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October 21, 2014

Mr. Steven Maijoor
Chair
European Securities and Markets Authority
CS 60747
103 Rue de Grenelle
75345 Paris Cedex 07
France

Re: *Discussion Paper: Calculation of Counterparty Risk by UCITS for OTC Financial Derivative Transactions Subject to Clearing Obligations*

Dear Mr. Maijoor:

ICI Global¹ appreciates the opportunity to provide comments on the discussion paper issued by the European Securities and Markets Authority (“ESMA”) on the calculation of counterparty risk by UCITS for financial derivative transactions subject to clearing obligations.² ESMA is seeking views on how counterparty risk exposure limits should apply in the context of centrally cleared OTC derivatives and whether the same system of risk exposure limits should be applied by UCITS to both centrally cleared OTC derivative transactions and exchange-traded derivatives (“ETDs”). A key underlying assumption in the Discussion Paper is that the application of the counterparty risk limits should depend on the type of segregation arrangement that is provided for assets posted as margin for the relevant transactions. We have concerns that this assumption may not be appropriate particularly when evaluating third country central counterparties (“CCPs”) and clearing members, especially for jurisdictions that operate an agency clearing model. We believe ESMA needs to conduct a more

¹ The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US\$18.7 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

² European Securities Markets Authority, Discussion Paper, Calculation of Counterparty Risk by UCITS for OTC Financial Derivative Transactions Subject to Clearing Obligations (July 22, 2014), *available at* <http://www.esma.europa.eu/system/files/2014-esma-876.pdf> (“Discussion Paper”).

complete analysis regarding the application of the counterparty risk limits for derivatives that are cleared through CCPs outside the European Union. We also are of the view that ESMA should do further study of ETDs before recommending to subject ETDs to the same UCITS counterparty risk limits as OTC derivatives. We discuss our concerns in more detail below.

Our members – US funds that are regulated under the Investment Company Act of 1940 and similar non-US regulated funds publicly offered to investors, such as UCITS (collectively, “Regulated Funds”) – use swaps and other derivatives in a variety of ways. Derivatives are a particularly useful portfolio management tool in that they offer Regulated Funds considerable flexibility in structuring their investment portfolios. Uses of swaps and other derivatives include, for example, hedging positions, equitizing cash that a Regulated Fund cannot immediately invest in direct equity holdings, managing a Regulated Fund’s cash positions more generally, adjusting the duration of a Regulated Fund’s portfolio, or managing a Regulated Fund’s portfolio in accordance with the investment objectives stated in a Regulated Fund’s prospectus. To employ derivatives in the best interests of fund investors, our members have a strong interest in ensuring that the derivatives markets are highly competitive and transparent and that central clearing is encouraged where appropriate to reduce systemic risk.

ICI Global members, as market participants representing millions of investors, generally support the goal of providing greater oversight of the derivatives markets. Given that many derivative transactions are conducted across multiple jurisdictions, we support efforts for real and meaningful coordination among regulators on how these regulations will be applied to market participants that engage in cross-border transactions. Our concerns discussed below mainly focus on UCITS that may engage in derivative transactions on a cross-border basis.

Background

Under the UCITS Directive, OTC derivative transactions are subject to counterparty risk exposure limits.³ The guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS also recommended that initial margin and variation margin relating to ETDs that are not protected by client money rules or similar arrangements be taken into account for the calculation of counterparty risk for UCITS.⁴ Given that under the European Market Infrastructure Regulation (“EMIR”)⁵ certain OTC derivatives will become subject to mandatory clearing, ESMA is now considering how counterparty risk exposure limits should apply in a cleared environment.

³ The counterparty risk exposure limits are set out in Article 52 of the UCITS Directive, which provides that where the limits apply, a UCITS’ risk exposure to a counterparty must not exceed 5% of the assets of a UCITS, or 10% where its counterparty is a credit institution.

⁴ CESR/10-788, available at http://www.esma.europa.eu/system/files/10_788.pdf.

⁵ 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.

The Discussion Paper appears to contemplate that the only situation in which counterparty risk exposure limits would not apply to a derivative transaction would be where the transaction is cleared through an authorized or recognized CCP and where margin in relation to the transaction is held subject to an EU-style individual segregation arrangement (as specified in EMIR). Moreover, if margin is held in an omnibus client segregation arrangement, ESMA is of the view that UCITS would apply counterparty risk limits to the clearing members. These positions would apply to both OTC derivatives and ETDs.

ESMA Must Conduct More In-depth Analysis of Non-EU CCPs that Are Not Recognized by the EU before Determining Whether to Apply Counterparty Risk Limits

In the Discussion Paper, ESMA briefly discusses the counterparty risk limits with respect to third country CCPs that have not been recognized pursuant to EMIR. ESMA concludes that, because those third country CCPs are subject to standards that may not be equivalent to those applicable to EU CCPs, transactions cleared through such CCPs would not receive a level of protection equivalent to OTC derivative transactions centrally cleared under EMIR. ESMA then states that UCITS should, therefore, treat those transactions as bilateral OTC derivative transactions and apply the 5%/10% counterparty risk limits of Article 52 of the UCITS Directive to clearing members.

For the reasons discussed below, we believe ESMA must conduct a more thorough analysis of non-recognized third country CCPs (and the different segregation models they provide) to determine whether (and how) counterparty risk limits should be applied. First, ESMA has given little explicit consideration to the distinction between the principal-to-principal clearing model and the agency clearing model, which is more common in non-EU jurisdictions (notably the United States).

In particular, we question whether the application of counterparty risk limits is appropriate in an agency clearing environment in which there is no back-to-back transaction structure with the clearing member acting as principal in a transaction with its client and a further back-to-back transaction with the CCP. Moreover, the agency clearing model may offer additional or different protections in a clearing member insolvency as compared to the principal-to-principal model. For example, in the United States, the agency clearing model relies on a regulatory regime that has been designed to facilitate portability of collateral. Porting would in particular help to avoid certain of the issues identified by ESMA as arising during a close-out of positions and the associated return of collateral.⁶

Second, we disagree with ESMA that third country CCPs that have not been recognized are subject to standards that are not equivalent to those applicable to EU CCPs or third country CCPs recognized under EMIR. The recognition process involves more than the EU Commission finding that

⁶ We note that ESMA's major concern with respect to omnibus segregation models is that "in the majority of cases" where a clearing member defaults, the CCP will deliver any residual collateral back to the clearing member or its liquidator following the liquidation of the clients' positions rather than delivering the collateral directly back to the clearing member's clients. ESMA also notes that returning the collateral to the clearing member rather than to its client could cause problems and delays for UCITS seeking the return of their assets given that the process will depend on the outcome of the clearing member's liquidation process.

a third country CCP is subject to an equivalent regulatory regime.⁷ In fact, we understand that the EU Commission has not yet recognized CCPs from certain jurisdictions because of the concern that the regulatory regime does not provide for the recognition of EMIR authorized CCPs rather than the regulatory standards not being considered equivalent.⁸

Instead of focusing only on the recognition of CCPs, ESMA may wish to link the treatment of third country CCPs to the issue of whether their home jurisdiction has been the subject of an implementing act on equivalence pursuant to Article 25(6) of EMIR. An implementing act on equivalence would in fact show that CCPs established in the relevant jurisdiction are subject to standards that are “equivalent to those applicable to EU CCPs,” without any further need for a recognition decision. Alternatively, we urge ESMA to take into account a CCP’s compliance with the Principles for Financial Market Infrastructures, which are intended to limit systemic risk and to enhance safety and efficiency in the market for clearing services and which the EMIR regime was designed to implement.

At a minimum, in light of continued delays in issuing implementing measures on equivalence under Article 25(6) of EMIR and the fact that no third country CCPs have as yet received recognition, a grace period should apply to these CCPs and their clearing members until ESMA is able to study CCPs from third countries.

Third, we do not agree with ESMA’s conclusory approach of applying the full counterparty risk limits to clearing members of third country CCPs without an adequate analysis of their clearing models and a thoughtful consideration of the asset segregation protections provided to client collateral. In this regard, ICI Global urges ESMA to review carefully the range of different segregation arrangements that fall within the umbrella of “omnibus” accounts, including the “legally segregated, operationally commingled” (“LSOC”) model.

We are of the opinion that the LSOC model should receive more favorable treatment than the standard EU “omnibus segregation” model for purposes of analyzing the impact of a clearing member default, given the client-protective structure and additional protections that are built into the LSOC model. Under the LSOC model adopted by the Commodity Futures Trading Commission (“CFTC”),

⁷ As part of the Article 25 recognition process, the EU Commission is required to adopt an act of equivalence determining that the legal and supervisory arrangements of the non-EU jurisdiction in which the non-EU CCP is authorized ensure that CCPs authorized in that jurisdiction comply with legally binding requirements that are equivalent to the requirements for CCPs set out in EMIR, that those CCPs are subject to effective supervision and enforcement in that jurisdiction on an ongoing basis, and that the legal framework of that third country provides for an effective equivalence system for the recognition of CCPs authorized under that jurisdiction’s legal regime.

⁸ Opening Statement of Chairman Timothy G. Massad, Open Meeting on Proposed Rule on Margin Requirements for Uncleared Swaps and Final Rule on Utility Special Entities (Sept. 17, 2014) (“That is, the issue today [cross-border recognition of clearinghouses] is not primarily about the standards that apply to our clearinghouses. Our clearinghouses have long met the standards agreed to by international regulators, known as the Principles for Financial Market Infrastructures”).

each futures commission merchant (“FCM”) and derivatives clearing organization (“DCO”) must segregate on its books and records the cleared swaps of each individual customer and related collateral positions. Operationally, each FCM and DCO is permitted to hold or commingle the relevant collateral in one account. Each FCM and DCO must ensure that such account is separate from any account holding FCM or DCO property or holding property belonging to a non-cleared swap customer. In addition, the DCO must develop rules that specify a “waterfall” of funds that is used to satisfy defaults. Under the CFTC rules, a clearinghouse may not, as part of its waterfall, allow the DCO to access the collateral of the non-defaulting cleared swap customers to address losses due to a defaulting swap customer upon a default of the clearing member. This requirement provides significant protection to swap customers, such as Regulated Funds. We believe LSOC protects cleared swap customer collateral by: (i) ensuring that customer assets, including excess margin assets, are held at the clearing agency and not the clearing member; (ii) providing for clear identification of customer assets; and (iii) mitigating or virtually eliminating the risk that a clearing agency would access the collateral of non-defaulting cleared swap customers as a result of a double default under the waterfall provisions.

This approach differs from the EU omnibus segregation model. Therefore, risk limits should be calibrated to recognize the unique features of the LSOC model and the protections that it affords customer collateral. Appropriate calibration of the risk limits is particularly important because US CCPs offering LSOC may not generally offer individual segregation arrangements. Without recognition of the benefits of LSOC as against the EU omnibus segregation model, UCITS may be restrained in their ability to invest in products that are cleared only by US CCPs and/or limited in their ability to invest in derivative instruments that would best hedge or reduce risk of their portfolios.⁹

Moreover, we recommend that, if ESMA proceeds to impose counterparty risk exposure limits in the context of omnibus segregation accounts, the regime should take into account the lower risks relating to omnibus segregation models in which CCPs are aware of clients’ identities. Although there are certain types of omnibus accounts in which the CCP may not be aware of individual clients’ identities (and as such would be more likely to return collateral to the insolvent clearing member’s liquidator), this is certainly not the case for all omnibus accounts. For example, LCH.Clearnet offers an “Identified Client Omnibus Segregated Account,” where the identities of a clearing member’s clients would be known to the CCP.¹⁰ Article 48(7) of EMIR provides that “any balance owed by the CCP after the completion of the clearing member’s default management process by the CCP *shall be readily*

⁹ We also believe that a lack of calibration of the risk limits for the LSOC segregation model would be problematic even if a US CCP was recognized under EMIR. As noted above, if a US CCP recognized under EMIR did not offer individual segregation, the ability of UCITS to invest in products that are cleared through such CCP may be diminished. We urge ESMA to study carefully the collateral and customer protections provided by the different collateral segregation models.

¹⁰ Indeed, LCH.Clearnet specifically notes in its disclosure document “Legal implications - Account Structures,” required to be provided by LCH.Clearnet under Article 39(7) of EMIR, that it may return collateral held in such accounts directly to individual clients on the satisfaction of certain conditions (*e.g.*, confirmation of the client’s identity), *available at* http://www.lchclearnet.com/Images/Ltd_Legal%20Implications_Account%20Structures_22-01-2013_tem6-64656.pdf.

returned to those clients when they are known to the CCP or, if they are not, to the clearing member for the account of its clients” [*emphasis added*]. Thus, given the operation of Article 48(7) of EMIR, we would contend that ESMA’s concerns in relation to clearing member liquidations and the return of client assets are minimized for omnibus segregation accounts in which CCPs are aware of individual clients’ identities.

Finally, under ESMA’s proposed approach, there would be no advantage to clearing OTC derivatives unless an individual segregation model was used because exactly the same risk limits would apply in relation to uncleared OTC derivatives and OTC derivatives cleared using an omnibus or LSOC segregation model. This application of the risk limits would produce odd results and would not promote “voluntary” clearing of OTC derivatives (*i.e.* clearing of those OTC derivatives that are not subject to EMIR’s mandatory clearing obligation). Such consequences appear to be contrary to the policy of EMIR and the G-20 commitments, which aim to encourage clearing of standardized contracts.¹¹ We submit that a better approach would be to apply risk limits that would incentivize UCITS to clear OTC derivatives.

ESMA Should Study Further Whether ETDs Should be Subject to the Same Counterparty Risk Limits as OTC Derivatives

Although the UCITS Directive does not impose counterparty risk exposure limits on investments in ETDs, ESMA is considering whether the same rules should apply to both OTC transactions that are centrally cleared and ETDs. We believe a more complete study must be conducted before ESMA makes any recommendation to apply the counterparty risk limits to investments in ETDs. UCITS commonly rely on omnibus client segregation when transacting in ETDs. The current practice reflects the way in which clearing has evolved generally in a futures context (*i.e.* to support a net omnibus rather than an individual segregation model). The additional market infrastructure required by individual segregation for ETDs with the attendant higher costs may discourage UCITS from investing in ETDs, an investment that has traditionally been seen as efficient and cost effective. A requirement to increase the use of individual segregation arrangements for ETDs may ultimately lead to a drop in market liquidity as well as requiring a significant shift in well-established market practice.

Moreover, given that the market for the provision of clearing services is fairly restricted in size¹² and that UCITS may generally have a relationship with only a small number of clearing members at any one time, it may be difficult for UCITS to diversify their counterparties sufficiently to stay beneath the

¹¹ We note in this regard ESMA’s statement at paragraph 7 of the Discussion Paper that “the EU regulatory framework and the clearing obligations under EMIR recognise that CCPs should contribute to lowering systemic risk by reducing the number of bilateral derivative exposures.”

¹² For example, in its recent progress report, the Financial Stability Board noted that the majority of client clearing activity is carried out by fewer than ten large banking groups and trading firms globally. *See* www.financialstabilityboard.org/publications/r_140408.pdf.

risk exposure limits. In addition, the onboarding and due diligence process involved in becoming a clearing member's client will result in significant costs and a substantial time commitment.

Finally, we note that indirect clearing arrangements are more common in the context of ETDs than in the case of OTC derivatives, and we understand that it is proving difficult to structure an individual segregation model that works effectively in the context of indirect clearing. Thus, forcing the adoption of individual segregation model for indirect clearing arrangements or applying counterparty risk exposure limits to ETDs could hamper the ability of UCITS to invest in ETDs.

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We appreciate the opportunity to respond to the Discussion Paper. If you have any questions on our comment letter, please feel free to contact the undersigned, Susan Olson at +1-202-326-5813, Sarah Bessin at +1-202-326-5835, or Jennifer Choi at +1-202-326-5876.

Sincerely,

/s/

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