asset management group

23 August 2016

European Commission
DG FISMA
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1000 Brussels
Belgium

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

European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA
United Kingdom

European Insurance and Occupational Pensions Authority
Westhafenplatz 1
60327 Frankfurt am Main
Germany

Re: EU Regulatory Technical Standards for Uncleared Swaps Transactions

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association's Asset Management Group ("SIFMA AMG" or "AMG")[1] writes to express its concern regarding a change in the treatment of investment funds in the most recent draft regulatory technical standards for risk mitigation techniques for OTC derivative contracts not cleared by a central counterparty ("Uncleared Swap Margin RTS"). While the prior draft published by the European Supervisory Authorities ("ESAs") on 8 March 2016 (the "ESA Draft") relieved investment funds from performing margin threshold calculations on a consolidated group basis (where there is sufficient insolvency remoteness), the recent European Commission ("EC") draft published 28 July 2016[2] (the "EC Draft") narrowed that relief to apply only to Undertakings for Collective Investment in Transferrable Securities authorized in accordance with Directive 2009/65/EC ("UCITS") and alternative investment funds ("AIFs") managed by alternative investment fund managers authorized or registered in accordance with Directive 2011/61/EU ("Authorized AIFMs"). For the reasons stated below, SIFMA AMG believes that relief from consolidated margin threshold calculations should apply to all investment funds, whether organized and managed in the EU or in a third country, given that the same underlying rationale for such relief applies equally across jurisdictions.

[1] SIFMA AMG's members represent U.S. asset management firms whose combined global assets under management exceed $34 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

[2] As amended 2 August 2016.

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Specifically, the ESA Draft provided that:

> "Investment funds may be considered distinct entities and treated separately when applying the [relevant threshold test][3] only where the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy that are not collateralised, guaranteed or supported by other investment funds or the investment managers."

In contrast, the EC Draft provides that:

> "UCITS authorised in accordance with Directive 2009/65/EC and alternative investment funds managed by AIFMs authorised or registered in accordance with Directive 2011/61/EU shall be considered distinct entities and treated separately when applying the [relevant thresholds test][4] where the following conditions are met: (a) the funds are distinct segregated pools of assets for the purposes of the fund's insolvency or bankruptcy; (b) the segregated pools of assets are not collateralised, guaranteed or otherwise financially supported by other investment funds or their managers."[5]

The key difference between the two sets of language is that the ESA Draft refers to "investment funds" where the EC Draft refers to UCITS and AIFs managed by Authorised AIFMs.

We believe the language used in the original ESA Draft was correct and should be reinstated for the following reasons:

1. The underlying rationale is insolvency remoteness (systemic risk) not registered status

As set out in Recital 12 of the EC Draft and Recital 14 of the ESA Draft, the underlying rationale for treating funds separately and not consolidating between them is that "where the funds are distinct pools of asset and they are not collateralized, guaranteed or supported by other investment funds or the investment manager itself, they are relatively risk remote from the group [so] should therefore be treated as separate entities when calculating the thresholds. The use or not of an Authorised AIFM has no relation to the insolvency remoteness between the funds (or between the manager and the funds) so should not be a criteria in determining whether the funds should be treated separately or consolidated.

[3] The relevant threshold tests being the phase-in for variation margin and initial margin (Article 39(4)); the subsequent, on-going Euro 8 billion test (Article 8(3)) for initial margin; and the Euro 50 million initial margin threshold (Article 9(3)).

[4] As with the ESA Draft, relevant threshold tests are the phase-in for variation margin and initial margin (Article 34(2)); the subsequent, on-going Euro 8, billion test (Article 27(3)) for initial margin; and the Euro 50 million initial margin threshold (Article 28(3)).

[5] *See* EC Draft Art. 28.

2 The EC Draft would introduce a divergence between the EU margin rules and BCBS-IOSCO Framework[6]

Recital 13 of the EC Draft (and Recital 11 of the ESA Draft) state that "In order to maintain a level playing field, this Regulation should introduce a threshold that is exactly the same as in the BCBS-IOSCO Framework below which two counterparties are not required to exchange initial margin." The BCBS-IOSCO Framework establishes the individual treatment of funds and the underlying rationale for such treatment. Footnote 10 states 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." We note that the BCBS-IOSCO Framework focuses on insolvency remoteness, it does not require or permit funds to be treated differently based on the type of regulatory recognition given to their manager.

3. The EU margin rules should align with the EU clearing rules

Each of the three regulatory technical standards[7] detailing the application of mandatory clearing under EMIR (the "Clearing RTS") contain a provision stating that UCITS and AIFs should be treated individually when applying the Euro 8 billion categorization threshold. We note that:

(i) the Clearing RTS state that the Euro 8 billion threshold was chosen to align with the BCBS-IOSCO Framework "in order to enhance regulatory convergence and limit the compliance costs for counterparties;"[8] and

(ii) the language in the Clearing RTS refers simply to AIFs, not AIFs managed by Authorised AIFMs. If the EC Draft language is used, an AIF without an Authorised AIFM would be treated differently for clearing than for margin.

As a final point on clearing, we wish to point out that while the Clearing RTS do refer to European concepts of alternative investment funds and UCITS when setting out the clearing categorization threshold test, third country entities would apply the clearing categorization threshold test by reference to what the third country entity would be if it were established in the EU,[9] ensuring

[6] "Margin requirements for non-centrally cleared derivatives" Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissions, published March 2015.

[7] Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015; Commission Delegated Regulation (EU) 2016/592 of 1 March 2016; and Commission Delegated Regulation (EU) 2016/1178 of 10 June 2016.

[8] See, for example, Recital 6 of Commission Delegated Regulation (EU) 2015/2205.

[9] As specified in section 4.2.4 (Third-country entities) of ESMA's "Final Report: Draft technical standards on the Clearing Obligation – Interest Rate OTC Derivatives" published 1 October 2014. We also note that clearing categorisation language in each Clearing RTS uses EU concepts such as "non-financial counterparties", without referencing non-EU entities, so can only be read as meaning that the third country entity considers its categorisation by reference to what it would be classed as if it were established in the EU. The alternative for many third country entities would be that they have no category.

conformity of application as between EU and non-EU funds and thus maintaining alignment with the BCBS-IOSCO Framework.

4. The EC Draft would create significant inequality between funds both in the EU and elsewhere.

As the margin threshold tests are all based on gross-notional amounts without the opportunity of netting, it is clear that funds which are treated on a consolidated basis are more likely to be subject to the additional costs of initial margin, and more quickly, than ones treated separately. Accordingly, the EC Draft would create a commercial inequality between funds which are managed by Authorised AIFMs and funds which are not.[10] For example:

(i) an AIF managed by an Authorised AIFM would be subject to less stringent requirements and lower costs than an AIF which is not managed by an Authorised AIFM; and

(ii) given third country funds are more likely to use a local manager than a European Authorised AIFM, the same inequality would arise between third country and EU funds.

Such inequalities both create an opportunity for regulatory arbitrage and disrupt on-going efforts by regulators to encourage cross-border consistency. In addition, the commercial advantage given to managers authorized by the EU, under EU law, may invite corresponding barriers to be imposed by third country regulators and legislators, disrupting the progress made in mutual recognition, such as with respect to US and EU authorized clearing houses.

5. The manager / fund relationship is distinct from the corporate parent / subsidiary relationship.

SIFMA AMG urges the EC and ESAs to adopt language that excludes all investment funds—whether organized and managed in the EU or not—from consolidated margin threshold calculations. Without this change, consolidated margin threshold calculations would include an investment fund in cases where the fund is consolidated onto the financial statements of the legal owner and/or manager. Investment funds, however, have a markedly different relationship with their managing entity than the relationship of an ordinary corporate affiliate. While a manager of an investment fund has influence over the fund beyond that of a passive, unaffiliated investor, the relationship between the manager and the investment fund is by no means the same as the relationship between a corporate parent and affiliate and, as such, should not be consolidated for margin threshold calculations. For example, investment funds that are registered as management companies under the United States' Investment Company Act of 1940 (the "'40 Act") are overseen by an independent board of directors/trustees and managed by a registered investment adviser that has fiduciary duties of care and loyalty to the fund and *all* investors in the fund. Similar features are present for U.S. unregistered funds relying on an exemption from registration under Section 3(c)(1) or 3(c)(7) of the '40 Act. All investment funds are distinct legal entities that are managed by an

[10] Despite Europe not requiring all funds to use Authorised AIFMs (Directive 2011/61/EU mandates the use of Authorised AIFMs in some situations, not others). See, for example, ESMA's answers to General Questions 3 and 4 in ESMA's "Questions and Answers: Implementation of Regulation (EU) No 648/2012 on OTC Derivatives, central counterparties and trade repositories" dated 6 June 2016.

investment adviser pursuant to an investment advisory agreement that, among other things, requires the assets of the fund to be managed in accordance with specified investment guidelines, objectives and strategies and not capriciously at the desire of the fund sponsor. (By way of comparison, a corporate parent is properly seen as owning its subsidiary and the value the subsidiary creates and contains.) To suggest that a fund under such circumstances should be treated like any other corporate affiliate unless it is a UCITS or AIF managed by an Authorised AIFM is inconsistent with these overriding structural, fiduciary and contractual safeguards, which apply to funds organized outside of the EU. Rather, investment funds organized and/or managed in third countries fit the insolvency remoteness rationale for relief set forth in the recitals to the Uncleared Swap Margin RTS, quoted above.

The inclusion of investment funds organized outside of the EU within a margin threshold test and, relatedly, imposing an obligation upon that investment fund to post margin on the basis of the group calculation will negatively impact investment funds and is inconsistent with the purpose and policy of the Uncleared Swap Margin RTS. The investment funds that meet the requirements set forth in Articles 27, 28 and 34 of the EC Draft are legally separate vehicles that, absent crossing the threshold on their own, do not pose the same level of credit risk as a large market participant. However, if they are consolidated, margin obligations will be imposed on these smaller, distinct participants and the costs of compliance will be borne by the investors in that fund.

* * *

For these reasons, SIFMA AMG requests that the EC and ESAs revert to the language used in the ESA Draft such that any investment fund that meets the insolvency remoteness requirements will be relieved from group consolidated calculation of margin thresholds. Alternatively, if the ESAs do wish to refer to "alternative investment funds as defined in Article 4(1)(a) of Directive 2011/61/EU or undertakings for collective investment in transferable securities as defined in Article 1(2) of Directive 2009/65/EC," the same language used in the Clearing RTS, then additional language should be added to clarify that a third country entity should consider what its status would be if it were established in the EU, to ensure alignment with the Clearing RTS and with the BCBS-IOSCO Framework.[11]

SIFMA AMG stands ready to provide any additional information or assistance. Should you have any questions, please do not hesitate to contact Tim Cameron at 202-962-7447 / tcameron@sifma.org or Laura Martin at 212-313-1176 / lmartin@sifma.org.

Respectfully submitted,

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[11] As noted in point 3 above.