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Submitted online via: https://www.eba.europa.eu/

10 July 2015

Dear Sirs,

AIMA/MFA Response: Second Consultation Paper on Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012

AIMA[1] and MFA[2] ("we") are grateful for the opportunity to respond to the Consultation Paper on Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (the "Second Consultation Paper")[3] published jointly by the European Securities and Markets Authority ("ESMA"), the European Banking Authority and the European Insurance and Occupational Pensions Authority (collectively, the "ESAs") on 10 June 2015.

[1] Founded in 1990, the Alternative Investment Management Association ("AIMA") is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry – including hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. Our membership is corporate and comprises over 1,500 firms (with over 9,000 individual contacts) in more than 50 countries. AIMA's manager members collectively manage $1.5 trillion in assets.

[2] Managed Funds Association ("MFA") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

[3] *See* https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf.

In Annex 1 we provide detailed comments on the questions raised by the ESAs in the Second Consultation Paper. In particular, AIMA and MFA:

- would be grateful for **clarity that equivalence under Article 13 of EMIR is available to entities "subject to the rules of" an equivalent third-country jurisdiction**, even if they are not "established" in the sense of being legally incorporated in that jurisdiction. We believe that it is also important to ensure that it is clear from the drafting of the RTS the instances in which a provision is intended to include not just "counterparties" (*i.e.*, FCs and NFC+s) but also third-country entities which would be FCs or NFC+s if they were established in the EU.

- reiterate the concerns we raised in our response to the First Consultation Paper on the difficulties of collecting IM "*within* the business day" [emphasis added] and recommend that the ESAs amend the draft RTS's language to provide that **a demand for IM be made no later than the end of the business day following execution**;

- recommend that the **flexibility granted in respect of the timing of VM collection be extended to smaller counterparties that are not required to post IM** due to their falling below the relevant IM threshold;

- ask the ESAs for clarification whether the **VM collection requirement will be deemed to have been met when the collecting party has exposures to the posting party that fall outside of the scope of the RTS** and which are reduced on a net basis as a result of the VM collection;

- recommend that **Articles 6 GEN (3) and 7 GEN (3) of the draft RTS** on the aggregation of aggregate notional amounts of non-cleared OTC derivatives across investment funds **for the purposes of IM thresholds be aligned with ESMA's draft RTS on mandatory clearing of IRS** so as to adopt a consistent approach throughout EMIR;

- request that the ESAs **give further consideration to the disapplication of concentration limits on posted collateral balances of a modest amount**, as the application of a percentage-based concentration limit to a small collateral balance would necessarily result in the counterparty with such smaller balance being subject to a smaller concentration limit;

- suggest that the ESAs clarify that the **"written trading relationship documentation" required in Article 2 OPD (1) refers to any master agreement governing the trading relationship**. We also ask the ESAs to clarify in the final RTS that a counterparty could **allow its internal counsel to carry out the required "independent legal review"** of bilateral netting and segregation arrangements;

- foresee certain **practical difficulties relating to the requirements in respect of IM posted in cash,** including the applicable costs of relevant IM segregation requirements and the operational uncertainties when converting cash IM into other types of collateral permitted by the RTS;

- request **clarity in relation to the treatment of FX mismatches**, including listing the types of IM and VM assets subject to an 8% haircut. We would also be grateful for clarification of the term "transfer currency"; and

- ask that explicit mention be made in the final draft RTS that, when **making IM threshold calculations involving FX forwards, the economic notional value of the contract to the counterparty be counted,** not the individual legs.

If you have any questions regarding our submission, please contact Adam Jacobs (ajacobs@aima.org) or Jiří Król of AIMA or Carlotta King (cking@managedfunds.org) or Stuart J. Kaswell of MFA.

Yours truly,

/s/	/s/
Jiří Król Deputy CEO Global Head of Government Affairs AIMA	Stuart J. Kaswell Executive Vice President & Managing Director, General Counsel MFA

Annex 1

Q1: Respondents are invited to comment on the proposal in this section concerning the treatment of non-financial counterparties domiciled outside the EU.

In responding[4] to the ESAs' April 2014 Consultation Paper on draft regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012[5] (the "First Consultation Paper"), we highlighted the fact that the proposals would impose an obligation on Financial Counterparties ("FCs") and Non-Financial Counterparties above the clearing threshold ("NFC+s") to collect initial margin ("IM") and variation margin ("VM") from their non-European Union ("EU") counterparties, even if such non-EU counterparties would be classified as Non-Financial Counterparties below the clearing threshold ("NFC-s") if they were established in the EU.

We are pleased to see recognition on the part of the ESAs that this approach would be inconsistent with the final margin policy framework for non-centrally cleared derivatives of the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO") (the "BCBS/IOSCO Standards"). We welcome the introduction of Article 2 GEN of the Second Consultation Paper, which provides that the risk management procedures of an FC or NFC+ may provide that no collateral is exchanged in relation to transactions with NFC-s or entities which would be NFC-s if they were established in the EU. We also welcome Article 3 GEN of the Second Consultation Paper that clarifies that where an entity established in the EU enters into an OTC derivative contract with a counterparty that is established in a third country, the counterparties must exchange IM and VM only if the third-country entity would be subject to the requirements of the European Market Infrastructure Regulation (EMIR)[6] if it were established in the EU.

In addition, we appreciate the ESAs' formulation in Article 3 GEN, which stipulates that in the context of transactions between a counterparty established in the EU and a third-country entity, "risk management procedures shall include that initial and variation margin are exchanged between the counterparties". We believe that this statement provides helpful clarification that two-way margin exchange is required in such a scenario and addresses our concern, as AIMA expressed in responding to the First Consultation Paper, that a framework based on one-way collection of margin would not work effectively in the context of transactions involving a third-country entity in a jurisdiction that has not implemented margin rules in relation to uncleared OTC derivatives contracts.

While the ESAs have clearly sought to address industry feedback in formulating the draft standards set out in the Second Consultation Paper, we take this opportunity to highlight again a related issue that we believe to be of fundamental importance to the effective application of EMIR to transactions involving an entity established in a third country, namely the matter of how Article 13 of EMIR should be applied.

The European Commission's stated and laudable intention behind Article 13 is to protect counterparties from becoming subject to duplicative or conflicting regulatory requirements.[7] Once the European Commission adopts an implementing act under Article 13 declaring the legal, supervisory, and enforcement arrangements of a third country to be equivalent to EMIR, counterparties are permitted to satisfy their obligations under EMIR by complying with the rules of the equivalent third country. Such an equivalence determination and potential substituted regulatory compliance is possible with respect to EMIR's mandatory margining requirements for uncleared OTC derivative contracts as such requirements form part of Article 11 of EMIR.

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[4] *See* https://www.eba.europa.eu/regulation-and-policy/market-infrastructures/draft-regulatory-technical-standards-on-risk-mitigation-techniques-for-otc-derivatives-not-cleared-by-a-central-counterparty-ccp-?p_p_auth=Ic5FlkTy&p_p_id=169&p_p_lifecycle=0&p_p_state=maximized&p_p_col_id=column-2&p_p_col_pos=1&p_p_col_count=2&_169_struts_action=%2Fdynamic_data_list_display%2Fview_record&_169_recordId=755380&_169_redirect=https%3A%2F%2Fwww.eba.europa.eu%2Fregulation-and-policy%2Fmarket-infrastructures%2Fdraft-regulatory-technical-standards-on-risk-mitigation-techniques-for-otc-derivatives-not-cleared-by-a-central-counterparty-ccp-%2F-%2Fregulatory-activity%2Fconsultation-paper%2F655146 and https://www.eba.europa.eu/regulation-and-policy/market-infrastructures/draft-regulatory-technical-standards-on-risk-mitigation-techniques-for-otc-derivatives-not-cleared-by-a-central-counterparty-ccp-?p_p_auth=Ic5FlkTy&p_p_id=169&p_p_lifecycle=0&p_p_state=maximized&p_p_col_id=column-2&p_p_col_pos=1&p_p_col_count=2&_169_struts_action=%2Fdynamic_data_list_display%2Fview_record&_169_recordId=755182&_169_redirect=https%3A%2F%2Fwww.eba.europa.eu%2Fregulation-and-policy%2Fmarket-infrastructures%2Fdraft-regulatory-technical-standards-on-risk-mitigation-techniques-for-otc-derivatives-not-cleared-by-a-central-counterparty-ccp-%2F-%2Fregulatory-activity%2Fconsultation-paper%2F655146.

[5] *See* https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf.

[6] Regulation (EU) No 648/2012, see http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2012:201:FULL&from=EN.

[7] *See* Article 13(1) of EMIR, which provides that the European Commission, assisted by ESMA, shall monitor and prepare reports for the European Parliament and to the Council on the international application of principles laid down in Articles 4, 9, 10 and 11 of EMIR (in particular with regard to potential duplicative or conflicting requirements placed on market participants) and recommend possible action.

However, Article 13 of EMIR states that the act of equivalence applies only where one of the counterparties is "established" in the equivalent third country. Therefore, it is not wholly clear whether an EU counterparty would be permitted to rely on compliance with the third-country rules to satisfy its EMIR requirements when trading with a third-country entity (*e.g.*, a Cayman Islands alternative investment fund with a U.S.-based manager) that is subject to regulation in the equivalent third country (*e.g.*, the U.S.) but is not legally incorporated in that country. If the European Commission were not to permit such reliance, in such circumstances, the EU counterparty and the third country entity would be required to comply with both the rules of the equivalent third country and EMIR.

AIMA and MFA consider that such an unintended outcome would be unnecessarily burdensome for EU counterparties and their third-country counterparties, and note that it could discourage such entities from transacting with each other, thereby reducing access to EU markets and stifling competition. We believe that this issue would create particular challenges if counterparties were required to comply with mandatory margin requirements of the nature set out in the draft regulatory technical standards ("RTS") and under U.S. law, given the different manner in which collateral is taken and held in the EU and U.S. because of local law. As such, it may not be possible to comply with both regimes at the same time. Accordingly, since market participants will want to rely upon Article 13, it is important that the European Commission interpret Article 13 in a manner that will achieve the objectives of Article 13.

Finally, we would also recommend, when considering the drafting of the RTS in the context of third-country counterparties, that the ESAs consider carefully the use of the terms "counterparties" and "counterparty". In Article 1 GEN (1), the ESAs define "counterparties" to include financial counterparties and non-financial counterparties above the clearing threshold. However, where "counterparties" or "counterparty" is used elsewhere in the RTS (*e.g.*, Article 6 GEN (1) and Article IFP (3)) it is intended to refer to third-country entities that would be financial counterparties or non-financial counterparties above the clearing threshold if established in the EU (collectively, "Assumed NFC+s and FCs"). We encourage the ESAs to ensure that it is clear from the drafting of the RTS the instances in which it intends a provision to include not only "counterparties" (*i.e.*, FCs and NFC+s) but also third-country entities that would be FCs or NFC+s if they were established in the EU. If the term "counterparty" is not used consistently, then there is a risk of: (1) creating confusion for third-country entities regarding the aspects of the framework that are applicable; and (2) undermining the overall coherence of EMIR definitions.

Q2: Respondents are invited to comment on the proposal in this section concerning the timing of calculation, call and delivery of initial and variation margins.

In responding to the First Consultation Paper, we noted that a requirement to collect IM "within the business day following the execution of a new derivative contract" could prove operationally impossible in certain scenarios and proposed alternative approaches based either on a T+2 collection requirement or alternatively a T+1 margin call and associated obligation that the transfer be made promptly following the demand, subject to standard settlement periods and any applicable grace period.[8]

We note that the ESAs have opted not to modify their approach in this regard and that Article 1 EIM (3) would require counterparties to "calculate and collect the total amount of initial margins within one business day". We, therefore, reiterate our request that the ESAs amend this language to provide that the collateral taker must make a demand for IM no later than the end of the business day following the execution of a new derivative contract. The word "within" could be interpreted to suggest that the RTS is envisaging a rolling 24-hour period that starts to apply from execution of the relevant derivative contract, which could necessitate intraday collection of IM (*e.g.*, where parties execute multiple contracts during a business day). Intraday posting of collateral is burdensome for both parties to a contract and would represent a substantial shift in current market practice, without contributing to a material reduction in counterparty risk. Since we do not believe that the ESAs intend such intraday collection of IM, we would appreciate clarity in this regard.

We note, however, that the ESAs permit greater flexibility in respect of VM in the Second Consultation Paper. Article 1 VM (3) requires that "[v]ariation margins shall be collected within three business days from the calculation date". In addition, Article 1 VM (4) provides that for all netting sets for which the collection of VM can exceed one business day, the margin period of risk shall be increased by the number of days in between the

[8] *See* MFA letter to the ESAs on the First Consultation Paper dated July 14, 2014 ("MFA Letter"), at 8-9, available at: https://www.managedfunds.org/wp-content/uploads/2014/07/ESAs-Joint-EMIR-Risk-Mitigation-RTS-for-Uncleared-Derivatives-Final-MFA-Letter-7-14-142.pdf.

calculation and the collection. Lastly, Article 1 VM (5) provides that where the RTS do not require any IM to be collected, the collection of VM should not exceed one business day.

AIMA and MFA welcome this additional flexibility for VM. However, we note that because settlement periods for certain types of collateral permitted by the RTS are longer than one day, Article 1 VM is effectively prohibiting counterparties from using such forms of collateral, unless they agree to transfer additional amounts of IM in order to qualify for the three business day settlement period. Furthermore, smaller market participants who are transacting derivatives that are exempt from the requirement to exchange IM under the RTS, or who are transacting below the IM thresholds set out in the RTS, are restricted to a one business day settlement period for VM. Therefore, these smaller market participants are also prohibited from using collateral with a longer settlement period.

We do not consider it appropriate for the ESAs to permit counterparties with smaller collateral to post a narrower range of collateral than those with large portfolios, which would be contrary to the BCBS/IOSCO Standards. Accordingly, we urge the ESAs to remove Articles 1 VM (4) and (5) from the RTS.

One matter that the ESAs have not addressed in the Second Consultation Paper, and which we have commented on previously, is whether the VM collection requirement is deemed to have been met when the collecting party has exposures to the posting party that fall outside of the scope of the RTS. To explain, consider a counterparty that has voluntarily posted IM on a title transfer basis and then receives a portion of that margin back as a VM payment (such that it remains a net poster of collateral). Has the counterparty satisfied the requirement to collect VM? From comments at the Public Hearing on the Second Consultation Paper held on 18 June 2015, we understand ESMA's view to be that the VM collection requirement would be met in this scenario, given that the rules are focused on whether there has been a transfer of value to satisfy the VM obligation, not the amount of the net exposure between the counterparties. We would welcome the ESAs' confirmation of this point. Given its significance, we suggest that specific reference to this matter is included in the RTS as a recital.

We also ask the ESAs to clarify that, where a counterparty is unable to collect margin as a consequence of a default or other form of termination event occurring in respect of its counterparty, then such circumstance will not cause the counterparty requesting the collateral to be in breach of EMIR. Based on certain confusion at the Public Hearing on this point, a clear statement in the RTS to this effect would be welcome.

Q3: Respondents are invited to provide comments on whether the draft RTS might produce unintended consequence concerning the design or the implementation of initial margin models.

In responding to the First Consultation Paper, we highlighted the importance of requiring that the IM model used be transparent, replicable, and predictable, whilst requiring the party developing the model to disclose the model (including assumptions and calculation methodologies) to its counterparty.[9] Transparency of the IM model directly correlates to the counterparty's ability to replicate any determination of the IM amount, which is critical to a party's capacity to model for, anticipate, and adjust to changes in its obligations. Such transparency also ensures that the IM model will be objective (*i.e.*, arrive at the same "base" IM amount for identical contracts, as computed without regard to the counterparty's identity or creditworthiness), and allow a party to identify clearly any additional IM amounts that the parties have agreed may be applied to reflect the relative creditworthiness of the parties.

We are, therefore, pleased to see the provision at Article 1 MRM (4) that stipulates that "[a]t the request of one of the two counterparties the other counterparty shall provide all the information necessary to explain the determination of a given value of initial margin", which would permit one counterparty to replicate the other's calculation. We are, however, concerned with the language in this article that requires the information to be provided in a way that a "knowledgeable third-party" would be able to understand it or replicate the calculation. AIMA and MFA do not agree with the ESAs' use of the "knowledgeable third-party" standard in this context because we believe that this test is unclear and would be difficult to apply in practice. We suggest instead that the ESAs delete the "knowledgeable third-party" test in Article 1 MRM (4), and instead require that the information and manner of explanation under Article 1 MRM (4) be sufficient only to allow "the requesting counterparty" to be able to replicate the calculation.

We are also concerned with the drafting of Articles 6 GEN (3) and 7 GEN (3), which state that "[i]nvestment funds that are managed by a single investment advisor may be considered distinct entities and treated separately in the course of applying the thresholds referred to in paragraph 1, only where the funds are distinct segregated pools of

[9] See *id.* at 10.

assets for the purposes of fund insolvency or bankruptcy that are not collateralised, guaranteed or supported by other investment funds or the investment advisor itself". This language conflicts directly with the drafting of ESMA's most recent draft RTS on the application of the EMIR clearing obligation to certain additional interest rate swaps ("IRS"). Article 2(3) of the latter draft RTS provides, for purposes of the €8bn threshold calculation for categorisation as a "Category 2" entity, that: "When counterparties are alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU or UCITS as defined in Article 1(2) of Directive 2009/65/EC, the EUR 8 billion threshold referred to in point (b) of paragraph 1 shall apply individually at fund level".[10] AIMA and MFA would recommend that the ESAs amend Articles 6 GEN (3) and 7 GEN (3) to adopt the same language as ESMA's draft RTS on mandatory clearing of IRS. This amendment would ensure a consistent approach throughout EMIR to application of the relevant thresholds to investment funds.

Q4: Respondents are invited to comment on whether the requirements of this section concerning the concentration limits address the concerns expressed on the previous proposal.

In the Second Consultation Paper, the ESAs recognise that some market participants might have constraints in posting collateral different from government debt securities and adopt the revised position that, for this particular asset class, the diversification requirements should only be applied to systemically important institutions or those with large collateral portfolios.

AIMA and MFA greatly appreciate the ESAs' decision to modify their approach on this issue. As previously explained, many market participants satisfy their entire collateral obligation by posting government bonds issued by a single issuer (*e.g.*, U.S. Treasuries) because such bonds are highly liquid even under stressed market conditions. As a result, imposing a 50% concentration limit on such collateral would deviate from many market participants' current practices and create numerous practical difficulties. For example, it could necessitate counterparties posting securities of at least three issuers because it would be difficult for a party to manage an equal division of collateral between two issuers due to fluctuations in the value of the relevant government debt. It would likely also encourage counterparties to post cash rather than securities as collateral.

Additionally, imposition of a 50% concentration limit on high quality government debt could force market participants that, for example, hold principally securities issued by one government issuer to enter into collateral transformation transactions in order to convert a portion of the debt into another asset (generally cash) that they can post as collateral in compliance with the concentration limits. Such transformation transactions are costly, involve their own risks, and can effectively result simply in shifting risk from one collateralized market to another collateralized market.

For these reasons, we strongly welcome the revised approach set out in the Second Consultation Paper. Nonetheless, we respectfully note that there are certain inconsistencies in the drafting of the relevant provisions, as set out below:

- Recital (27) of the draft RTS suggests that the EUR 1 billion threshold applies in relation to all of the concentration limits set out in the draft RTS, whereas Article 7 LEC only applies the EUR 1 billion threshold to government debt. We request that the ESAs amend recital (27) accordingly.

- Article 7 LEC (2) provides that the government debt concentration limits apply to collateral collected in excess of EUR 1 billion, whereas Article 7 LEC (4)(a), which sets out the government debt concentration limits, appears to apply to all collateral posted by a counterparty. We request that the ESAs amend Article 7 LEC (4)(a) accordingly.

In relation to the application of concentration limits in respect of other permitted collateral, we would welcome the ESAs giving further consideration to the application of concentration limits on posted collateral balances of a modest amount. The concentration limits are required to reflect a percentage of the value of the collateral balance. However, this requirement disproportionately impacts posting counterparties with small collateral balances as the application of a percentage-based concentration limit to a small collateral balance would necessarily result in the counterparty with such small balance being subject to a small concentration limit. Accordingly, we would welcome the ESAs devising concentration limits such that the limits permit counterparties to post collateral in an amount equal to the greater of: (i) a fixed amount, and (ii) the concentration limit determined by using the applicable percentage referred to in Article 7 LEC (1). By prescribing a fixed amount alternative, it would allow counterparties required to post smaller collateral balances to use a wider range of

[10] Consultation Paper – Clearing Obligation under EMIR (no.4), available online: http://www.esma.europa.eu/system/files/esma-2015-807_-_consultation_paper_no_4_on_the_clearing_obligation_irs_2.pdf.

collateral rather than being unable to post certain collateral due to the practical and economic difficulties associated with transferring small amounts of collateral in a particular asset class (*e.g.*, equities).

Q5: Respondents to this consultation are invited to highlight their concerns on the requirements on trading relationship documentation.

AIMA and MFA agree with the ESAs that timely and accurate legal documentation is a vital component of a trading relationship. In this regard, we broadly support the requirement under Article 2 OPD (2) that a counterparty "shall perform an independent legal review at least on an annual basis in order to verify the legal enforceability of its bilateral netting arrangements and always be able to provide documentation supporting the legal basis for compliance of the arrangements in each jurisdiction." Notwithstanding the foregoing, we ask the ESAs to clarify in the final RTS that a counterparty could allow its internal counsel to carry out the required "independent legal review" (please see our response to Q6, below). We also question whether such a review should be required on an annual basis, which might prove unnecessarily frequent, particularly for smaller entities.

We note that Article 2 OPD (1) lists a number of terms that counterparties must include in their trading documentation. AIMA and MFA request that the ESAs clarify that the "written trading relationship documentation" required in Article 2 OPD (1) refers to any master agreement governing the trading relationship. In particular, the ESAs should make clear that such documentation does not include the confirmation of a particular transaction as the term "confirmation" is defined in Commission Delegated Regulation (EU) No 149/2013.

Q6: Respondents are invited to comment on the requirements of this section concerning the legal basis for the compliance.

In responding to the First Consultation Paper, we commented on some of the operational challenges associated with requirements in respect of legal opinions on the effectiveness of the segregation arrangements in place with a given counterparty.

AIMA and MFA greatly appreciate the modifications made in the Second Consultation Paper to clarify that an independent legal review in respect of segregation arrangements operates at the level of arrangements "in each jurisdiction" (Article 1 SEG (5)).

In comments made at the Public Hearing on the Second Consultation Paper held on 18 June 2015, representatives of the ESAs indicated that the "independent legal review" referred to in Article 1 SEG (5) could be completed by an independent department within the same legal entity (*i.e.*, the legal function). This position is reinforced by the comment in the explanatory text for consultation that notes the need to comply with the "fundamental due diligence principle of producing an internal assessment of the reliability" of those agreements. We would encourage the ESAs to clarify this point by appending the following wording to the drafting of Articles 1 SEG (5) and 2 OPD (2): "[…].The independent legal review may be performed by the counterparty's internal legal function."

As noted in our response to Q6, we also question whether it is necessary to require that such a review be undertaken annually, which might in practice generate unnecessary operational and legal expense.

Q7: Does this approach address the concerns on the use of cash for initial margin?

In responding to the First Consultation Paper, we highlighted our concerns that the requirements of the RTS would effectively prevent IM from being posted on a title transfer basis. Because market participants will be unable to effect their IM arrangements by way of title transfer arrangements such as under CSA, we believe action would need to be taken in relation to the current uncertainty related to the Directive 2002/47/EC (Financial Collateral Directive).[11] We have serious concerns as to the enforceability of security financial collateral arrangements in many EU Member State jurisdictions, due to the requirement under the Financial Collateral Directive for "possession" or "control" and the way these concepts have been interpreted by the respective courts and legislatures of EU Member States.

AIMA and MFA believe that the Financial Collateral Directive should first be amended to address any ambiguities in this regard, before the ESAs take any steps which potentially force market participants to use a collateral arrangement that will not achieve the objectives of the Financial Collateral Directive. As a general point, by increasing the likelihood that potentially unenforceable collateral arrangements will be used, a collecting party

[11] *See* http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32002L0047&from=EN.

can have no certainty that the collateral it receives can be used against the loss it incurs due to a counterparty default. In essence, without amending the Financial Collateral Directive, markets participants using such arrangements would find that, *ex post facto*, they have transacted with their counterparties without having the benefits of the Financial Collateral Directive, something that would in turn increase systemic risk.

In respect of the approach taken in the Second Consultation Paper, MFA and AIMA support the ESAs' efforts to develop a framework in which it is possible for counterparties to post IM in the form of cash (to the extent it is then transformed into securities that can be effectively segregated). We are not convinced, however, that market participants will in practice be able to make use of this option given the applicable costs and the fact that existing custody structures are unlikely to be compatible with the possibliity of reinvestment of cash IM. We also foresee practical difficulties with the operation of Article 1 REU, which allows counterparties to convert cash IM into other types of collateral permitted by the RTS. For example, as a consequence of applying required haircuts to various types of collateral posted as IM under Article 1 HC or Article 2 HC, counterparties will need to post a greater amount of cash IM than would otherwise be required as the cash will need to be converted into other collateral that will also be subject to a haircut. There might also be uncertainty as to how much cash IM to post, given that the final value of collateral obtained following conversion of the cash will be unclear at the time of the initial posting.

Q8: Respondents are invited to comment on the requirements of this section concerning treatment of FX mismatch between collateral and OTC derivatives.

We have previously emphasised that the proposed 8% haircut to the market value of assets where the collateral currency is different from the settlement currency should not apply to cash collateral. Cash is the most liquid type of collateral that market participants can post such that even in stressed market scenarios cash retains its liquidity. We, therefore, very much welcome the approach the ESAs adopted in the Second Consultation Paper, which clarifies that "[a]s cash for VM is considered the pure settlement of a claim, this should not be subject to any haircut".[12]

Nonetheless, the provision setting out the proposed 8% haircut with respect to VM[13] refers to "assets posted as collateral" and does not clarify that such assets are non-cash assets only. Recital 11 indicates that the intention is that cash collateral should not be subject to any haircut. We respectfully invite the ESAs to clarify the drafting of Annex II, paragraph 7 to the RTS.

Similarly, the ESAs should amend Annex II, paragraph 5 of the draft RTS to carve out cash IM[14] from the 8% haircut. At present, neither the VM nor the IM provisions identify the types of assets that are subject to the 8% haircut, and we are concerned that these provisions could cause confusion for market participants that are trying to implement them.

We note also that the ESAs have replaced the references to the "settlement currency" in the First Consultation Paper with references to the "termination currency" (with respect to IM) and to the "transfer currency" (with respect to VM).[15] The meaning of the term "transfer currency" is unclear, particularly as counterparties may divide their transactions into separate currency portfolios and post collateral in the currency of those portfolios. Accordingly, we urge the ESAs to clarify what is meant by this term.

Finally, AIMA and MFA would like to raise one additional point relating to FX for the purposes of calculating aggregate notional amounts of non-centrally cleared exposures for the IM implementation thresholds. We would be grateful if the ESAs could clarify within the final draft RTS that, when calculating their aggregate notional amounts for OTC FX forward contracts, that each counterparty need not count the individual legs of the forward transaction as separate gross exposures - instead taking the economic notional value of the contract to the counterparty only. Therefore a EUR/USD forward with a notional value of $20m to the counterparty, being the amount expressed to be delivered by the counterparty, should be included in the relevant threshold calculation of the counterparty as increasing the aggregate notional amount of exposure by $20m and not by the amount of individual legs.

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[12] *See* Second Consultation Paper at 57, the explanatory text.

[13] Annex II, paragraph 7 to the RTS.

[14] Annex II, paragraph 6 to the RTS.

[15] Annex II, paragraphs 6 and 7 to the RTS.