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ESMA's Consultation Paper on the Clearing Obligation under EMIR (no. 1)

Dear Sirs,

We welcome the publication of ESMA's Consultation Paper on the *Clearing Obligation under EMIR (no.1)* (the "***Consultation Paper***" or "***CP***") and we appreciate the opportunity to provide you with our comments.

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics for internal capital models, and related services across regions, asset classes and financial instruments. Our products and services are used by numerous market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.[1]

Markit has been actively and constructively engaged in the debate about regulatory reform in financial markets, including topics such as the implementation of the G20 commitments for OTC derivatives and the design of a regulatory regime for benchmarks. Over the past years, we have submitted more than 100 comment letters to regulatory authorities around the world and have participated in numerous roundtables. We also regularly provide the relevant authorities with our insights on current market practice, for example, in relation to valuation methodologies, the provision of scenario analysis, or the use of reliable and secure means to provide daily mid-market marks. We have also advised regulatory authorities on appropriate approaches to enabling a timely and cost-effective implementation of newly established regulatory requirements, for example through the use of multi-layered phase-in or by providing market participants with a choice of means for satisfying regulatory requirements.

Comments

Markit's most relevant services in the context of this CP are our derivatives processing platforms which facilitate confirmation, matching and processing for OTC derivatives across regions and asset classes and provide universal middleware connectivity for downstream processing such as clearing and reporting. Specifically, the MarkitSERV[2] platforms a) facilitate the agreement[3] between parties on the details of the

[1] Please see www.markit.com for further information.
[2] MarkitSERV, a wholly owned subsidiary of Markit Group Limited, provides a single gateway for OTC derivatives trade processing. The company offers trade processing, confirmation, matching, and reconciliation services across regions and asset classes, including interest rate, credit, equity, and foreign exchange derivatives. MarkitSERV also connects dealers and buy-side institutions to trade execution venues, CCPs, and trade repositories. Please see www.markitserv.com for additional information.
[3] Depending on the asset class and type of execution, different methods will be used to achieve such "agreement", including affirmation/confirmation or matching.

transactions that they have entered into, b) provide them with connectivity to CCPs,[4] trading venues ("***TVs***") and inter-dealer brokers, trade repositories, and the whole range of counterparties, including buyside and sellside, and c) report the relevant transaction and counterparty details to trade repositories under newly established regulatory requirements.[5] Such services that are offered also by various other providers, are widely used by participants in the global OTC derivatives markets today and are recognised as tools to increase efficiency, reduce cost, and secure legal certainty. With globally over 1,500 firms using the various MarkitSERV platforms that process, on average, 80,000 OTC derivative transaction processing events every day, our legal, operational, and technological infrastructure plays an important role in supporting the OTC derivatives markets in Europe, North America, and the Asia-Pacific region.

Based on our experience in supporting the introduction of clearing requirements in various other jurisdictions, please find our responses to ESMA's questions below.

Question 4: Do you have any comment on the public register described in Section 2.3?

Consistent with the feedback that ESMA received we believe that a process to remove a class of derivatives from the clearing obligation as a matter of urgency should be available.

Specifically, we believe that ESMA should be empowered to remove a class of derivatives from the public register of derivatives that are subject to the clearing obligation in a timely manner in response to, for example, exceptional market conditions. We generally believe that the decision to remove a specific class of OTC interest rate derivative from the clearing obligation should not depend on whether a CCP still clears the product, because CCPs might have little incentive to remove a product once it has been listed. Instead this determination should be mostly based on the actual liquidity in that product and on the extent to which the different factors relevant for the clearing determination[6] still apply at that time as determined by ESMA.

We are therefore supportive of ESMA's plan to raise the issue of the removal of a clearing obligation and the level of urgency potentially attached to it during the 2015 review of EMIR.[7]

Question 5: In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to interest rate OTC derivatives? Please include relevant data or information where applicable.

We generally agree with the conclusions that ESMA draws from its analysis of the three specific criteria, i.e. the level of standardisation, the liquidity, and the availability of reliable pricing data, for OTC interest rate derivatives that form the basis for the clearing determination.

Based on our involvement in processing OTC interest rate derivatives transactions that are submitted to various CCPs for central clearing we believe that ESMA's determination captures the vast majority of transactions in interest rate derivatives today. We also welcome the fact that ESMA's proposed clearing determination is largely compatible with the one that has been performed by the CFTC in the United States[8] as we believe that international consistency of products to be cleared is a key ingredient to allow for a smooth implementation of this requirement. However, we note that ESMA proposed requiring the clearing of OIS with maturities of up to 3 years in contrast to the 2 year maximum maturity that is already effective under the

[4] Our processing platforms are currently connected, or are planning to connect, to more than 10 CCPs around the globe and in various asset classes.
[5] For the reporting of derivatives transactions to Trade Repositories, the MarkitSERV platforms are now live in Europe, the United States, Japan, Hong Kong, Australia, and Singapore.
[6] CP Chapter 3.2
[7] CP Par. 67
[8] "Clearing Requirement Determination Under Section 2(h) of the CEA." 77 Fed. Reg. 74284. (December 13, 2012).

CFTC's rule makings.[9] In the interest of "strengthening international regulatory convergence"[10] we encourage ESMA to harmonize its proposed maximum maturity for OIS with the CFTC's requirements.

Question 5: In view of the criteria set in Article 5(4) of EMIR, do you consider that this set of classes addresses appropriately the systemic risk associated to interest rate OTC derivatives? Please include relevant data or information where applicable.

Question 7: Do you consider that the classification of counterparties presented in Section 4.2 ensures a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

We believe that ESMA's proposed classes of OTC interest rate derivatives that are suitable for clearing and phase-in of the clearing obligation for three broad categories of counterparties are generally appropriate and would provide the right conditions for a smooth implementation of the clearing obligation in Europe.

We note that ESMA acknowledges the relevance of confirmation/processing and connectivity platforms in several sections of the CP and wanted to make ESMA aware of some related concerns:

- As part of its analysis of the standardisation of operational processes[11] ESMA found that the relevant CCPs "are connected to affirmation and confirmation platforms that are commonly used by market participants" and that they "are making references to the same platforms". ESMA concludes that post-trade processes in this asset class "are dealt with in a common manner and are widely agreed among market participants"[12] and that the criterion of "standardisation of operational processes" is hence satisfied.

- When analysing the level of preparedness of different categories of counterparties and proposing a phased-in implementation for the clearing obligation for those,[13] ESMA repeatedly argues that certain types of market participants should not be included in Category 1 given that "they have no direct connection" to the relevant CCPs.[14]

These examples highlight the importance that ESMA assigns to market participants' ability to use neutral connectivity mechanisms with CCPs for the introduction of the clearing obligation. Indeed, platform-neutral connectors such as MarkitSERV are also widely recognized by market participants as tools that enhance the efficiency, reduce cost and risk of a horizontal model in the OTC derivatives markets and foster competition on the levels of execution and clearing.[15] Importantly in the context of this CP, ESMA should note that experience in other jurisdictions has shown that market participants' ability to continue to rely on such platform-neutral

[9] "The IRS submissions provide that the DCOs do not accept for clearing OIS swaps beyond two years. Accordingly, the Commission did not consider OIS swaps beyond two years in this clearing requirement determination." "Clearing Requirement Determination Under Section 2(h) of the CEA." 77 Fed. Reg. 74310. (December 13, 2012).
[10] CP par. 73
[11] Criteria 1(b): Standardisation of the operational processes. CP p.23.
[12] CP Par. 94 as part of ESMA's analysis of Criteria 1(b): Standardisation of the operational processes
[13] Chapter 4.3 Determination of the dates from which the clearing obligation takes effect. CP p.52.
[14] See, for example, CP Par. 169 and 180. Also Par. 210 where ESMA points out that within Category 1, some participants "will need to establish connections with other CCPs for some Class+, or with CCPs to which they are already connected but in different asset classes".
[15] As we have stated in our recent response to ESMA's MiFID II/ MiFIR Discussion Paper, available at http://www.esma.europa.eu/system/files/esma_mifid2_dp_markit_replyform.doc., we are generally supportive of the access requirements introduced in Articles 35 to 37 of MiFIR as means to increase competition in European financial markets. Recital 40 of MiFIR asserts that "access to licences is critical to facilitate access between trading venues and CCPs under Articles 35 and 36 of MiFIR as otherwise licensing arrangements could still prevent access between trading venues and CCPs that they have requested access to. The removal of barriers and discriminatory practices is intended to increase competition for clearing and trading of financial instruments in order to lower investment and borrowing costs, eliminate inefficiencies and foster innovation in Union markets".

connectivity services to connect to CCPs in a timely and efficient manner is a key condition required to achieve the desired "smooth implementation"[16] of the clearing obligation.

To enable a "smooth implementation" of the clearing obligation in Europe and to ensure that ESMA's analysis of the criteria underlying the clearing determination remains valid market participants must be able to continue to use established connectivity to CCPs once the clearing obligation is implemented. However, in this context, we note that neither Article 35 of MiFIR nor ESMA's related DP acknowledged the vital role of third party connectivity providers with the discussion evolving solely around "access of Trading Venues to CCPs". We believe that failure to recognize the role of third party connectivity providers in ESMA's implementing measures would increase the risk of CCPs abusing their market power by potentially refusing access to third parties that want connect to them on behalf of counterparties and/or TVs. This risk will be particularly pronounced where CCPs operate their own processing platforms as they could, by requiring TVs and/or counterparties to only use those for establishing connectivity to them, directly foster the development of their own vertical silo or in asset classes where central clearing is only provided by a small number of CCPs, or even just one. By undermining market participants' level of preparedness for the introduction of the clearing obligation such behaviour would also question the validity of ESMA's analysis of the criteria underlying the clearing determination, in addition to standing in direct conflict with the spirit of Article 35 of MiFIR.

ESMA should note that under the United States' Dodd-Frank Act some CCPs have interpreted "open access" requirements to encompass third party connectivity providers[17] while others explicitly allow third party connectivity providers open access under their rules.[18] To prevent the occurrence of competition-restricting practices in this respect in Europe, we recommend that ESMA reflect established market practices and workflows also in its various implementing measures. Specifically, ESMA should clarify that the requirement for CCPs to provide open, non-discriminatory access to TVs equally applies for the provision of access to *third party providers that act (and establish connectivity) on behalf of TVs or counterparties*. In addition, in asset classes where the number of CCPs providing central clearing is small or just one, we encourage ESMA to reflect the elevated risks that this might create for the implementation process in its clearing determination.[19]

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[16] CP Par. 208

[17] "ICE Clear Credit shall ensure that, consistent with the requirements of [Commodity Exchange Act] Section 2(h)(1)(B) and Securities Exchange Act Section 3C(a)(2), there shall be open access to the clearing system operated by ICE Clear Credit pursuant to these Rules for all execution venues (including, without limitation, designated contract markets, national securities exchanges, swap execution facilities and security-based swap execution facilities) and trade processing platforms…" ICC Rulebook, Rule 314, available at https://www.theice.com/publicdocs/clear_credit/ICE_Clear_Credit_Rules.pdf (last revised Nov. 18, 2013). Commodity Exchange Act section 2(h)(1)(B)(ii)(B)'s (as amended by Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") section 723) open access requirement states that DCOs must "provide for non-discriminatory clearing of a swap (but not a contract of sale of a commodity for future delivery or option on such contract) executed bilaterally or on or through the rules of an unaffiliated designated contract market or swap execution facility."

[18] "See CME Rulebook Rule 8H17, available at http://www.cmegroup.com/rulebook/CME/I/8H/8H.pdf ("CME shall provide open access to its CDS Contract clearing services for any execution venue or trade processing or confirmation service that desires to facilitate the submission of CDS Product transactions to the Clearing House for clearing, subject to the Clearing House's normal operational requirements applied to all such third-party services[.]"). See also LCH Rulebook, available at http://www.lchclearnet.com/Images/Voluntary%20Submission%20of%20Rulebook%20and%20Supporting%20Materials_tcm6-62205.pdf (Definition of "Approved Trade Source System" as "a system or facility, such as an exchange, a clearing house, a swap execution facility, a designated contract market or other similar venue, approved by the Clearing House for executing Transactions and/or presenting such Transactions to the Clearing House."). LCH Rule 2A.3.3 provides that "Currently the Approved Trade Source Systems designated by the Clearing House for SwapClear are MarkitWire, Bloomberg and Tradeweb. Where the Clearing House approves additional Approved Trade Source Systems, it will notify Clearing Members via a member circular."

[19] We note ESMA's view that, even if "the existence of a single CCP to clear the class does not lead to an automatic exclusion of the that class from the scope of the clearing obligation determination" it "should not be understood as meaning that the number of CCPs clearing the same class is irrelevant for the purpose of determining the classes." See CP Par. 145. We believe that introducing a clearing obligation in an asset class with only a small number of CCPs creates significant systemic risk issues and the number of CCPs should hence play an important role in ESMA's clearing determination.

Finally, ESMA should consider establishing procedural safeguards to ensure non-discriminatory access to clearing for all classes of counterparties, including those using third-party connectivity providers. In this context, ESMA should clarify, for example, that CCPs should submit new rules and rule amendments relevant in relation to access to their competent authority for their review.[20, 21]

Question 8: Do you consider that the proposed dates of application ensure a smooth implementation of the clearing obligation? Please explain why and possible alternatives.

ESMA proposed a phased-in implementation of the clearing obligation consisting of three phases, namely 6 months, 18 months and 3 years after entry into force of the RTS for Category 1, 2 and 3 counterparties respectively.[22]

We believe that the phase-in of the clearing obligation as proposed by ESMA is generally reasonable. This is particularly true for Category 1 counterparties, i.e. Clearing Members, as those already centrally clear a substantial amount of their transactions in OTC interest rate derivatives today. We also believe that providing Category 2 counterparties with an additional 1 year phase-in period is generally reasonable.

However, ESMA should be cognisant of the fact that a substantial number of counterparties that are active in OTC interest rate derivatives today are not yet set up to centrally clear these transactions[23] which will create a need for a large number of firms to "onboard" ahead of a clearing obligation applying to them. Notwithstanding the amount of time that ESMA provides to Category 2 counterparties, there is a significant risk of an "onboarding bottleneck" occurring.[24] This would be consistent with experience in other jurisdictions[25] based on the fact that many firms will be naturally inclined to delay their onboarding until close to the compliance date. We believe that ESMA and National Competent Authorities could reduce this risk by ensuring that counterparties, and Category 2 counterparties in particular, prepare for central clearing well ahead of time and/or by encouraging them to start centrally clearing before the actual compliance dates.

Also, as a general matter, we urge ESMA to be cognisant of both the time during the year and the day of the week when the clearing obligation would start for the different categories of counterparties. Specifically, we recommend for ESMA to draft its RTS as such that any start date for the clearing obligation would not fall onto the end of the year. This is because at this time of the year IT-related challenges such as general "code freezes" will make implementation much more challenging for counterparties and providers of market infrastructure alike. Also, the implementation of the clearing requirement would best fall on a Monday instead of a weekday. This is because such timing will allow CCPs, counterparties and infrastructure providers to perform final testing over the weekend when the markets are closed and no "live" transactions will need to be processed.

Further, ESMA should be aware of the operational challenges that will be created by the ongoing need for Category 3 counterparties to inform their counterparties if they have exceeded the clearing threshold and must

[20] Regulation (EU) No 648/2012 at (51)
[21] Moreover, the relevant new policy changes should be required to be subjected to competent authority review, i.e. any change in policy, practice, or interpretation affecting in any material respect the CCP's operations should be deemed to be a proposed rule change. See e.g., SEC Rule 19b-4(c) (17 CFR 240.9b-4), available at http://www.law.cornell.edu/cfr/text/17/240.19b-4.
[22] CP Chapter 4.3
[23] Our analysis of OTC interest rate derivative transactions processed on the Markitwire platform in the recent past shows that almost 60%, or more than 400, of the total number of counterparties that were active over this period do not currently centrally clear their transactions.
[24] ESMA stated that the phase-in of the clearing obligation should be designed to "avoid[ing] "bottleneck" situations to the extent possible". CP Par. 133.
[25] Our view is based on the implementation and onboarding challenges experienced with the clearing obligation for "CAT2" firms in the US. Specifically, more than 400 counterparties requested to be onboarded to our processing platforms within the last couple of weeks before the compliance date.

then clear. Experience with similar requirements in other jurisdictions has shown that third party platforms can be helpful in addressing the challenges in relation to gathering the relevant information from firms and making it available to their counterparties.[26]

Finally, we note that ESMA discusses the topic of "indirect clearing" in this section. We agree with ESMA that an offering for indirect clearing is currently "only at a very early stage"[27] and that market infrastructure to support the workflows for such transactions that are cleared indirectly is currently not available. Based on our experience, we believe that a period of 3 years might not suffice to establish the relevant infrastructure to support indirect clearing. To avoid creating any unnecessary operational risk we therefore recommend for ESMA to retain the ability to extend the deadline for indirect clearing depending on the status of the infrastructure at that time.

Question 9: Do you consider that the proposed approach on frontloading and the minimum remaining maturity ensures that the uncertainty related to this requirement is sufficiently mitigated, while allowing a meaningful set of contracts to be captured? If not, please explain why and provide possible alternatives compatible with EMIR.

We generally support the frontloading approach proposed by ESMA.[28]

However, we respectfully question ESMA's decision proposal of a 6 month minimum maturity for the frontloading of transactions that are concluded in Period B.[29] This is because we believe that the cost of requiring the central clearing of derivatives transactions with such a short remaining maturity is likely to exceed the benefits from a systemic risk perspective. We therefore recommend for ESMA to set a minimum maturity of at least 12 months, which would be consistent with the responses that ESMA received to its discussion paper.[30]

Further, ESMA should be cognisant of concerns about the legal status of derivatives transactions that are subject to the frontloading requirement and as part of the legal confirmation process to create legal certainty.[31] ESMA should note that such discussions are not in an advanced stage[32] and that, once a decision about use of a frontloading flag as part of the confirmation process was taken, the relevant providers of market infrastructure, including MarkitSERV, would require a sufficient amount of time to implement it.

Finally, to minimize the degree of uncertainty attached to the frontloading requirement, ESMA should design this requirement as such that there is clarity around the need to frontload a transaction. For example, such determination should be based on the status of the counterparties at the time they enter into the transaction and not be subject to change during the period between execution and the time when the frontloading occurs.

Question 10: Do you have any comment on the analysis on the Equity OTC derivative classes presented in Section 6?

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[26] Third party connectivity providers, such as MarkietSERV, provide universal, timely, and secure connectivity between the numerous counterparties, execution venues and CCPs as well as Trade Repositories and other post-trade service providers. Third party connectivity providers not only route trades to CCPs, Trade Repositories and other post-trade service providers but also provide trade counterparties with notifications as to the transaction's status.

[27] CP Par. 214, also Par. 156: "indirect client clearing activity remains undeveloped".

[28] CP Chapter 5.2

[29] CP Par. 251

[30] "Among those few responses, the median answer was found to be 12 months". CP Par. 248

[31] The general objective would be for parties to the transaction to be bound to suitable language regarding the requirement to frontload or terminate the transaction at a later stage.

[32] Specifically, ISDA had suggested some language to be added to the confirmations that dealt with a scenario where someone would not clear the trade but it was traded as "frontloaded". However, this effort was discontinued sometime last year. ESMA should note that we have some concerns about adding a flag, specifically its relevance as part of the legal confirmation.

ESMA analysed the relevant criteria for OTC equity derivatives[33] and proposed to not submit any classes of equity derivatives to the clearing obligation.[34]

Based on our experience[35] we agree with the feedback that ESMA received[36] and with ESMA's conclusion that clearing of OTC equity derivatives is still in its infancy. We therefore support ESMA's decision to not propose any clearing obligation for this asset class at this time.

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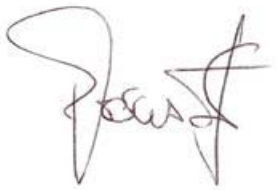
We hope that our above comments are helpful to ESMA. We would be more than happy to elaborate or further discuss any of the points addressed above in more detail. In the event you may have any questions, please do not hesitate to contact us.

Yours sincerely,



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[33] CP Chapter 6.3
[34] "ESMA is not proposing at this stage to submit any equity classes to the clearing obligation". CP Par. 257
[35] MarkitSERV is connected to a CCP that clears OTC equity derivatives. However, only a handful of transactions in a single product involving a very small number of market participants have cleared thus far.
[36] "Most respondents consider that .. equity OTC derivatives are not suitable for the clearing obligation, or at least not in priority .. ". CP Par. 265