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22 October 2014

European Securities and Markets Authority (ESMA)
CS 60747 – 103 rue de Grenelle
75345 Paris Cedex 07
France

Re: Response to Discussion paper – Calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations (the Discussion Paper)

1. Introduction and summary

The Asset Management Group (the **AMG**)[1] of the Securities Industry and Financial Markets Association (**SIFMA**) welcomes this opportunity to contribute to your consideration of the application of counterparty risk limits to UCITS in OTC derivatives transactions that are centrally cleared (**Cleared OTC Derivatives**).

The AMG focuses its response in this letter to the question of whether it is appropriate to introduce counterparty risk limits to central counterparties authorised or recognised by ESMA under EMIR[2] (**CCPs**) or clearing members of those CCPs (**CMs**) in relation to Cleared OTC Derivatives entered into by UCITS. On this basis, the AMG has not responded to each of the questions posed by ESMA in the Discussion Paper.

For the reasons detailed below, the AMG believes that:

(a) UCITS should not be subject to counterparty risk limits vis à vis CMs or CCPs in respect of Cleared OTC Derivatives;

(b) to the extent counterparty risk limits in respect of CMs are considered necessary by ESMA in relation to Cleared OTC Derivatives with UCITS, the assessment of "counterparty risk" should be determined by the UCITS from a holistic perspective by reference to the guiding principle that counterparty risk limits are only needed if UCITS' assets are not otherwise adequately ring-fenced from the CM's insolvent estate; and

(c) there is no need to distinguish between Cleared OTC Derivatives and exchange traded derivatives (**ETDs**) in this context.

2. No counterparty risk limits should be imposed on UCITS vis à vis CMs or CCPs

Our view is that the counterparty risk limits set out in Article 52 of Directive 2009/65/EC (the **UCITS Directive**) should exclude exposures to CMs and CCPs in the context of Cleared OTC Derivatives and ETDs.

[1] The AMG's members represent US asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.
[2] 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.

2.1 Background

(a) The purpose of imposing counterparty risk limits is to ensure that UCITS are not overly exposed to one counterparty leading to a loss of the UCITS' assets on such entity's insolvency.

(b) The issue of counterparty risk limits in the context of Cleared OTC Derivatives should be considered against the backdrop of global regulatory reform in respect of derivative transactions. Following the financial crisis, the G20 leaders agreed that as part of the endeavour to reduce systemic risk, all standardised OTC derivative contracts should be subject to mandatory clearing via a central counterparty. The financial crisis highlighted the interconnectedness of market participants through OTC derivative transactions and the contagion that could quickly spread across the market following an entity's default.

(c) Mandatory clearing is viewed as a key method of eliminating this systemic risk and, as part of this, reducing counterparty risk. As stated in the International Monetary Fund's paper "Making over-the-counter derivatives safer: the role of central counterparties", published in April 2010:

> "The primary advantage of a CCP is its ability to reduce systemic risk through multilateral netting of exposures, the enforcement of robust risk management standards, and mutualization of losses resulting from clearing member failures."[3]

The Discussion Paper supports the view that mandatory clearing via CCPs will lower systemic risk by reducing the number of bilateral derivative exposures.[4] We expand on the reason why this should be the case in paragraph 2.2(b) below.

(d) In the EU, EMIR comprises the legislative framework for mandatory clearing and sets out the framework for CCP regulation and client protection in relation to both Cleared OTC Derivatives and ETDs. Under EMIR, a UCITS will be subject to the mandatory clearing obligation whenever it enters into an OTC derivative transaction which has been declared subject to the clearing obligation with certain counterparties. Similarly, other jurisdictions (notably, the US) impose (or will impose) a mandatory clearing obligation with which a UCITS will need to comply when it enters into certain OTC derivative transactions which will be declared subject to the clearing obligation with certain counterparties.

(e) Before discussing the interaction between the impact of the mandatory clearing obligation and counterparty risk limits imposed on UCITS, it is important to understand how UCITS will satisfy the mandatory clearing obligation under EMIR or other relevant legislative framework. UCITS' access to CCPs will be as a "client", meaning one of the following established models for client clearing will be adopted:

(i) the "principal to principal model", which involves the client accessing the relevant CCP through a CM and two principal but back-to-back contracts: one between the client and the CM and one between the CM and the CCP; and

(ii) the "agency model", which also involves the client accessing the relevant CCP through a CM, but effectively, with only one contract between the client and the CCP and the CM acting as agent on behalf of the client.

The "agency model" is predominantly used in the US or outside of the US where the relevant CCP has an FCM Service[5]. The "principal to principal model" is predominantly used outside of the US. In either model, the client (the UCITS) will effectively access the CCP through a CM.

[3] https://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/chap3.pdf
[4] Paragraph 7 of the Discussion Paper.
[5] "FCM Service" refers to services offered by central counterparties to clients via a Futures Commission Merchant under an agency clearing model.

(f) We consider this background detail important as it clarifies the relationships that will arise in any Cleared OTC Derivative and why it is relevant to consider both the CM and the CCP in the context of a UCITS' exposure under a Cleared OTC Derivative.

2.2 No counterparty risk limits should be imposed in respect of CCPs

(a) *Access to CCPs*

(i) As set out in paragraph 2.1, the mandatory clearing obligation under EMIR will require UCITS to clear certain OTC derivative transactions through a CCP. However, there are a limited number of CCPs due to the strict authorisation (or recognition) requirements imposed under EMIR. Moreover, not all CCPs are authorised (or recognised) to clear all OTC derivative products, meaning the pool of CCPs through which a UCITS is able to clear certain OTC derivative products is potentially very limited. Consequently, if UCITS need to comply with counterparty risk limits in relation to CCPs in the context of Cleared OTC Derivatives, a conflict could arise between the UCITS' ability to satisfy the mandatory clearing obligation and its ability to comply with counterparty risk limits in respect of CCPs.

(ii) This conflict is exacerbated as long as third country CCPs are not recognised by ESMA (in particular, currently, in respect of US CCPs), and European CCPs are not recognised by US regulators. As long as these circumstances exist, the pool of CCPs through which UCITS may clear would be further limited.

(iii) This conflict between the need to comply with mandatory clearing through a small pool of available CCPs and counterparty risk limits could lead to a situation where UCITS are unable to comply with both obligations (i.e. there are not a sufficient number of CCPs through which to clear to enable the UCITS to satisfy counterparty risk limits). To the extent UCITS are unable to reconcile this conflict, it may ultimately mean that UCITS are unable to enter into OTC derivative transactions when they would otherwise need to do so for prudent hedging and risk management reasons. We acknowledge that this risk could be mitigated by setting very high counterparty risk limits in respect of CCPs at levels appropriate to the number of CCPs clearing each product class. However, this would create an additional layer of complexity for both the regulators and UCITS, which we believe would be unnecessary and counterproductive to policy goals. Our view is that regulation which makes compliance with the mandatory clearing obligation more challenging – or even impossible – is not beneficial and undermines the regulatory drive to move to increased levels of clearing.

(b) *CCP counterparty risk*

(i) As set out in paragraph 2.1 of this letter and, as recognised by the Discussion Paper, the counterparty risk posed by CCPs should be considered to be extremely low. CCPs are regulated entities designed to be risk neutral and the requirements imposed on them by Title IV of EMIR either directly, or through the recognition process, provide substantial minimum protections for counterparties to Cleared OTC Derivatives. These protections should give regulators sufficient comfort that the counterparty risk posed by CCPs is negligible. In our view it does not make sense to impose counterparty risk limits on UCITS in respect of CCPs when their counterparty risk is considered to be so low.

(ii) We would also note that while CCPs, by their very nature, concentrate counterparty exposure in the CCP itself, counterparties to Cleared OTC Derivatives also benefit from increased collateralisation and multilateral netting arrangements which, together with a default process and presence of a default fund, ultimately reduce their total exposure. Imposing counterparty risk limits on UCITS in respect of CCPs would undermine these beneficial arrangements. Moreover, if UCITS needed to clear through a greater number of CCPs, their initial margin requirements would be increased and they would lose the risk-mitigating benefits of netting. This would require UCITS to use a greater proportion of their assets as initial margin, resulting in a drag on investment returns for investors.

(c) *US position*

The US imposes portfolio diversification and concentration limits in respect of US funds registered under the Investment Company Act 1940, as amended (the **1940 Act**), which is the closest corollary of the UCITS regime in the US. In particular, US registered funds must comply with section 12(d)(3) of the 1940 Act and the rules promulgated thereunder with respect to limits on transactions with "securities-related issuers".[6] The current practice in the US is that central counterparties and exchanges are not included in these limits.[7] We believe it is instructive to look at US practice for the treatment of central counterparties and exchanges with respect to US registered funds.

2.3 No counterparty risk limits should be imposed in respect of CMs

(a) *Policy considerations*

(i) As set out in paragraph 2.1 of this letter, the regulators view the introduction of mandatory clearing as a key method to reduce systemic risk and counterparty risk in the market. It is therefore of primary importance that entities subject to mandatory clearing are able to clear without meeting any conflicting regulatory requirements which would make compliance with the mandatory clearing obligation more challenging. Imposing counterparty risk limits in respect of CMs in the context of Cleared OTC Derivatives (A) imposes an additional regulatory burden on UCITS in their endeavour to comply with the mandatory clearing obligation and (B) may actually make it impossible for UCITS to comply with both the mandatory clearing obligation and the counterparty risk limits (for example, if there are not enough CMs for UCITS to transact through (in this respect, the analysis on the limited number of CCPs set out in paragraph 2.2(a) applies)).

(ii) Moreover, the conflict between mandatory clearing requirements and counterparty risk limits would be further exacerbated following a CM default. One of the key ways in which systemic risk is reduced following a CM default is through the porting of transactions to an alternative CM. If counterparty risk limits are imposed on UCITS in respect of CMs, there is a risk that where a UCITS' transactions are ported to another CM following its CM's default, the porting arrangements may cause it to breach its counterparty risk limits. Either, this would mean the UCITS could not port to the alternative CM, or the UCITS would quickly have to take action to remedy the breach. This is objectionable on two grounds: first, porting on a CM default is designed to happen automatically and without "client" specific directions; and secondly, if UCITS cannot port to a CM without breaching its counterparty risk limits, it would likely need to liquidate those transactions. If a CM has defaulted, it is likely to be a period of market turmoil and in such circumstances we are of the view that (A) it is not appropriate to force UCITS to take action in such circumstances in order to comply with counterparty risk limits and (B) it is not conducive to stabilising the market and limiting contagion by potentially forcing UCITS to liquidate their positions.

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[6] Under section 12(d)(3) of the 1940 Act, certain funds are limited from purchasing or otherwise acquiring any securities issued by, or any other interest in, the business of a broker, dealer, underwriter or investment advisor (a **Securities-related Issuer**). In the context of an OTC derivative, the fund receives the obligation of its counterparty to perform under the contract. If the fund's counterparty is a Securities-related Issuer, the obligation may fall within scope of section 12(d)(3), and, in the context of an ETD, the counterparty may be the central counterparty.

[7] It should be noted that this practice is not currently expressly codified. However, the US Securities and Exchange Commission (**SEC**) recently requested industry commentary in this area. See Use of Derivatives by Investment Companies under the Investment Company Act of 1940, 76 Fed. Reg. 55237 (Sept. 7, 2011) (the **Concept Paper**), available at http://www.gpo.gov/fdsys/pkg/FR-2011-09-07/pdf/2011-22724.pdf. The SEC has also issued no-action relief in this context. See e.g., Institutional Equity Fund, SEC Staff No-Action Letter (Feb. 27, 1984) which found that exchange-traded options were not an acquisition of a security issued by, or an interest in, a Securities-related Issuer..

(b) *Costs and operational difficulties*

Even if the issues set out in paragraph 2.3(a) could be overcome, applying counterparty risk limits to CMs may require UCITS to increase the number of CMs they transact with. Netting (both pre-default payment netting and close-out netting) plays an important role in reducing counterparty risk. Forcing UCITS to increase the number of CMs that they transact with may result in netting sets being split and a possible reduction in the efficacy of netting in protecting against counterparty risk. In addition, increasing the number of counterparties that UCITS must transact with could lead to the need to clear through less creditworthy counterparties and the imposition of increased costs and greater operational risks on UCITS. UCITS would need to negotiate arrangements with additional CMs, pay fees to additional CMs for their services, monitor counterparty risk levels (in particular, following a CM default and application of porting arrangements) and any beneficial liquidity arrangements of clearing may be reduced. As discussed in paragraph 2.1, given the beneficial outcomes of clearing in terms of reducing systemic risk and counterparty risk, we do not think it is appropriate to impose legislation on UCITS via counterparty risk limits that will potentially undermine the regulatory drive to move OTC derivative transactions into clearing.

3. Other considerations if ESMA proceeds with limits

While our view is that it is not appropriate or desirable to impose counterparty risk limits on UCITS in relation to CCPs or CMs in respect of Cleared OTC Derivatives for the reasons set out in paragraphs 2.2 and 2.3 of this letter, if ESMA did decide to impose such counterparty risk limits on UCITS in respect of Cleared OTC Derivatives, we urge ESMA to take into account the following considerations.

3.1 The Guiding Principle

(a) As set out in paragraph 2.1, the purpose of imposing counterparty risk limits is to ensure that UCITS are not overly exposed to one counterparty, leading to a loss of the UCITS' assets on such entity's insolvency. In the context of Cleared OTC Derivatives, the guiding principle in assessing whether to impose counterparty risk limits must be whether assets posted by UCITS as initial margin or the intrinsic value of the Cleared OTC Derivatives represented by variation margin, will be adequately ring-fenced from the CCP's or CM's insolvent estate.

(b) For the reasons set out in paragraph 2.2 of this letter, we do not think it is appropriate to impose counterparty risk limits on UCITS in respect of CCPs. To the extent ESMA considers it necessary to impose counterparty risk limits on UCITS in respect of Cleared OTC Derivatives, such counterparty risk limits should only be imposed on CMs, and even then, only in limited circumstances (as discussed below) by reference to the guiding principle set out in this paragraph 3.1.

3.2 Deference to UCITS to assess in a holistic manner

(a) The assessment of whether there is any counterparty risk in respect of a CM should be left to the UCITS to determine in accordance with principles of prudent risk management by reference to the guiding principle set out in paragraph 3.1. In assessing their counterparty risk in this way, UCITS would have the flexibility to take into account: segregation arrangements, client money rules, security arrangements, local law protections, the insolvency analysis in respect of the applicable CM and any other considerations the UCITS deems to be appropriate. We emphasise that counterparty risk limits based on segregation arrangements *alone* are overly simplistic and would fail to fully account for the levels of counterparty risk. This view is supported by ESMA's current guidance to UCITS on the calculation of counterparty risk for ETDs and Cleared OTC Derivatives (which requires UCITS to consider the clearing model in assessing the level of counterparty risk, paying regard to both the segregation arrangements and the insolvency analysis in respect of the CM or CCP) and the practice for UCITS when managing risk in respect of ETDs today.[8]

(b) Given the multiplicity of considerations for assessing counterparty risk,[9] any legislation prescribing how to measure counterparty risk (for the purpose of imposing counterparty risk limits) would be incredibly complex to the point of being unworkable from both the regulators' and UCITS' perspective. Instead, UCITS should be left to determine their counterparty risk in a holistic manner and based on the specific facts by reference to the guiding principle set out in paragraph 3.1.

3.3 Approach

To the extent that ESMA does decide to recommend counterparty risk limits to UCITS in respect of Cleared OTC Derivatives, the approach we advocate is analogous to the position already applicable to ETDs under the UCITS Directive and the Committee of European Securities Regulators' (**CESR**) Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (10/788) (the **CESR Guidelines**). Under the current rules, the counterparty risk limits set out in Article 52(1) of the UCTIS Directive do not apply to ETDs *except* in circumstances where initial margin (**IM**) posted to and variation margin (**VM**) posted from a broker is not protected by client money rules or other similar arrangements (**Unprotected IM / VM**), in which case the counterparty risk limits of Article 52(1) apply to the IM / VM exposure.[10] Arguably, the reason for applying counterparty risk limits to Unprotected IM / VM is because there is insufficient protection in respect of the UCITS' assets, thereby increasing the risk that, on the insolvency of the broker, the UCITS will not receive these assets back. Conversely, where there are sufficient protections in place in respect of IM / VM, there is no need to apply counterparty risk limits as there is no counterparty risk. We think that the treatment of ETDs under the current regime strikes the correct balance between allowing UCITS to manage their risk (by ensuring their arrangements benefit from client money protections, for example (which, in our view under the UK regime, at least, would satisfy the guiding principle set out in paragraph 3.1) or other similar rules) and imposing risk mitigants (via the counterparty risk limits rules in respect of Unprotected IM / VM) where UCITS' assets are not otherwise protected.

3.4 Application of counterparty risk limits

To the extent that the guiding principle set out in paragraph 3.1 is not satisfied, whether counterparty risk limits are, in fact, a practical method of managing risk, will depend on ESMA's specific proposals and, crucially, the level of the limits. For the reasons we have set out in paragraph 2.3 above, there are real risks in imposing counterparty risk limits in respect of CMs in the cleared context and these issues will be exacerbated the more conservative the counterparty risk limits are. On this basis, to the extent ESMA considers it necessary to impose any counterparty risk limits, we would urge ESMA to consider limits which balance the risk mitigation effects created by counterparty risk limits against the risks created by making UCITS transact Cleared OTC Derivatives with a greater number of counterparties, or possibly preventing them from accessing certain cleared products at all. Our view is that this balance cannot be struck through prescriptive legislation based on segregation models alone and can only be achieved by allowing UCITS to assess their counterparty risk in a holistic manner as set out in paragraph 3.2 above and by reference to the

[8] Question 5 of ESMA's Questions and Answers for Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS.

[9] See, for example, the factors relating to Risk Management included in the results of AMG's separate account survey contained in the attachment to AMG's letter to the SEC and the Financial Stability Board on April 4, 2014. "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions"; "Asset Management and Financial Stability" Study by the Office of Financial Research", SIFMA AMG, April 4, 2014, pps. 9-12, available at http://www.sifma.org/issues/item.aspx?id=8589948419. Although the survey related specifically to separate accounts, as noted in the letter, "asset management firms treat separate client accounts using the same process applied to all fiduciary assets and accounts that they manage", which would include UCITS. As noted in the letter, "counterparty selection is a multi-departmental process with a strict evaluation of potential counterparties based on factors ranging from their creditworthiness, pricing, regulatory oversight, and trading capacity."

[10] Box 27 of the CESR Guidelines.

guiding principle set out in paragraph 3.1 above and, to the extent deemed necessary, the approach set out in paragraph 3.3 above.

We appreciate your consideration of our response and stand ready to provide any additional information or assistance that you might find useful. Should you have any questions, please do not hesitate to contact Matt Nevins at +1-212-313-1176.

Sincerely,

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