MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

July 14, 2014

Via Electronic Submission

The Joint Committee of the European Supervisory Authorities

European Banking Authority
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London EC2N 1HQ
United Kingdom

European Insurance and Occupational Pensions Authority
Westhafenplatz 1
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European Securities and Markets Authority
CS 60747
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Re: 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

Dear Sir or Madam:

Managed Funds Association[1] ("**MFA**") welcomes the opportunity to provide comments to the European Supervisory Authorities ("**ESAs**")[2] in response to their consultation paper (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"[3] dated 14 April 2014 related to the European Market

[1] Managed Funds Association 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, the Americas, Australia and many other regions where MFA members are market participants.

[2] Collectively, the European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority ("**ESMA**").

[3] Available at: http://www.esma.europa.eu/system/files/jc_cp_2014_03_cp_on_risk_mitigation_for_otc_derivatives.pdf.

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Infrastructure Regulation ("**EMIR**").[4] MFA supports the ESAs' efforts to reduce counterparty credit risk and to mitigate the potential for systemic risk resulting in the uncleared over-the-counter ("**OTC**") derivative markets. We also strongly support ensuring that collateral posted by market participants in respect of such contracts is subject to robust and appropriate regulatory protections. Therefore, MFA appreciates the opportunity to provide comments on the regulatory technical standards ("**RTS**") in the Consultation Paper because we recognize that these proposed mandatory margin and segregation requirements with respect to uncleared OTC derivative contracts are a fundamental component of the EMIR risk mitigation framework and will contribute to the critical risk mitigation and counterparty protection goals discussed above.

In particular, in this letter, MFA, among other things:

(1) Emphasizes the need to ensure that the final RTS are consistent with the mandatory margin requirements in other jurisdictions;

(2) Informs the ESAs of certain issues that may arise under Article 13 of EMIR, in the context of the RTS, due to interpretational issues in respect of what it means for an entity to be "established" in a third country;

(3) Requests that the ESAs require financial counterparties ("**FCs**") and non-financial counterparties ("**NFCs**") over the clearing threshold ("**NFC+s**") to post as well as collect variation margin ("**VM**");

(4) Requests that the ESAs confirm that the RTS do not apply to: (a) non-EU counterparties that would be NFCs below the clearing threshold ("**NFC-s**") if they were established in the EU; or (b) voluntary exchanges of collateral;

(5) Asks the ESAs to clarify that the EUR 50 million threshold that permits parties not to exchange initial margin ("**IM**") and the applicable threshold set out in Article 1 FP, 3 of the RTS ("**Minimum Notional Threshold**")[5] apply to all contracts and not solely to contracts between FCs and other FCs or NFCs;

(6) Seeks clarity that the requirements related to daily collection and calculation of IM do not require calculations or collections to take place intraday or more than once a day;

(7) Urges the ESAs to require that the model used to calculate IM requirements be transparent, replicable, and predictable;

(8) Expresses concern with the significant documentation and operational changes that the proposed requirements on the eligibility and treatment of collateral might necessitate;

[4] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

[5] Consultation Paper at 46, Article 1 FP, 3

(9) Encourages the ESAs not to apply the concentration limits in the RTS to high quality government debt (*e.g.*, debt instruments of G-7 countries[6]); and

(10) Requests that the ESAs not require counterparties to obtain legal opinions verifying that their segregation arrangements meet the requirements of the RTS.

In the Consultation Paper, the ESAs invite comments on all proposals in addition to the specific questions summarized in section 5.2. Accordingly, MFA presents its comments below sequentially in the order in which the RTS are set out in the Consultation Paper.

I. Global Consistency of Margin Requirements

MFA emphasizes that it is critical that, in finalizing the RTS, the ESAs coordinate with their regulatory counterparts in other jurisdictions and ensure that, to the greatest extent possible, there is global harmonization of margin requirements for uncleared OTC derivative contracts.

The introduction of mandatory margin requirements in respect of uncleared OTC derivative contracts in the form proposed in the RTS represents a fundamental change to the operation of the global OTC derivatives markets. In addition, because market participants' trading of uncleared derivatives involves counterparties and derivatives markets in multiple jurisdictions, their trading activities will be subject to regulation in these different jurisdictions. Therefore, we are concerned that, without sufficient coordination and harmonization as to the timing and scope of these different initiatives, conflicting rules will pose significant challenges to market participants and will impair the derivatives markets. For example, in the absence of such uniformity, market participants, will have to monitor and comply with multiple mandatory margin regimes, which will be administratively difficult, costly, and burdensome, and may increase the likelihood of unintended errors.

As a result, MFA strongly supported adoption of an internationally uniform set of margin requirements to facilitate orderly collateral management practices and minimize regulatory arbitrage[7] as provided by the international standards on margin requirements for non-centrally cleared derivative transactions issued by the Basel Committee for Banking Supervision and the International Organisation of Securities Commissions on September 2013 (the "**BCBS/IOSCO Standards**").[8] Accordingly, MFA appreciates the ESAs' initial step of transposing the BCBS/IOSCO Standards into the RTS.

As a further step, MFA urges the ESAs to monitor developments of, and coordinate with, its regulatory counterparts in other key jurisdictions with the goal of ensuring that the final RTS are consistent with, and operate in the same manner as, the mandatory margin rules of other key global derivatives markets, such as that of the U.S. Such coordination and consistency is critical to preventing market participants from having to comply with duplicative and potentially conflicting regimes. For example, if part of ensuring such international convergence between key jurisdictions necessitates the ESAs shifting the proposed timeframe for completion and implementation of the RTS, then MFA respectfully requests that the

[6] The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

[7] *See* MFA Letter to BCBS/IOSCO on its "Second Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives", dated March 15, 2013, available at: https://www.managedfunds.org/wp-content/uploads/2013/03/Basel-IOSCO-Second-Consultative-Document-on-Margin-Requirements-MFA-Final-Letter.pdf.

[8] Available at: http://www.bis.org/publ/bcbs261.pdf.

ESAs reconsider the proposed timeframe in order to foster the continued vitality of the global derivatives markets.

II. Operation of Article 13 of EMIR in the Context of the RTS

In the context of developing the RTS, MFA asks the ESAs to be mindful of certain problems in the application of Article 13 of EMIR on equivalence.[9]

The European Commission's stated and laudable intention behind Article 13 is to protect counterparties from becoming subject to duplicative or conflicting regulatory requirements.[10] 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.

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.

MFA considers that such an unintended outcome would be unnecessarily burdensome for EU counterparties and their third country counterparties, and notes 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 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 is reasonable and will achieve the objectives of Article 13.

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[9] *See* MFA and the Alternative Investment Management Association joint letter to ESMA, dated 12 March 2013, at 12, available at: https://www.managedfunds.org/wp-content/uploads/2013/03/MFA-AIMA-Joint-Letter-Proposing-ESMA-EMIR-QAs-Final-Letter.pdf; and MFA Discussion Paper on Equivalence Issues under Article 13(3) of EMIR, dated June 4, 2014, available at: https://www.managedfunds.org/wp-content/uploads/2014/06/MFA-Discussion-Paper-on-Article-13-EMIR-Equivalence-Final-6-3-14.pdf. In each of which, MFA raises the importance of the issue of where the European Commission determines an alternative investment fund to be "established" for purposes of Article 13.

[10] *See* Article 13(1) of EMIR, which provides that 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.

III. Counterparties' Risk Management Procedures Required for Compliance with Paragraph 3 of Article 11 of EMIR

A. Scope

1. Requirement for FCs and NFC+s to Post VM

The RTS provide that in-scope entities (*i.e.*, entities classified under EMIR as FCs or NFC+s) are required to collect VM and IM from their counterparties.[11] MFA considers that the RTS should also require the posting, not just the collection, of VM by FCs and NFC+s, which is consistent with current market practice.

The one-way "collection" approach may appear appropriate in the context of transactions among FCs and NFC+s because, under the RTS, each would be under an obligation to collect margin from the other, and accordingly, would be obliged to post margin to the other. However, this approach is unwieldy in the context of cross-border transactions (*i.e.*, where one of the counterparties is located in a third country jurisdiction), where the ESAs appear to be relying on the rules of a third country jurisdiction to require entities subject to the margin rules in such jurisdiction to collect VM from European counterparties.

For example, where one counterparty is located in a third country jurisdiction that has not implemented margin rules in relation to uncleared OTC derivative contracts, EMIR would require the FC/NFC+ counterparty to collect margin but would not require the third country counterparty to collect margin.[12] As a matter of risk mitigation, this outcome is not logical. In addition, in such circumstance, it would be difficult for the counterparties to construct a collateral arrangement that would both permit the FC/NFC+ counterparty to collect VM and IM in accordance with EMIR and allow the other counterparty to collect margin in accordance with the requirements of the third country jurisdiction. MFA envisages that these documentation difficulties would be even greater where the third country jurisdiction imposes a requirement on its in-scope entities to both collect and post margin because such a requirement could potentially conflict with the EMIR requirement, leaving parties uncertain about with which regime they must comply.[13]

On balance, MFA does not consider it appropriate to rely upon the third country entity to require an EU dealer to post VM, or to rely on the EU dealer to agree to post VM as a matter of contractual agreement. Rather, we believe that the RTS should require FCs and NFC+s to post VM to third country entities because, as noted above, such a requirement is consistent with current market practice among many EU dealers and their non-dealer counterparties.

2. Application of RTS to Non-EU NFC-s

The RTS state that in-scope entities may agree not to exchange IM and VM in respect of transactions entered into with NFC-s.[14] However, the RTS also impose an obligation on FCs

[11] Consultation Paper at 23, Article 1 GEN, 3(a) and (b).

[12] *Id.*, Article 1 GEN, 3.

[13] MFA considers that the foregoing illustrates the need for counterparties to be able to satisfy EMIR by complying with the margin rules of a comparable third country. Article 13 of EMIR is intended to provide appropriate protection in these circumstances and the problems described above highlight the importance of our views expressed in Section II above.

[14] Consultation Paper at 24, Article 2 GEN, 4(b).

and NFC+s to collect IM and VM from their non-EU counterparties, even if such non-EU counterparties would be classified as NFC-s if they were established in the EU ("**Assumed NFC-s**").[15]

It seems an inequitable and unexpected outcome to require such a non-EU entity (or Assumed NFC-) to post IM and VM when trading with FCs and NFC+s when it would not have to do so if it were established in the EU. Compliance with mandatory margin requirements increases costs for smaller market participants, and therefore, MFA considers it inappropriate and unintended that an Assumed NFC- should be subject to such increased costs (necessarily including the re-negotiation of existing collateral documentation) whereas NFC-s benefit from an exclusion. In addition, although other jurisdictions have not yet published their mandatory margin rules, it is generally anticipated that such jurisdictions will exempt such smaller market participants from their margin rules. Therefore, if Assumed NFC-s remain indirectly subject to the RTS in the manner contemplated at present, their EU counterparties will be at a disadvantage because they will be obliged to apply more stringent requirements than their non-EU competitors, which will discourage Assumed NFC-s from trading with EU counterparties.

MFA strongly recommends that the ESAs correct this inconsistency in the application of the RTS and align the application of the RTS to NFC-s and Assumed NFC-s by not requiring FCs and NFC+s to collect IM and VM from Assumed NFC-s. Such an approach would be consistent with the treatment of NFC-s elsewhere under the RTS (*e.g.*, in relation to the mandatory clearing obligation) and create equal treatment across the globe for entities below the clearing threshold.

MFA also believes that narrowing the RTS' application to Assumed NFC-s in this manner would be consistent with EMIR. There is no indication in EMIR that the collateral requirements under Article 11(3) apply to FCs and NFC+s differently depending on whether they are transacting with NFC-s or Assumed NFC-s. EMIR also does not indicate that it is appropriate for increased regulatory requirements to apply where an FC or NFC+ transacts with a non-EU entity. For example, the clearing obligation under Article 4 of EMIR does not apply to contracts involving either NFC-s or Assumed NFC-s. Therefore, MFA believes it is permitted and prudent for the ESAs to align the margin requirements for NFC-s and Assumed NFC-s such that FCs and NFC+s are not required to collect IM or VM from either group.

3. Application of RTS to Voluntary Exchange of Collateral

MFA requests that the ESAs confirm that the RTS do not apply to counterparties that exchange collateral not because the RTS require them to do so, but rather because of bilaterally negotiated contractual agreements. We consider that such voluntary arrangements should be outside of the scope of the RTS, and the ESAs should not require the counterparties to comply with other obligations under the RTS (*e.g.*, requirements related to eligible collateral and segregation). Rather, the ESAs should permit counterparties that exchange collateral on a voluntary basis to determine and apply the parameters on which such an exchange takes place. MFA understands that the generally held view is that the RTS do not apply in these circumstances, but it would be helpful for the ESAs to confirm this disapplication explicitly in the RTS by including a simple statement that the RTS only apply to FCs and NFC+s to the extent they are required to collect collateral under the RTS.

[15] *Id*. at 7.

4. Application of Exemptions Only with Written Agreement

MFA notes that the various exemptions under the RTS only apply after counterparties have entered into a written agreement to claim the benefit of the exemption. In particular, FCs and NFC+s are required to collect IM and VM from NFC-s and certain other entities,[16] unless the counterparties formally agree that such collection is not required.[17] Similarly, FCs and NFC+s are required to collect IM where either party falls below the Minimum Notional Threshold, unless the counterparties formally agree to the contrary.[18] The written agreement requirement imposes an unnecessary administrative burden on smaller counterparties that the European Commission did not intend to fall within the scope of the RTS. Therefore, MFA does not consider it appropriate that these exemptions should only operate following formal agreement, and we encourage the ESAs to provide that these exemptions are mandatory and apply automatically, without further action by the counterparties.

B. <u>EUR 50 Million IM Threshold</u>

MFA notes that the draft RTS provide that an FC may "agree in writing or equivalent permanent electronic form with its financial or non-financial counterparties that where the total initial margin calculated to be exchanged for all non-centrally cleared OTC derivatives between counterparties at group level . . . is equal to or lower than EUR 50 million, they may agree that no initial margin will be exchanged and that they will hold capital against their exposure to their counterparties".[19]

MFA applauds the ESAs for confirming that each investment fund (*i.e.*, distinct legal entity) counts separately for purposes of determining whether it exceeds the EUR 50 million threshold.[20] This confirmation is helpful clarification and is consistent both with prior guidance given by ESMA[21] and with the BCBS/IOSCO Standards.[22]

We also support the intent behind the RTS, which is to allow parties not to exchange IM if they do not have significant exposures to each other.[23] However, such exclusion appears to

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[16] *See* Article 1(4) and (5) of EMIR, which excludes: (1) certain EU Member States, EU public bodies, and the Bank for International Settlements from EMIR; and (2) certain multilateral development banks, public sector entities, the European Financial Stability Facility, and the European Stability Mechanism from all EMIR requirements, except the reporting obligation.

[17] Consultation Paper at 24, Article 2 GEN, 4(b) and 4(c).

[18] *Id*. at 46, Article 1 FP, 3.

[19] *Id*. at 23, Article 2 GEN, 3.

[20] *Id*. at 18-19, recital (5), which applies the threshold at the group level to entities other than investment funds.

[21] *See* ESMA "Questions and Answers Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)" (21 May 2014) ("**ESMA Q&A**"), at 9, General Answer 1(a), available at: http://www.esma.europa.eu/system/files/2014-550.pdf, explaining that when EMIR "refers to a number of trade or to a threshold, this should be assessed at the level of the fund (or in case of umbrella funds, at the level of the sub-fund), and not at the level of the fund manager".

[22] *See* BCBS/IOSCO Standards at 9, footnote 10. The BCBS/IOSCO Standards state that "investment funds that are managed by an investment advisor are considered distinct entities that are treated separately when applying the threshold as long as the funds are distinct legal entities that are not collateralised by or are otherwise guaranteed or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy."

[23] Consultation Paper at 8.

be narrow and available only to FCs and only for their transactions with FCs or NFCs. It does not seem to permit NFC+s to choose to apply the EUR 50 million threshold when transacting with other NFC+s. The exclusion also does not allow FCs to apply the EUR 50 million threshold when transacting with third country entities (*e.g.*, Assumed NFC+s). Given the ESAs' laudatory goal, consistent with the BCBS/IOSCO Standards, of minimizing the burden of exchanging IM, MFA asks the ESAs to clarify that the EUR 50 million threshold applies in all cases where an FC or NFC+ collects collateral from a counterparty and where an Assumed FC or Assumed NFC+ collects collateral from a counterparty under Article 11(12) of EMIR.

In addition, MFA is concerned that using EUR to denominate the proposed EUR 50 million threshold and EUR 500,000 minimum transfer amount[24] in the RTS could give rise to practical difficulties, given that market participants' contracts may be denominated in another currency (*e.g.*, USD). MFA has two suggestions for ways in which the ESAs could address this difficulty. One suggestion is to allow parties to convert the threshold or minimum transfer amount to a different currency using an average rolling spot rate for a defined prior period (*e.g.*, the prior calendar year) with rounding to the nearest 100,000 (of the applicable currency). A second suggestion is to allow parties to denominate such threshold or minimum transfer amount in another currency rounded to the nearest 100,000 (of the applicable currency) at the start of each calendar year with a reset at the start of each subsequent calendar year. MFA expresses no preference between the two options; however, we emphasize the importance of permitting parties some alternative to the proposed EUR-denominated thresholds that is reasonable and of universal application.

C. <u>The Minimum Notional Threshold</u>

MFA also notes that, similar to the treatment in the RTS of the EUR 50 million threshold, the Minimum Notional Threshold applies only where FCs and/or NFC+s transact with one another, in accordance with the definition of 'counterparties'.[25] Accordingly, the RTS do not allow the Minimum Notional Threshold to apply where FCs or NFC+s are transacting with third country entities. For the reasons set out in Section III.B above, we ask the ESAs to clarify that the Minimum Notional Threshold applies in all cases where an FC or NFC+ would otherwise be required to collect collateral, including when transacting with third country entities.

D. <u>Daily Collection and Calculation of IM</u>

The RTS require a counterparty to collect IM "within the business day following the execution of a new derivative contract".[26] MFA would appreciate it if the ESAs could amend this language to provide that the collateral taker must make a demand for collateral 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 twenty-

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[24] *See id*. at 23, Article 2 GEN, 4(a), which provides that where the total collateral amount based on all OTC derivatives transactions between two counterparties is equal to or lower than EUR 500 000, they may agree not to exchange collateral.

[25] *Id*. at 46, Article 1 FP, 3: "Counterparties' risk management procedures may include the agreement in writing . . . that initial margins are not collected . . . when the conditions in points (a) to (e) are met"; and at 21, Article 1 DEF, 1(a): "'Counterparties' means financial counterparties . . . and non-financial counterparties referred to in Article 10 of Regulation (EU) 648/2012".

[26] *Id*. at 27, Article 1 EIM, 3.

four hour period that starts to apply from execution of the relevant derivative contract, which could necessitate intraday collection of collateral. Intraday posting of collateral is burdensome for both parties to a contract and would represent a substantial shift in current market practice. Since we do not believe that the ESAs intend such intraday collection of margin, we would appreciate clarity in this regard.

In addition, MFA believes that the ESAs should modify the timing specified in the RTS to: (1) focus on the time at which a collateral taker makes a demand for a transfer of collateral (rather than the time at which its counterparty makes a transfer); and (2) provide that such transfer must be made promptly following the demand, subject to standard settlement periods and any applicable grace period.

We believe that focusing on the time of demand by the collateral taker is appropriate because settlement periods for certain types of collateral permitted by the RTS are longer than one day. However, we also appreciate that for systemic risk purposes it is important that once a collateral taker makes a demand for transfer of collateral, its counterparty complete such transfer promptly. Therefore, MFA suggests that the ESAs stipulate that once a collateral taker makes a demand for collateral that its counterparty must complete such transfer of collateral by no later than the expiry of the standard settlement period for the collateral following the date of the relevant demand, subject to any bona fide dispute that may exist in respect of the collateral demand[27] and any applicable grace period.

We believe that it is necessary to reference standard settlement periods, rather than prescribing a set period of time, to facilitate use of the wide range of collateral permitted under the RTS and to provide sufficient time to transfer collateral following a demand.[28] Using standard settlement periods also gives parties the flexibility to account for operational and practical difficulties involved in transferring different types of collateral across time zones. In practice, collateral arrangements often provide for shorter settlement periods than the standard settlement period, but MFA considers that a shorter time period should be a matter of contractual negotiation between counterparties based on the type of collateral permitted under the relevant collateral arrangement and any particular operational efficiencies that may exist between the two counterparties in question.

Lastly, MFA notes that the draft RTS provide that a party must recalculate and collect IM from its counterparty at least (among other events) when the parties execute a new contract.[29] Given that it is possible for two parties to execute multiple contracts during a business day, the requirements in the RTS suggest that the parties would have to recalculate and collect IM each time (*i.e.*, multiple times during the same business day). Such an approach would be unduly burdensome. Therefore, MFA recommends that the RTS not provide for recalculation or collection of IM more frequently than once per day, which would align the timing applicable to this requirement with the RTS requiring daily re-evaluation of collateral.[30]

[27] *See* Article 11(1)(b) of EMIR and Article 15(1)(a) of Commission Delegated Regulation (EU) No. 149/2013, available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF, which require parties to have in place procedures for resolution of disputes relating to collateral.

[28] *See* Consultation Paper at 32, Article 1 LEC.

[29] *Id.* at 27, Article 1 EIM, 4(a).

[30] *Id.* at 34, Article 2 LEC, 1(a).

IV. Margin Methods

A. IM Models

Although the RTS permit parties to develop an IM model jointly,[31] MFA anticipates that in the ordinary course only one party will develop the IM model that both parties will use to calculate their respective IM requirements. As a result, it is important that the ESAs require the IM model used to be transparent, replicable, and predictable and require the party developing the model to disclose the model (including assumptions and calculation methodologies) to its counterparty. 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. Therefore, MFA encourages the ESAs to confirm expressly that if only one party develops the IM model used, that the party must provide sufficient information about its model to its counterparty to ensure that: (1) there are no variations from a baseline model on the IM amount required by the party for identical contracts; and (2) any additional IM that the counterparty must post to reflect its relative creditworthiness is identifiable.

In the absence of transparent, replicable, and predictable IM Models, the potential for material and frequent disputes between parties increases, which is an outcome that is contrary to the ESAs stated goal of providing access to applicable IM models while reducing the materiality and probability of disputes in respect of IM.[32] In addition, without such transparency, replicability, and predictability, a counterparty will need to hold excess assets in reserve in case it needs to post such assets as collateral to account for an unanticipated IM change. Reserving such excess collateral is an inefficient use of the counterparty's assets, but is necessary because, if the counterparty does not hold such excess assets, an unanticipated IM change could result in such counterparty's default as it may not have adequate collateral available to it in order to satisfy the unexpected demand for further IM.

Therefore, to prevent such disputes and margin inefficiencies, MFA requests that the ESAs require transparency as to the functionality and parameters of the IM model used, as discussed above, and ensure that it (and any credit-based adjustment that may be agreed by the parties) is replicable and predictable to prevent such undesirable outcomes.

B. Netting of IM

MFA would appreciate it if the ESAs would clarify the position taken in the RTS with respect to the netting of IM.

Article 1 GEN, 3(a) of the RTS provides that the collection of IM should be "without the possibility of netting the initial margin amounts between each other".[33] This provision appears to prohibit the netting of IM. On the contrary, Article 4 MRM, 6 provides that the

[31] *Id*. at 28, Article 1 MRM, 1(a).

[32] *Id*. at 29, Article 1 MRM, Explanatory text for consultation purposes.

[33] *Id*. at 23.

total IM requirements for a netting set shall be "the sum of initial margin requirements calculated for each underlying class within the netting set".[34] This provision appears to permit netting of IM within netting sets.

MFA has continuously been a strong supporter of netting[35] because effective netting arrangements lower systemic risk by reducing both the aggregate credit exposure of the posting party arising from any requirement to deliver margin and the trading costs for market participants. Moreover, permitting netting across a wide variety of offsetting exposures, in addition to reducing aggregate counterparty credit risk and lowering trading costs, would: (1) allow entities to make efficient use of their capital; (2) provide market participants and regulators with better transparency as to the overall amount of counterparty risk between two parties, which is informative of risk in the derivatives markets; and (3) reduce complexity and settlement risk. Accordingly, MFA supports the netting of IM within asset classes of derivatives as contemplated in the BCBS/IOSCO Standards and encourages the ESAs to clarify that the RTS conform to the BCBS/IOSCO Standards.[36]

C. Qualitative Requirements

MFA notes that the RTS require counterparties to have a process for verifying at least annually that the netting agreements considered for the IM calculation are legally enforceable.[37] The RTS does not prescribe the process by which this verification must occur, which creates uncertainty as to the requirements of the RTS. For example, we do not believe it is necessary or intended for such process to include obtaining legal opinions on an annual basis, which would be costly, disproportionate to any perceived benefit, difficult for industry bodies to develop, and challenging for smaller market participants to access.[38] Rather, we believe that such verification should include a review (at least annually) by internal or external legal counsel to determine that there has been no change in law that would result in the netting agreements ceasing to be legally enforceable. This approach and level of verification is appropriate and sufficient to assure the counterparties that their arrangements remain legally enforceable. Accordingly, MFA requests that the ESAs clarify that the RTS do not require counterparties to obtain a legal opinion to satisfy the verification requirement.

V. Eligibility and Treatment of Collateral

MFA supports the ESAs' intention to impose limits on the eligibility and treatment of collateral in order to, among other things, reduce reliance on external ratings. However, we

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[34] *Id*. at 31.

[35] *See* MFA Updated Response on Proposed Regulation on OTC Derivatives, Central Counterparties and Trade Repositories, dated January 19, 2012, at 3, Section III, available at: https://www.managedfunds.org/wp-content/uploads/2012/01/Final_MFA_Updated_WhitePaper_on_EMIR.pdf; and MFA letter to the ESAs on their joint discussion paper on "Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories", dated April 2, 2012, available at: https://www.managedfunds.org/wp-content/uploads/2012/04/ESA-Joint-Risk-Mitigation-Discussion-Paper-Final-MFA-Letter.pdf.

[36] *See* BCBS/IOSCO Standards at 12, 3.4. The BCBS/IOSCO Standards state that IM models may account for diversification, hedging and risk offsets within well-defined asset classes such as currency/rates, equity, credit, or commodities, but not across such asset classes and provided these instruments are covered by the same legally enforceable netting agreement.

[37] Consultation Paper at 32, Article 6 MRM, 2.

[38] *See* Section VI.C below for further discussion of the challenges of obtaining legal opinions.

emphasize the significant documentation and operational changes that these requirements will necessitate, and thus, urge further analysis and consideration of these requirements.

A. Concentration Limits

1. High Quality Government Debt

MFA strongly believes that the proposed concentration limits in the RTS for certain high quality government debt are inappropriate and unnecessary. Therefore, we believe that the ESAs should exempt certain high quality government debt from the concentration requirements (*e.g.*, debt instruments of G-7 countries).[39] Additionally, we recommend including proportionality thresholds in the RTS below which the concentration limits would not apply.

Currently, 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, which MFA does not believe is intended under the RTS, or envisaged under the BCBS/IOSCO Standards.

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. As a result, MFA considers it contrary to the goals of reducing systemic and counterparty risk to require the application of fixed concentration limits without regard to the quality and liquidity of the relevant collateral.

Further, MFA is concerned that the proposed concentration limits will have a disproportionate effect on counterparties that are required to post a modest amount of collateral. Where the amount of collateral posted by a counterparty is modest, requiring diversification amongst a number of issuers could be unduly burdensome given the overall exposure covered by the collateral.

Accordingly, MFA supports, in addition to an exemption for high-quality government debt, the suggestion in the Consultation Paper that the RTS should include proportionality thresholds, below which the concentration limits would not apply.[40]

[39] Consultation Paper at 39, Article 7 LEC, 1(a).

[40] *Id*. at 38, Article 7 LEC, Explanatory text for consultation purposes.

2. Other Types of Eligible Collateral

With respect to other types of eligible collateral, if the ESAs determine to impose concentration limits, MFA recommends that the ESAs provide a grace period during which counterparties can address any concentration limits that they have breached. We understand the risks that such a breach poses, and thus, are not suggesting a lengthy grace period. However, due to changes in the market value of the collateral posted, periodic breaches of the concentration limits may occur that counterparties cannot foresee or rebalance in time to avoid. Therefore, in such circumstances, we would ask the ESAs to provide a reasonable grace period to allow parties to bring the diversification of their posted collateral back into compliance with the RTS. Specifically, we suggest that a grace period of two (2) business days would be appropriate to allow parties sufficient time to obtain and post the necessary diversified collateral. In addition, we recommend that the ESAs permit the counterparties to determine what the term "business day" will mean for these purposes to ensure that the counterparties are able to account for the various time zones and locations that may apply to their transactions.

B. Haircuts on Collateral Market Values

Annex II of the RTS provides that counterparties should apply an 8% haircut to the market value of assets where the collateral currency is different from the settlement currency.[41] MFA recommends that the ESAs clarify that this provision is not intended to apply to cash collateral, but only to securities that are denominated in a currency different from the currency of the underlying derivative obligation. Cash is the most liquid type of collateral that market participants can post such that even in stressed market scenarios cash retains its liquidity. Therefore, MFA does not believe that it is appropriate to subject cash collateral to this requirement, particularly where very liquid currencies (*e.g.*, EUR, GBP, or USD) are posted as collateral.

Nonetheless, if the ESAs decide to retain the proposed 8% haircut where the collateral currency differs from the settlement currency,[42] MFA urges the ESAs to confirm that the reference to "settlement currency" refers to the "base currency" specified in the underlying collateral arrangements. This clarification is necessary because we expect that, pursuant to such collateral arrangements, the amount of collateral which one party posts to the other will be calculated and denominated in such a base currency. Therefore, MFA believes that where a party posts margin in the base currency, no haircut should apply.

C. Credit Quality Assessment

Article 3 LEC requires a collateral taker to assess the credit quality of certain assets using (among other options) "an approved internal model as referred to in Article 5 LEC".[43] However, Article 5 LEC does not contain a reference to any internal model. As a result, this cross-reference appears to be an error, although it is not immediately clear what the correct reference should be. Therefore, MFA would appreciate it if the ESAs could clarify the reference to an "approved internal model" for these purposes.

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[41] *Id*. at 49-50.

[42] *Id*. at 50, Table 2 VA.

[43] *Id*. at 34, Article 3 LEC, 1(a).

D. Collateral Management

MFA strongly supports the requirement in the RTS that collateral be freely transferable, without any regulatory or legal constraints or third party claims, including those of a third party custodian (other than for costs and expenses incurred for that purpose) that impair liquidation or the return to the collateral provider on default of the collateral taker.[44] We recognize that in the negotiation of segregation arrangements, it is common for custodians to seek to place various restrictions on the transferability of collateral or subject such collateral to rights of set-off against unrelated liabilities owed to the custodian. As a result of such custodian restrictions, set-off rights, or equivalent arrangements, during times of market uncertainty or stress, counterparties can be delayed in accessing or transferring their collateral until a custodian's related rights, disputes, or legal claims are resolved, which can be a lengthy and time-consuming process. It is also uncertain how much of the collateral will be available to the collateral provider. We understand that it can often be challenging to persuade custodians to accept this position because it exposes the collateral provider to uncertainty. Therefore, the ESAs mandate of such a requirement for custodians is helpful to ensure that counterparties will be able to access and transfer their collateral when necessary.

VI. Operational Procedures

A. Scope of Operational Procedures

MFA requests that the ESAs confirm that the requirements set out in Article 1 OPE of the RTS, such as operational processes for the exchange of collateral, ("**Operational Procedures**") only apply to in-scope entities. In the case of entities other than an in-scope entity ("out-of-scope" entities), they are not directly subject to the RTS, but must post collateral to their FC and NFC+ counterparties to ensure the FCs and NFC+s are in compliance with their obligations under EMIR. Therefore, it would be consistent with the ESAs' approach to out-of-scope entities generally, to exclude them from compliance with the Operational Procedures. MFA believes that this approach is also consistent with Article 11(3) of EMIR, which introduces the requirement to exchange collateral, and which applies directly to in-scope entities only. Nonetheless, a clear statement to this effect in the RTS will be helpful to parties putting arrangements in place to adapt to the requirements of the RTS.

The ESAs may be aware that the International Swaps and Derivatives Association, Inc. ("**ISDA**") took a similar approach in the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol of July 19, 2013, with respect to the dispute resolution procedures required under Article 11(1)(b) of EMIR.[45] The protocol only requires adhering parties that are in-scope entities to have internal dispute policies in place, whereas all adhering parties must follow the dispute resolution procedures agreed between them in the protocol. This distinction means that parties that are not directly subject to EMIR are not required to have internal arrangements in place in order to comply with EMIR, except insofar as it is necessary to comply with the contractual arrangements set out in the protocol. MFA believes that the ESAs should take a similar approach with respect to the Operational Procedures, which would reduce the administrative burden on out-of-scope entities.

[44] *Id.*, Article 2 LEC, 1(g).

[45] *See* the Attachment to the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol of July 19, 2013, Part 1(5). The protocol is available at: http://www2.isda.org/functional-areas/protocol-management/protocol/15

B. Individual Segregation

MFA strongly supports the requirement in the RTS that the collecting counterparty should provide the posting counterparty with the option of individual segregation with respect to its IM.[46] MFA has consistently supported measures aimed at increasing protections for counterparty assets posted as collateral for uncleared OTC derivatives, and believes that it is essential for counterparties to have the right to elect individual segregation of IM for uncleared contracts.[47] Many large buy-side market participants already have individual segregation arrangements in place with respect to the IM they post for uncleared OTC derivative contracts, but we believe all counterparties, regardless of size, should have the right to benefit from these protections. Such individual segregation not only protects a party's property in the event of their counterparty's default, but also ensures certainty, stability, and integrity in the OTC derivatives markets.

C. Legal Opinions

MFA is strongly opposed to the requirement in the RTS that counterparties must obtain legal opinions in all relevant jurisdictions on whether the applicable segregation arrangements meet the requirements of the RTS at inception of the transaction and at least annually thereafter.[48] We consider that complying with such a requirement would be an expensive and burdensome exercise, and it is unclear whether counsel would be willing or able to give such legal opinions. For example, we believe that it would be difficult for counsel to provide an opinion stating that the posting entity is "sufficiently protected" where the collecting entity enters bankruptcy or other insolvency proceedings, as required under the prescriptive wording of the draft RTS.[49] Therefore, if the ESAs will require opinions at all, MFA does not consider it appropriate for the RTS to determine effectively the language that an opinion must adopt. Rather, the RTS should permit the beneficiary of an opinion to form its own view on whether, based upon the opinion, the posting entity is "sufficiently protected".

In addition, each custodian generally has its own form of custody and related documentation to address segregation, which is usually subject to extensive negotiation among the parties. Many market participants have already completed these extensive and time-consuming negotiations and currently have the agreements are already in place and operational. As a result, although for other RTS requirements (*e.g.*, IM models) developing an industry standard seems likely, in the case of segregation arrangements, it may prevent industry bodies from producing standard form legal opinions. The absence of such standardized opinions would significantly increase the burden on counterparties attempting to comply with the RTS.

Moreover, even if industry bodies were able to develop a standard form opinion (*e.g.*, ISDA), MFA notes that not all market participants would have ready access to the standard form opinions. Access to such opinions usually requires that a party be a member of the relevant

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[46] Consultation Paper at 42, Article 1 SEG, 2.

[47] *See e.g.*, MFA Letter to ESMA on its Consultation Paper on "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories", dated August 5, 2012, at 1 and 6-8, available at: https://www.managedfunds.org/wp-content/uploads/2012/08/ESMA-EMIR-Level-2-Draft-Technical-Standards-MFA-Final-Letter.pdf.

[48] Consultation Paper at 42, Article 1 SEG, 5.

[49] *Id.*, Article 1 SEG, 4(b).

industry body and the additional costs required to become a member of such associations may be too costly for some parties (*e.g.*, smaller market participants).

Given the foregoing difficulties, MFA believes that an appropriate approach would be to require parties to seek legal advice from either in-house or external counsel on the effectiveness of their segregation arrangements, and not prescribe the form such legal advice should take. Although we recognize that not all market participants have in-house counsel, MFA believes that this approach is reasonable because, for market participants that have in-house counsel, such counsel is at least as well versed as external counsel (if not more so) in dealing with issues that arise in practice with individual segregation arrangements at their particular institution.

D. Immediate Availability of IM

MFA is concerned about the RTS requirement that counterparties ensure that their segregation arrangements provide that IM be "immediately available" to the collecting entity where the posting counterparty defaults.[50] Although we appreciate the need for a party to have access to collateral when its counterparty defaults, such access must be balanced against other concerns related to such arrangements, such as the protection of a posting party's collateral, which concerns the ESAs have recognized in the context of other requirements.[51]

Segregation agreements are generally subject to extensive negotiation, and the secured parties are highly incentivized to protect and preserve their access to collateral. However, within this framework of protecting the secured party's rights, it is very common for derivative counterparties to agree between themselves to enumerated dispute rights and waiting periods in respect of their segregation arrangements.[52] Therefore, preserving the effectiveness of counterparties' rights is important because they help to strike the balance between providing a secured party with prompt access to collateral and providing an appropriate degree of protection to a pledgor with respect to such collateral. Limiting or prohibiting these rights will undermine such contractual arrangements and the protections that they provide both parties in various default scenarios. Therefore, MFA requests that the ESAs provide that IM must be "immediately available" to the collecting entity subject to any counterparty (not custodian) dispute rights and waiting periods set out in the relevant collateral documentation.

VII. Final Provisions

A. Identification of Parties below the Minimum Notional Threshold

MFA asks the ESAs to clarify how they anticipate a party will determine whether its counterparty belongs to a group that is below the Minimum Notional Threshold. As discussed previously, the IM requirement only applies if both parties are above the Minimum Notional Threshold.[53] However, in practice, for counterparties to ensure that they are complying with the IM requirements, each party will need to be able to ascertain whether its counterparty falls above or below the Minimum Notional Threshold. To address this issue,

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[50] *Id*., Article 1 SEG, 4(a).

[51] *See e.g.*, *Id*. at 42, Article 1 SEG, 2; *Id*. at 34, Article 2 LEC, 1(g); and *Id*. at 43.

[52] We note that these rights are separate from, and should be treated differently than, the third party custodian's rights as discussed in Section V.D. above because of the parties' economic interest in the posted collateral.

[53] Consultation Paper at 46, Article 1 FP, 3.

we suggest that the ESAs permit parties to rely on written confirmations by, or representations from, their counterparties as to their status in relation to the Minimum Notional Threshold.

ESMA has permitted such an approach for other purposes under EMIR (*e.g.*, the determination as the whether an NFC exceeds or falls below the clearing threshold), and MFA considers that a similar approach in this instance would be helpful.[54]

B. Exclusion of Offsetting Trades from the Minimum Notional Threshold

MFA notes that the RTS permit counterparties to agree in writing that the collection of IM is not required when at least one of the counterparties belongs to a group whose "aggregate month-end average notional amount" of uncleared derivative contracts is under the Minimum Notional Threshold.[55] MFA respectfully requests that the ESAs permit counterparties to exclude offsetting trades in the calculation of their "aggregate month-end average notional amount". Such an approach is consistent with the position taken by ESMA[56] with respect to the calculation of the clearing threshold.

While MFA acknowledges that the clearing threshold and the Minimum Notional Threshold apply to different obligations under EMIR, the purposes of these thresholds are similar in that both are intended to protect smaller market participants from disproportionate regulatory burden and costs.[57] The Minimum Notional Threshold is particularly significant, given that the scope of the RTS currently extends to Assumed NFC-s, as discussed earlier in this letter.

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MFA thanks the ESAs for the opportunity to provide comments on the Consultation paper. We would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact Stuart J. Kaswell or Carlotta D. King at (202) 730-2600 with any questions the ESAs or their respective staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director & General Counsel

[54] *See* ESMA Q&A at 17, OTC Answer 4. ESMA states that "FCs are not expected to conduct verifications of the representations received from NFCs detailing their status and may rely on such representations unless they are in possession of information which clearly demonstrates that those representations are incorrect. "

[55] Consultation Paper at 46, Article 1 FP, 3.

[56] *See* ESMA Q&A at 17, OTC Answer 3(e). ESMA states that "[i]n order to determine whether it is above or below the clearing threshold, the NFC should first net their positions per counterparty and contracts and then add up the absolute notional value of all these net positions (calculated based on the notional amounts of the contracts). Netting per contracts and counterparty should be understood as fully or partially offsetting contracts having exactly the same characteristics (type, underlying, maturity, etc.) with the only exception of the direction of the trade and notional amount (in case of partial offset) concluded with the same counterparty."

[57] *See* Consultation Paper at 7, explaining that the Minimum Notional Threshold "reduces the burden on smaller market participants, while still achieving the principle objective of a sizable reduction in systemic risk".