asset management group

18 July, 2017

SIFMA AMG's Feedback on European Commission's EMIR Proposal

The Securities Industry and Financial Markets Association's Asset Management Group ("**SIFMA AMG**")[1] appreciates the opportunity to provide feedback on the European Commission's legislative proposal to amend EMIR.[2]

Overall, SIFMA AMG members welcome the efforts of the Commission to improve the current EMIR regime, in particular, by simplifying the rules and reducing the costs and burdens for end-users of derivatives. However, we have a number of concerns with the Commission's legislative proposal, which are outlined below.

1. **Definition of Financial Counterparty**

According to the Commission's legislative proposal "*an AIF as defined in Article 4(1)(a) of directive 2011/61/EU*" would fall within the definition of "financial counterparty". Currently, only "*an alternative investment fund managed by AIFMs authorised or registered in accordance with Directive 2011/61/EU*" is in scope of the "financial counterparty" definition.

The definition of alternative investment fund, or "**AIF**", in the Alternative Investment Fund Managers Directive (the "**AIFMD**")[3] reads as follows:

"*collective investment undertakings, including investment compartments thereof, which:*

(i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

(ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC".

The definition is not limited in territorial scope. If the Commission's proposal were to be enacted in its current form, read literally, all types of fund, other than those that

---

[1] SIFMA AMG's members represent U.S. and multinational 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] Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories.

[3] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

are regulated in the EU under the UCITS Directive,[4] including hedge funds, private equity funds, real estate funds and mutual funds, regardless of whether or not they are established in the EU, would be brought directly in scope of EMIR as "financial counterparties". By way of example, a US mutual fund dealing in OTC derivatives with a US bank or dealer counterparty would have to comply with the full set of requirements in EMIR (subject only to the proposed relief from the EMIR clearing obligation for "small financial counterparties"), despite neither the parties nor the transactions having any connection with the EU. Currently, only if it was managed by an alternative investment fund manager, or "**AIFM**", authorised or registered in accordance with the AIFMD, would a US mutual fund have to comply with EMIR to this extent.

Given the difficulties in applying the EMIR regime to non-EU entities (e.g., taking our example, the US mutual fund, not being managed by an AIFM authorised or registered in accordance with the AIFMD, would not have a national competent authority in the EU), we doubt whether the Commission foresaw the extra-territorial and far-reaching consequences of its proposed change to the "financial counterparty" definition. Rather, we imagine that the intention of the Commission was to bring in scope of the "financial counterparty" definition those EU AIFs that are currently classed as "non-financial counterparties" under EMIR, because they are not "*managed by AIFMs authorised or registered in accordance with Directive 2011/61/EU*".

If the Commission is intent on amending the current "financial counterparty" definition to capture all EU AIFs, we propose the following wording for the AIF limb of the "financial counterparty" definition:

"an alternative investment fund as defined in Article 4(1)(a) of directive 2011/61/EU which is either established in the Union or managed by an AIFM authorised or registered in accordance with that Directive…".

If this approach were followed, existing AIFs currently caught by the "financial counterparty" definition would continue to be treated as financial counterparties, and the status of those EU AIFs that are not managed by AIFMs authorised or registered in accordance with the AIFMD would change from non-financial counterparty to financial counterparty. It is worth noting that non-EU AIFs that are not managed by AIFMs authorised or registered in accordance with the AIFMD would still be affected by this approach. If the above language were adopted, all non-EU AIFs would need to declare themselves to their EU bank and dealer counterparties as "third country financial counterparties", with the result that OTC derivatives entered into by any non-EU AIF with an EU bank or dealer counterparty will potentially be in scope of the EMIR clearing obligation and margin requirements for non-cleared OTC derivatives.

[4] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

2. **Client clearing services to be provided on "fair, reasonable and non-discriminatory" (FRAND) commercial terms**

SIFMA AMG members welcome the proposal to require clearing services to be provided on fair, reasonable and non-discriminatory commercial terms, as, in principle, the requirement should improve their access to clearing services in the EU. We note that the FRAND requirement is to be further articulated in a delegated act. However, we are concerned that the scope of the FRAND requirement is not sufficiently clear at the level of the EMIR regulation itself. In particular, the meaning of "non-discriminatory" is ambiguous. Does this mean, for example, that a clearing member must provide clearing services to all its clients on the same commercial and contractual terms? If so, we believe there is a danger that the FRAND requirement would have the opposite outcome than the policy objective behind the proposal, e.g., it might serve as a further disincentive from providing clearing services and ultimately act to reduce the availability of clearing services to clients. It might also cause those clearing members providing clearing services to provide them on terms that are less favorable to clients, including pursuant to standard, "non-negotiable" contracts borne out of the need to satisfy the FRAND requirement.

3. **Amendments relating to Reporting Obligation**

Whilst we are supportive of the aim of the proposed changes to Article 9 of EMIR (which appears to be to reduce the compliance burden currently falling on end-users of derivatives), in our view, the proposed changes to Article 9 do not go far enough. The overwhelming preference of SIFMA AMG members is for a single-sided (or entity-based) reporting regime to be introduced in the EU. In other words, the CCP or financial counterparty should not be responsible for reporting transactions "*on behalf of both counterparties*"; it should simply be the party required to file a single report for the transaction.

We have in a previous submission set out our view of the benefits that a single-sided reporting regime would bring.[5] A single-sided reporting regime would eliminate the difficulties currently faced with data matching, and the poor quality of data resulting from duplicative or unmatched reports. Discrepancies in counterparties' reports can arise, for example, through the use of different taxonomies, UTIs and the LEIs needed to identify the various parties involved in the transaction, or due to the differing interpretations and practices adopted by market participants in completing the data fields. Many buy-side market participants satisfy their reporting obligation through delegation arrangements entered into with bank and dealer counterparties. However, delegated reporting brings with it additional and unnecessary costs and operational burdens. Delegated reporting agreements must be negotiated and put in place with each of the buy-side entity's counterparties. Buy-side entities are frequently required by their bank and dealer counterparties to whom they have delegated reporting to on board with the relevant trade repository, in order to submit certain items of the "counterparty data" direct to the trade repository or to check the accuracy of reports submitted on their behalf. In all, we do not think the dual-sided reporting process enhances the quality of the data reported; rather, it serves only to increase the costs to the market of compliance.

[5] http://www.sifma.org/issues/item.aspx?id=8589955996.

On the specific amendments to Article 9 put forward by the Commission:

(a) We believe that CCPs should be required to report all derivatives cleared through them, including OTC derivatives.

(b) The current proposal alleviates the reporting burden for a narrow category of end-users of derivatives, i.e., non-financial counterparties that do not maintain positions in OTC derivatives exceeding the clearing threshold. We believe that a greater obligation to report derivative transactions should be placed on financial counterparties, depending on their corporate sector. For example, a financial counterparty that is a credit institution or an investment firm should be required to report derivative transactions entered into with pension schemes, insurers, and UCITS and other investment funds, regardless of whether the other counterparty is also a financial counterparty.

(c) The proposal to place the responsibility for reporting derivative transactions entered into by UCITS and AIFs onto UCITS management companies and managers of AIFs, respectively, introduces legal uncertainty to the current reporting regime. The meaning of "*manager of an AIF*" is unclear, and potentially broad. Moreover, the management company or manager may need to rely on certain information provided to it by the fund or other parties, in order for accurate details to be reported. Overall, the new responsibility placed on UCITS management companies and managers of AIFs has the potential to increase the cost of compliance with the reporting obligation (with any increased costs potentially being passed on to the investment fund).

4. Amendments relating to Margin Requirements for Non-cleared OTC Derivatives

4.1 Outstanding Concerns in relation to Margin Requirements

First, we believe that the amendments to EMIR should address the following concerns:

(a) Physically-settled FX Derivatives

SIFMA AMG members strongly advocate for physically-settled FX forwards and swaps to be excluded from both the variation margin and initial margin requirements under the regulatory technical standards adopted pursuant to Article 11(15)(a) of EMIR (the "**Margin RTS**").

The EU is the only jurisdiction that has adopted rules under the BCBS-IOSCO framework[6] that include physically-settled FX swaps and forwards in the variation margin requirement. Physically-settled FX forwards will come in scope of the EMIR variation margin requirement from 3 January 2018.[7] Investment managers and their funds and other clients face significant operational challenges in meeting this deadline, to the point where some may

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

[7] Article 37(2)(b) of the Margin RTS applies variation margin for physically-settled FX forwards from MiFID II's application date (3 January 2018).

be deterred from continuing to manage their FX risk through the use of physically-settled FX forwards. From the time when the variation margin requirement applies to physically-settled FX forwards, they may face new challenges and conflicts when dealing with non-EU bank and dealer counterparties.

We urge the Commission to seek to exclude physically-settled FX forwards and swaps from the variation margin requirement through an amendment to the Margin RTS. We note that the Basel Committee on Banking Supervision has issued supervisory guidance stating that banks should exchange variation margin for FX swaps and forwards with certain counterparties.[8] SIFMA AMG members believe that the relevant risks are adequately addressed by supervisory guidance, and that the additional requirement on EU counterparties to implement variation margin exchange in relation to physically-settled FX forwards and swaps in compliance with the Margin RTS should be removed. At the very least, the upcoming 3 January 2018 compliance date for physically-settled FX forwards should be postponed, while the relevant EU regulatory bodies consider how best to deal with this problem.

(b) **Minimum Transfer Amount for Separately Managed Accounts**

SIFMA AMG members are concerned that the provisions in Article 25 of the Margin RTS permitting a "minimum transfer amount" (or "**MTA**") to be set by counterparties, up to a maximum of €500,000, are being interpreted in such a way that the minimum transfer amount has to be applied at the level of the counterparty (i.e., the legal entity).

The amount of collateral due is determined (in the case of both variation margin and initial margin)[9] on the basis of the derivative contracts in the netting set, a "netting set" being defined as "*a set of non-centrally cleared over-the-counter ('OTC') derivative contracts between two counterparties that is subject to a legally enforceable bilateral netting agreement*".

Large institutional clients, including pension schemes and UCITS funds, often hire multiple asset managers, in addition to managing funds internally. This approach achieves diversity of investment perspectives and asset allocations for the invested assets, with the goal of maximising returns while minimising the risk that any one strategy causes a major loss. The institutional client will typically hire the asset manager to exercise investment discretion over a portion of the client's assets referred to as assets under management (AUM) for management in accounts referred to as "separately managed accounts". (The accounts are also referred to "segregated accounts", referring to the practice of institutional clients setting up a "segregated mandate" with the

[8] "Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions", published in February 2013.
[9] Article 10 (Calculation of variation margin), Article 11 (Calculation of initial margin), Annex IV (Standardised Method for the calculation of initial margin for the purposes of Articles 9 and 11) and Section 4 (Initial margin models) of the Margin RTS.

asset manager, which means their money will be managed independently of other investors.)

A bank or dealer counterparty will often face the same separately managed account client through multiple separately managed accounts of multiple asset managers. While it is difficult to generalise about the average number of separately managed accounts established by each client that trades OTC derivatives, we estimate that large pension funds, investment funds and other institutional investors may have dozens of asset managers with these accounts.

Each separately managed account that trades OTC derivatives will typically have its own "netting set" corresponding to each ISDA master agreement and credit support annex used by the relevant asset manager. As a result, collateral movements for initial or variation margin are not netted across the client's separately managed accounts (including separately managed accounts with different investment strategies handled by the same asset manager). Although the client could post less collateral by netting across all accounts, separation is needed to allow asset managers to execute effectively on the investment strategy and to track the profits and losses for each strategy (in turn, allowing the institutional client the ability to measure the effectiveness of each strategy and asset manager).

The interpretation of the MTA as applying at the level of the client, when, as described, it could apply across multiple master agreements and therefore multiple "netting sets", is making the MTA provision ineffective for a significant number of market participants. In many instances, asset managers are left with no alternative but to set the MTA at zero for its separately managed accounts. Third party offerings to calculate collateral requirements across the separately managed accounts' master agreements have proved unworkable, adding expense and, at the same time, being extremely hard to manage. Even though calculations can be consolidated, collateral transfers cannot be similarly consolidated, so clients still end up having to move small amounts of collateral. Likewise, bank and dealer counterparties cannot dynamically calculate and manage MTA across the client's separate master agreements for several reasons, including timing, additional regulatory risk and confidentiality. Moreover, splitting the MTA (e.g., giving €50,000 "shares" of MTA to ten separately managed accounts) creates regulatory risk in ensuring that such a split is not being applied to more accounts than would be permitted by the €500,000 MTA limit. In addition, given that clients may have dozens of relationships, this solution would only meaningfully cover a subset that have a maximum of ten accounts.

SIFMA AMG urges the Commission to take the opportunity provided by the EMIR review to clarify how the MTA applies through a clear definition of "netting set" that takes into account that there can be multiple netting sets (i.e., master agreements) within the same legal entity. If it is felt that the EMIR regulation itself is not the appropriate place to deal with the MTA feature of the margin requirements, we urge the Commission to propose amendments to the definition of "netting set" in Article 1 of the Margin RTS, in order to clarify that the netting set can be calculated below the legal entity level in

certain situations (i.e., relevant to the asset management sector) where multiple netting sets exist within the same legal entity.

(c) **Greater Use of Money Market Funds as Initial Margin**

We ask the Commission to reduce the barriers to using money market funds as initial margin under the Margin RTS, such as the concentration limits applicable to shares or units in UCITS under Article 8(1)(a) of the Margin RTS. Money market funds meeting strict criteria provide a secure and easier to segregate alternative to cash, addressing the difficulties noted in Recital 29 of the Margin RTS. We ask that public debt constant net asset value MMFs (as defined in the Money Market Fund Regulation)[10] [where their credit quality has been assessed to credit quality step 1] be permitted without a concentration limit. For other defined money market funds, the current 15% concentration limit in Article 8(1)(a) of the Margin RTS should be raised. The EUR 10 million limit should be removed: as a practical matter, it can equate to a concentration limit of below 5% of collateral collected from the posting counterparty, making money market funds too inefficient for use as initial margin under the current rules.

4.2 Specific Comment on Risk-Management Procedures Validation

We are concerned by the amendments to Article 11(15) put forward by the Commission. The wording is unclear, but it appears that the European Supervisory Authorities (ESAs) will be given a mandate to amend the Margin RTS to introduce a new procedure for the initial and continuing supervisory validation of the risk-management procedures requiring the exchange of collateral. SIFMA AMG members strongly disagree with this proposal. Such a requirement introduces legal uncertainty, is unnecessarily burdensome, and inhibits firms from taking a risk-based approach. Moreover, any requirement for pre-approval of risk-management procedures before OTC derivatives can be traded is simply not practical.

5. Other Concerns and Comments

5.1 Equivalency Determinations

We are concerned with the apparent lack of progress towards any equivalency declarations by the Commission under Article 13 of EMIR. The dual application of the various EMIR requirements and potentially conflicting rules of another jurisdiction is proving to be a real impediment to the smooth implementation of the EMIR requirements by SIFMA AMG members. In the absence of any facility to opt into the rules of a non-EU country which have been declared as equivalent, SIFMA AMG members face the cost and burden of negotiating situations where multiple jurisdictions' requirements, particularly clearing and margin requirements, apply to the same transaction.

[10] Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds.

We have some additional considerations about the practical application of Article 13(3), where a non-EU regime has been declared equivalent pursuant to Article 13(2) of EMIR. Article 13(3) suggests that, where EMIR applies to the derivatives dealings between two counterparties and an equivalency determination in respect of the rules of a non-EU country is available, the counterparties will be deemed to have complied with EMIR, as long as they comply with the non-EU country's rules. If this is the correct reading of Article 13(3), an unintended consequence of an equivalency decision could be that counterparties are forced into complying with the, potentially more onerous, requirements of the non-EU jurisdiction's "equivalent" regulatory regime, in order to satisfy the obligations incurred by one or other of the counterparties under EMIR. In our view, the correct outcome of an equivalency determination under Article 13(2) should be that counterparties whose transactions are subject to the requirements in EMIR are able to choose whether EMIR or the non-EU country's "equivalent" rules apply to the derivative transactions between them. This facility should be available to counterparties, even where neither of them is, strictly speaking, "*established in*" in the non-EU jurisdiction, but where at least one of them is nevertheless *subject to* the rules of that country, e.g., by virtue of being a "U.S. person" for the purposes of rules and guidance issued by the U.S. Commodity Futures Trading Commission (which term is wide enough to capture certain non-EU entities).

5.2 CCP Investment Policy - Money Market Funds

Currently, there is a lack of harmonisation of the rules governing permitted investments by EU CCPs and U.S. "derivatives clearing organisations". We ask the Commission to permit CCPs, under Article 47 of EMIR and the related regulated technical standards ("**CCP RTS**"),[11] to invest in money market funds meeting certain strict criteria, to align their investment powers with the equivalent US rules (17 CFR 1.25). This change would: (i) allow CCPs to exchange cash for non-cash collateral, which is easier to segregate and is more secure; (ii) remove an existing disadvantage suffered by EU CCPs, leveling the playing field and helping EU CCPs compete with US rivals; and (iii) promote the EU's UCITS and money market fund products. This can be achieved by adding a new section 1a to Annex II of the CCP RTS, specifying the required characteristics, directly or by reference to the permitted type of money market fund defined in the Money Market Fund Regulation, such as a public debt constant net asset value MMF [where their credit quality has been assessed to credit quality step 1].

5.3 Timing

Many of the changes to EMIR in the Commission's proposal are set to come into effect 20 days after the amending regulation is published in the Official Journal. This timing presents market participants (both bank and dealer counterparties and buy-side entities, including asset managers and their clients) with significant implementation challenges, particularly in instances where the client's status under EMIR will change from "non-financial counterparty" below the clearing threshold to "financial counterparty" and the parties are faced with clearing and margining their transactions

[11] Commission Delegated Regulation (EU) No 153/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties.

in accordance with EMIR for the first time. Moreover, the exemption from the clearing obligation applicable to “small financial counterparties” in new Article 4a of EMIR is expressed not to apply until six months after the amending regulation enters into force. This mismatch between when the various requirements in the Commission’s proposal apply creates a potential problem for those counterparties who will become “financial counterparties” as a result of the amending regulation (in particular, where they are currently classed as “non-financial counterparties” below the clearing threshold), as they will not be able to avail themselves of the exemption from the clearing obligation for small financial counterparties until six months later. In the meantime, those financial counterparties will have to comply with the full set of requirements in EMIR, including the clearing obligation. We urge the Commission to set a later application date for the requirements in the proposal in general, and to avoid any mismatches of the application dates for interconnected provisions, such as the one described.

Should you have any questions, contact Tim Cameron at +1 202-962-7447 or tcameron@sifma.org, Laura Martin at +1 212-313-1176 or lmartin@sifma.org, or Anna Lawry, Ropes & Gray at + 44 20 3201 1590 or anna.lawry@ropesgray.com.

Respectfully submitted,

Timothy W. Cameron, Esq.
SIFMA Asset Management Group – Head

Laura Martin
SIFMA Asset Management Group – Managing Director and Associate General Counsel