TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

The Association of Corporate Treasurers

Interest Representative Register ID: 64617562334-37

Comments in response to:
ESMA consultation paper: Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

Issued by ESMA on 25June 2012

3rd August 2012

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer* magazine and our Policy and Technical Committee.

General

The ACT responded to your February discussion paper and now welcomes the opportunity to comment on this consultation, but has restricted its comments to those sections relevant to non-financial companies.

This document is on the record and may be freely quoted or reproduced with acknowledgement.

We note that this consultation includes some changes that we sought in our earlier response and we welcome that, but we also notice that some new obligations seem to be imposed on non financial companies. We regard it as important to remember that non financial companies are not generally regarded as posing a systemic risk to financial systems and that therefore the EMIR legislation included some significant exceptions to ensure that the burden on non-financials is not excessive. We have some concerns that in drafting the detailed technical standards (such as the reporting requirements) ESMA is creating an administrative nightmare for non-financial companies, the burden of which will be an inevitable drag on economic activity for little real benefit in terms of risk reduction.

The ACT believes that the technical standards should be set with the aim that the vast majority of companies must be largely outside the EMIR provisions so that the burdens of administration and any enforced procedures on the real economy are minimised.

Regarding process: the rush to finalise the technical standards by 30 September could result in inappropriate rules being devised. We wonder if an extended timetable for creating the detailed rules might be a good idea.

<u>Comments on specific questions</u>

<u>Non-financial counterparties</u>

Criteria for establishing which derivative contracts are objectively measurable as reducing risk directly related to the commercial or treasury financing? (For convenience we refer to this as an EMIR hedge or just hedging.)

We welcome the clarification that meeting the IFRS hedging test is an alternative criterion for qualifying as an EMIR hedge and not a necessary condition. We welcome too the specific acceptance that proxy hedging can qualify as an EMIR hedge.

As mentioned above there is a danger that EMIR and the technical standards could introduce a massive burden on companies, a huge unproductive effort that does not help reduce systemic risk. Therefore we have an objective to seek simplifications to ease that burden while keeping within the spirit of the legislation. We propose that ESMA accepts as qualifying EMIR hedges not only transactions qualifying for IFRS hedge accounting but also those qualifying under local GAAP, remembering that the universe of companies that must comply with local GAAP is far larger than that which applies IFRS.

In the February paper you proposed that an EMIR qualifying hedge is one where individually or in combination with other derivative contracts, **<u>its objective</u>** is to reduce the potential change in the value …The “objective” test is now missing from your proposal which could mean bona fide transactions technically fail your definition. For example a company may hedge a portion of the currency exposure from a new sales tender it is competing for. If the company fails to win the tender the risk being hedged disappears and the deal ceases to be an EMIR hedge notwithstanding its objective as a hedge. The company will normally want to close this deal off with an equal and opposite derivative perhaps with a different bank, but presumably closing what you now regard as speculative will also count as speculative, thus leaving two non qualifying derivatives on the books rather than none.

Our understanding of Art 1 NFC is that a derivative done to reduce the risk of another derivative would be allowable for EMIR purposes since that would be an asset or liability as listed in art 1 (a) NFC. However for clarity it would be helpful to replicate some of the US wordings to make it clear that use of a derivative to hedge or mitigate the risk of another derivative which itself is used to hedge or mitigate a business risk is still “hedging”.

Then in Art1(a) NFC on page 72 your listing of acceptable risks to be hedging you add the caveat that they must be incurred “in the ordinary course of business”. In certain UK interpretations this terminology can exclude activity related to mergers and acquisitions and disposals along with certain capital related exercises. We suggest that “in the ordinary course of business” be deleted.

On exclusions we fail to see why the hedging of stock options can not be considered as directly related to the commercial or treasury financing activities and request that this exclusion be removed.

Clearing thresholds

We note the monetary amounts of the thresholds proposed and regard these as reasonable. We accept that using notional amounts is a pragmatic approach and this too seems reasonable to us.

Art 10.4 (b) of EMIR requires ESMA to specify:

“values of the clearing thresholds, which are determined taking into account the systemic relevance of the sum of net positions and exposures per counterparty and per class of OTC derivatives.”

This does specify **net positions** but yet in the technical standards we can see no mention of any netting that is allowed in calculating the transactions that cumulate towards the threshold. We presume this in an oversight. Where there is an exact match and contractual bilateral netting we would expect that derivatives could be netted off since the exposure is legally netted.

Likewise we would expect that the rules should not count toward the threshold any derivatives that are in fact collateralised.

ESMA also takes the position that once the threshold is breached for one asset class the clearing obligation will apply to all subsequent OTC derivatives, even in other asset classes. This seems somewhat at odds with the instructions given to ESMA in the above EMIR article which direct ESMA to consider the operation of thresholds by class of asset. For non-financial companies we expect that most will have non-hedging transactions that are well within the size of the thresholds. But for companies whose business itself is connected with commodities, such as oil and energy companies, mining companies and large consumers of commodities be that foodstuffs or metals they will often have a trading subsidiary that does trade commodity derivatives. Separately they will have a treasury department or company that manages the hedging of treasury risks. It seems perverse that activity solely linked to commodities that exceeds the threshold should taint the hedging activity elsewhere and force that side of the operations to post margin.

The arguments that non-financial companies were not the cause of systemic risk and that it is detrimental to the European economy to tie up large amounts of corporate liquidity and funding lines on collateral were well made and accepted in the drafting and approvals of EMIR. The same arguments still apply here.

Normally intra-group transactions will be hedging given that at each end of an intra-group there is an equal and opposite transaction. Nonetheless we feel that explicit clarification is needed that intra group transactions do not cumulate towards the threshold.

Risk mitigation for OTC derivative contracts not cleared by a CCP

Timely confirmation and reconciliations

The ACT recognises the importance of good controls through timely exchange of confirmations and periodic reconciliations and recommends all non-financial companies to have rapid and good procedures in this area. Even so we do have a concern that the time periods for confirmations and the frequency of reconciliations will be difficult for some companies to achieve either because of the need to make systems changes or because of the inherent complexity of the transactions. Almost by definition OTC transactions are tailor made and can take more time to process than standardised derivatives. We suggest extended confirmation periods perhaps with a tightening of the requirements after an initial two years, based on ESMA's experiences gained in that period.

There is a further complication that even if the transaction is confirmed promptly there can still be some legal details or parameters of the derivative that take longer to be set. The concept of a confirmation should allow that not all the details will be available at time of dealing, e.g. a derivative priced by reference to an index at some future date so the initial fixing is not yet fully determined.

If confirmation processes are robust then the marginal benefit of frequent reconciliations is less. Once again with the aim of reducing the admin burden that will fall on every company that executes derivatives, no matter how small, we would propose that reconciliations are only required 6 monthly for companies that have to report 6 monthly and annually for all others.

Intra-group exemptions

Subject to certain requirements in EMIR article 11 allows that companies that exceed the thresholds do not have to exchange collateral on intra group derivatives. In technical standards Art7 RM you specify that legal opinions are required to demonstrate that there are no legal impediments to the prompt transfer of funds. This will create a huge duplication of effort across companies transacting across similar jurisdictions and is a further cost and burden on non financial companies. We suggest that the regulatory authorities approving the intra-group exemptions be given discretion to satisfy themselves as to the legal impediments to funds transfers, only seeking legal opinions in contentious areas. Where a group cash sweeping arrangement is in place with the group's banks we would hope and expect that this would be strong evidence that approval for the clearing exemption would be granted. As started at the start of our response it should be remembered that the systemic risk posed by non financial companies is likely to be modest, so that any requirements on them should be proportionate to that risk.

Going further it would be helpful if the competent authorities could give indicative guidance on transaction types and countries where approval is likely to be forthcoming.

EMIR (Article 4, para 2a), requires pre-notification of the intention to use the intra group exemption but yet the ESMA drafting (Article 7, para 4), allows for notification within 14 days of utilising the exemption. We propose that notifications could be required no later than 30 days after the use of the exemption to allow users flexibility and to help avoid any initial peak work overload for competent authorities once the rules come into force.

Reporting obligation

The EMIR reporting requirements apply to every single non-financial company transacting derivatives no matter how small or how large. It is therefore absolutely critical that this administrative burden is kept to a minimum to avoid costs cumulating across the whole European economy for little real risk-reducing benefit. Indeed if the volume of data is too large there will be the danger that its utility to regulators will be lost in the confusion of the small details.

Reporting may be delegated and we expect this to be commonplace for derivatives done with financial counterparties but even so we ask that ESMA reconsiders the level of details required so that the number of reporting fields can be significantly reduced.

For intra-group transactions the reporting will have to be generated from within the non-financial group and we fear that the obligations being put forward are totally impractical, even for companies that currently have reasonable systems and databases. We strongly recommend that the level of detail be reduced to simply the parties, the derivative type, the maturity, notional amount, reference rate and settlement date. This would be in line with EMIR Art 9.5.

We are particularly alarmed by the implication of page 49, paragraphs 283 and 284 which taken together with Annex V, field 34 seem to introduce a totally new requirement for all companies to mark to market all transactions daily. We hope that we have misunderstood your proposed rules, but if this was indeed intentional we must object in the strongest terms. This is totally unacceptable and in practice would be totally impossible to achieve and was in our view never part of the intention of EMIR.

TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

Our 4,400 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

Contacts: Martin O'Donovan, Deputy Policy and Technical Director (020 7847 2577; modonovan@treasurers.org) John Grout, Policy and Technical Director (020 7847 2575; jgrout@treasurers.org) Colin Tyler, Chief Executive (020 7847 2542 ctyler@treasurers.org)	The Association of Corporate Treasurers 51 Moorgate London EC2R 6BH, UK Telephone: 020 7847 2540 Fax: 020 7374 8744 Website: http://www.treasurers.org

The Association of Corporate Treasurers is a company limited by guarantee in England under No. 1445322 at the above address

Interest Representative Register ID: 64617562334-37