risk and would observe that positive steps towards increased clearing should still allow for the preservation of robust and prudently managed bilateral trading arrangements, especially to the extent that CCPs may not fully achieve the desired degree of systemic risk mitigation. Moreover, any regulatory approach needs to be sensitive to the characteristics of different asset classes and their respective markets and users.

CCPs do not necessarily confer all the professed advantages

2. CCP clearing offers a number of potential advantages over bilateral clearing: multilateral netting; robust margining procedures; stronger risk management control;

increased operational efficiency; regulatory capital savings; and reduction of disruptive information problems.

3. However, we believe that such potential advantages should not be exaggerated. For example, the supposed advantages of credit risk mitigation and member guarantees need to be qualified.

(a) Credit risk: while it is acknowledged that existing CCPs presently provide effective clearing for a set of products, depending on the expanded range of products, volume and clearing members to existing and new CCPs, it cannot be said that clearing trades via CCPs will necessarily eliminate credit exposure (contrary to Working Paper, paragraph 2.4.2: *"CCP is better placed than single counterparties of a bilateral transaction to absorb the failure of a member"*). If margin and member guarantees are insufficient, CCPs could default in circumstances where a well capitalised counterparty to a bilateral transaction would not default. In addition, the consequences of such a CCP default would have further reaching consequences than those of a single counterparty. This point is especially critical given the proposals to increase the scope and volume of cleared products and CCP membership. Any proposal for CCP regulation must also adequately address the risk of custodian default. Leaving the issue of *custodian credit risk* unanswered potentially generates risk for many of the proposed safeguard measures in the Consultation Paper, such as margin requirements (section II.8.C), default fund (section II.8.D), and collateral requirements (section II.8.G), depending on where such assets are held and how they are held. If non-cleared, bilaterally traded instruments are appropriately risk managed (e.g. close-out netting and collateralization) then additional capital charges should not be imposed simply to compel migration to CCPs unless it can be certain that credit risk is effectively eliminated or materially reduced.

(b) Member guarantees: whether or not the member guarantees place any CCP in a better position to absorb losses than a bilateral counterparty is a matter of fact for each CCP (cf. Working Paper, paragraph 2.4.2: *"In addition, the CCPs ability to mutualise losses enables it to absorb defaults far better than any individual participant in bilateral clearing").* More importantly, the ability to mutualise losses under member guarantees may itself limit the growth of CCPs since (i) clearing member "guarantors" may adopt a conservative approach to clearing new products and accepting new members; and (ii) contingent liabilities under a member guarantee may become extremely difficult to value and be unnecessarily expensive from a credit and regulatory capital perspective.

Accessibility should be facilitated but without dilution of standards

4. We agree with the proposal for market participants to have full access to a CCP according to clearly defined access criteria (Consultation Paper, section I.3). Overly onerous capital and margin requirements imposed by CCP regulation may have the effect of restricting accessibility, particularly for relatively smaller users, however, a consistent approach should be adopted which facilitates accessibility without diluting eligibility standards that are in fact necessary for operational and systemic risk mitigation. In order to ensure adequate risk mitigation it may be helpful to consider some threshold level of regulation for non-financial institution CCP members (i.e. where such entities are not otherwise subject to regulation).

5. We are also supportive of the risk mitigation techniques mentioned in the Consultation Paper (section I.5), which largely summarise sound market practice. Items identified in the Consultation Paper sections II.1 to II.6 regarding organisation

requirements, risk committee, conflicts of interest, outsourcing, participation requirements and transparency are generally positive proposals.

6. Application of mandatory clearing for non-financial counterparties that exceed certain thresholds (Consultation Paper section I.4) is likely to generate disagreement on what exactly are the appropriate threshold levels across types of entities and member states. How would any such thresholds be monitored on a real-time basis and where would the responsibility for such monitoring sit? It may be the case that thresholds will not be manageable and instead a qualitative approach to distinguish amongst categories of users would be more effective. We believe there is a case for some exemptions for end-users and we would encourage the Commission to investigate carefully the feasibility of such exemptions in practice. Also, we would emphasize that not all non-financial institutions will be true end-users. Except for a potential exemption for end-users, which would need to be both clear and practical, legislation on derivatives clearing should instead apply to all market participants, each of which would need either (i) to satisfy CCP membership requirements based on prudential standards plus open accessibility or (ii) to access a CCP via a clearing member. Entities unable to meet membership requirements would need to trade via a financial institution clearing member, which in turn would manage its credit exposure to that counterparty and allocate capital as required by its respective regulator and/or to hedge its position through a CCP-cleared trade. We note in this regard the application of the "0 exposure value" rules of the Capital Requirements Directive (per Consultation Paper section II.7(d)).

7. We support appropriate rules for conflict of interest management but would observe that shareholder membership alone would not generate unmanageable conflicts in respect of aggregated information available to CCPs and the possible commercial advantage of this knowledge to CCP-owners (per Consultation Paper section II.3(e)).

Segregation and portability require additional EU-level legislative support

8. This topic (Consultation Paper, section 7) presents material legal challenges due to the inevitable impact of local registration, notarial, tax and insolvency considerations. Depending on the characteristics of the legal system in the CCP's jurisdiction, the goals of segregation for clearing members' assets/positions in ordinary circumstances may be achievable (sections 7(a), (b)). However, as acknowledged by Consultation Paper section 7(e), it would be necessary to trump many local regulations and administrative provisions in order to fulfil the requirement to reliably transfer assets/positions upon certain trigger events occurring (section 7(c)). Further, mandating this triggered transfer in proposed EU level legislation could create complex constitutional problems, undermine enforceability of trades and detract from effective netting within the CCP, which directly contradicts the legal certainty sought to be achieved (e.g. in Consultation Paper section II.8.I.(d) *("A CCP should establish that its default procedures are enforceable, taking into account the national insolvency laws applicable to the defaulting clearing member…").*

9. Legal certainty with respect to this topic can only be achieved at the EU level because the primary obstacle here is the interference of national insolvency regimes which would govern the dissolution of a failing CCP or clearing member. In order to support its proposals for CCPs, the Commission should consider enacting clear, appropriate rules to prevent any transfer of position and margin from being challenged by the receiver (or equivalent administrator) of the failed CCP/member. Such rules must also address the consequences of an insolvency of a CCP's custodian, in order to protect the CCP participants and provide legal certainty to the

economic positions reflected in the CCP system.

The future CCP landscape will need to balance efficiencies of scale with the need for competitiveness of specialized services

10. CCP regulation should allow scope for different CCPs to be established to meet the requirements of different clearing member groups and product types. Any CCP should be required to satisfy high-level prudential standards in line with the CPSS-IOSCO Recommendations, which we would support being included in any proposed European legislation. We note that that it is possible for asset-class specialized CCPs to become *de facto* monopolies and the Commission should be vigilant regarding such CCPs' pricing power and activities pursuant to European competition law. The Commission should be sensitive to the risk of creating a highly fragmented CCP market serving divergent geographies, asset classes and member groups. In these circumstances, economies of scale would not be realised, multilateral netting would be limited, and the necessary investments in technology and risk management infrastructure would be compromised. We recommend that the Commission should create a regulatory environment which allows for the development of scalable, cross asset class CCPs with broad and open membership, subject in each case to compliance with the CPSS-IOSCO Recommendations and EU competition rules.

Prudential requirements must be sensitively tailored, not 'one-size-fits-all'

11. With respect to specific prudential requirements, we generally support the themes identified in the Consultation Paper (section II.8) but would caution against imposing a too-prescriptive approach. Appropriate levels of credit support and concentration risk management for a CCP will depend on factors like each CCP's scope of clearing membership, product range and volume/size. [In each case, it will be necessary for national home-state regulators to take responsibility for monitoring compliance with prudential requirements as they will bear the burden of addressing systemic risk upon any CCP failure.] Demanding that a CCP should *"only accept highly liquid collateral with minimal credit and market risk"* (section II.8.G(a)) is understandable, but likely to be unrealistic: factors like liquidity of collateral and credit risk are dynamic and may be highly volatile during periods of market disruption and/or systemic shock. Recent crises have demonstrated that even AAA-rated securities, investment grade sovereign debt, money market instruments and even short-term interbank deposits could fail to meet these unduly onerous standards. The requirement to "apply adequate haircuts to asset values" and the possibility to accept the derivative's underlying asset as collateral (section II.8.G(b)) are more feasible approaches.

12. Should a CCP require access to central bank liquidity in order to satisfy its risk management requirements, then such CCP should be regulated as a bank (Consultation Paper section II.8), with the necessary additional risk-taking limitations. However, a CCP (whether or not it is a bank) should be limited in function to its clearing activities and should not undertake any other activities which might introduce additional risks to that entity. If a CCP is capable of meeting necessary risk management standards without recourse to central bank liquidity, for instance by sound collateral management, appropriate capitalisation based on risk levels and scale, plus access to liquidity from other sources, then it may not require access to central bank liquidity and consequently bank status may not be necessary.

The EFMLG is fully supportive of efforts to achieve a more robust framework for

CCPs and derivatives related risk management. This should be conducted with due regard to the technical and market considerations highlighted above.

The EFMLG is ready to assist further should the Commission so wish.

Yours sincerely,

[signed]

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