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France

Submitted Electronically

14 July 2014

Dear Sir/Madam,

AIMA Response to Consultation Paper – 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

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to respond to the Consultation Paper – Draft regulatory technical standards (Draft RTS) on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (EMIR) published by the EBA, EIOPA and ESMA (together, the ESAs) on 14 April 2014 (Consultation Paper).[2]

AIMA commends the efforts of the ESAs to work towards a robust regime for risk mitigation techniques, specifically margin requirements, for non-centrally cleared derivatives. Many of the proposed requirements in the Consultation Paper demonstrate a considered approach by the ESAs to ensure that a comprehensive regime for margin for non-centrally cleared derivatives is implemented under EMIR. However, AIMA would like to raise certain concerns with the proposals put forward in the Consultation Paper which it believes are relevant not only to AIMA members but for all market participants potentially impacted by the proposals in the Consultation Paper. Broadly speaking, these concerns are as follows:

1. **Requirement to Exchange Variation Margin:** It is unclear how the requirement for the exchange of variation margin will be satisfied under current frameworks.
2. **Requirement for Third Party Custodian:** We seek clarity that the Draft RTS provide for the option of the use of a third party custodian and the collecting counterparty acting as custodian.
3. **Initial Margin and Title Transfer Arrangements:** The Draft RTS restrictions on initial margin potentially force market participants to use collateral arrangements under the Financial Collateral Directive, which has various outstanding issues which need to be resolved.
4. **Timing of Exchange of Initial Margin:** The proposed collection period for initial margin is unworkable from an operational perspective.

[1] AIMA is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry – including hedge fund managers, fund of hedge fund managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. Our membership is corporate and comprises over 1,400 firms (with over 7,000 individual contacts) in more than 50 countries. AIMA's manager members manage a combined $1.5 trillion in assets (as of March 2014).

[2] *See* Consultation Paper here.

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5. **Exchange of Variation Margin under FX Contracts:** The proposed 8% haircut on collateral where the collateral currency is different from the settlement currency is unnecessary.
6. **Concentration Limits:** The concentration limits proposed in the Draft RTS are unnecessary and should be removed.
7. **Legal Opinions:** The legal opinions required under the Draft RTS should be of industry standard form and should be issued on the establishment of the segregation arrangement only.

We refer the ESAs to the Annex of this Letter for further details in respect of each of the above points.

AIMA would like to thank the ESAs for the opportunity to respond to the Consultation Paper and would welcome the opportunity to discuss the contents of this Letter in greater detail. Please do not hesitate to contact Jiří Król (jkrol@aima.org) or Adam Jacobs (ajacobs@aima.org) on +44 (0)207 822 8380 in this regard.

Yours faithfully,

Adam Jacobs
Director, Head of Markets Regulation

Annex – AIMA Concerns with the Draft RTS

1. Requirement to Exchange Variation Margin

AIMA members typically enter into collateral agreements for derivatives in the form of a standard ISDA Credit Support Annex (CSA) or a prime brokerage agreement (PBA). To meet the requirement to post variation margin, both of these relationships will need to be redocumented, and it is a material concern that there will be insufficient time and resources to do so before December 2015.

Under a CSA the fund is typically required to give initial margin to a bank counterparty. The collateral is passed by way of title transfer. Variation margin is then exchanged between the fund and the bank. But because of the title transfer nature of the arrangement, the transfer of initial margin by the fund creates a credit risk for the fund on the bank, and the fund's right to call for variation margin is on a net basis with the initial margin. So if the initial margin is EUR 1m on trade date, the fund must give the bank EUR 1m, and is exposed for the value of EUR 1m. If the value of the trade moves to be EUR 400,000 in favour of the fund, then the bank will return EUR 400,000, leaving the net collateral as EUR 600,000 posted by the fund to the bank. The fund is always exposed for an aggregate amount of EUR 1m when the value of the collateral and the derivative are added together. Although the fund has received some collateral back, on a net basis it is posting EUR 600,000 and so it is unclear that Article 1 VM is satisfied. If we take the view that the Article is not satisfied then the solution would be to enter into a segregated initial margin agreement with the bank so that the EUR 1m was set to one side.

The problem with this is two-fold:

i. The limited time before December 2015 to redocument the relationships with segregated initial margin (the large majority of non-UCITS funds in Europe will need to, and with every derivative counterparty); and
ii. Segregating initial margin will cause a large drain on the finances of the bank recipients of the collateral.

It appears to us that the liquidity effect of the loss of this collateral from the financial system has not been included in the modelling in the consultation paper, as it appears that relationships with less than EUR50m of initial margin and below the portfolio notional size thresholds have been ignored. However, we believe that the implication of this possible interpretation of Article 1 VM is that a great many collateral relationships will require segregation.

Adding to this problem is the fact that PBAs do not provide for prime brokers to provide variation margin. PBAs will also need to be redocumented to provide for this. The legal work to do so will not be as significant as for the CSAs, but the loss of liquidity for the prime broker banks will again be material.

We strongly recommend that, in the same way that you have lessened the impact of the segregation of initial margin by imposing a EUR 50m threshold before initial margin must be posted, you give a tolerance for the posting of initial margin by way of title transfer, provided that it is agreed to contractually by the parties. Separately, we suggest that the relationship between a fund and its prime broker be exempted from the scope of these rules, and instead be subject to specific rules that look at the overall credit relationship between a fund and its prime broker, covering all risk exposures such as cash lending and deposits, stock loans and rehypothecation.

We also propose that the current proposed start date for the variation margin requirements, of December 2015, be phased in on the same basis as for the initial margin requirements. As described above, there are numerous legal and operational requirements that our members will need to implement to ensure compliance with the provisions proposed in the Draft RTS. While OTC derivatives transactions (other than FX forwards) are likely to already be subject to bilateral variation margin requirements, the legal and operational changes required by the Draft RTS still make the implementation timeframe difficult.

In particular, the application of such a phase-in to the requirements to post variation margin would give smaller market participants, who represent far less market risk, sufficient time to comply with the RTS.

2. Requirement for a Third Party Custodian

Article 1 SEG provides that "*initial margin shall be segregated from proprietary assets on the books and records of a third party holder or custodian, or other legally effective arrangements made by the collecting counterparty*". AIMA recommends that (i) the RTS make clear that the collecting counterparty can act as custodian for the initial margin (subject to the gathering of the necessary legal opinions and any other necessary steps); and (ii) the party posting collateral be given the choice whether to insist that the collateral be held with a third party holder or custodian rather than the collecting counterparty.

While it may superficially appear a better choice for our members to always ask for a third party to hold collateral, use of a third party custodian does increase costs compared to the collecting counterparty acting as custodian.

3. Initial Margin and Title Transfer Arrangements

The restrictions on the collection and use of initial margin contained in the Draft RTS, specifically Article 1 GEN(3) in Chapter 1[3] and Articles 1 SEG(4)[4] and 1 REU(1)[5] both in Chapter 4, effectively mean that, under English law at least, the initial margin has to be posted by way of security arrangement and not under a title transfer arrangement.

Because market participants would be unable to effect their initial margin arrangements by way of title transfer arrangements such as under CSA, we believe action would need to be taken in relation to the current uncertainty related to the Directive 2002/47/EC (**Financial Collateral Directive**).[6] We have serious concerns as to the enforceability of security financial collateral arrangements in many EU Member State jurisdictions, due to the requirement under the Financial Collateral Directive for "possession" or "control"[7] and the way these concepts have been interpreted by the respective courts and legislatures of EU Member States. AIMA believes the Financial Collateral Directive should first be amended to address any ambiguities in this regard, before the ESAs take any steps which potentially force market participants to use an unenforceable collateral arrangement.

As a general point, by increasing the likelihood that potentially unenforceable collateral arrangements will be used, a collecting party can have no certainty that the collateral it receives can be used against the loss it incurs due to a counterparty default. In essence, markets participants using such arrangements would find that, *ex post facto*, they have transacted with their counterparties on an uncollateralised basis which increases systemic risk.

4. Timing of Exchange of Initial Margin

We do not believe the current call period for initial margin[8] is operationally practicable for our members. The calculation and calling of initial margin requires a level of trade reconciliation between counterparties. Trade reconciliation typically takes place on a T+1 basis. Having so reconciled, there needs to be a period for delivery. This issue is compounded for our members by the fact that many transact with counterparties in different jurisdictions across different time zones.

On this basis, we propose that initial margin should be collected a T+2 basis.

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3 Initial margin must be posted on a gross basis.

4 Initial margin must be: (i) held in such a way as to ensure that the initial margin collected is available for immediate use to the collecting party in the event of its counterparty's default; and (ii) subject to arrangements that protect the posting party from the collecting party's insolvency.

5 The collecting party is not permitted to rehypothecate initial margin received.

6 *See* Financial Collateral Directive here.

7 *See* Article 2(2), Financial Collateral Directive.

8 *See* Article 1 EIM(3), Chapter 1, Draft RTS.

5. Exchange of Variation Margin under FX Contracts

The Draft RTS seeks to apply an 8% haircut to collateral where the collateral currency is different from the settlement currency.[9] We believe that this proposal, in certain cases, discourages market participants from employing sound risk management practices.

For example, a fund might have an FX contract with a Swedish bank where the bank pays the fund if Swedish Krona (SEK) falls in value. If the Swedish bank gives the fund SEK cash then the fund has exposure to significant wrong-way risk. However, if the fund is paid in Euros i.e., to alleviate such wrong-way risk, the 8% haircut would apply. The above issue is compounded by the fact that it is rare to find that the value of a large portfolio of derivatives is heavily exposed to the direction of any one currency.

We, therefore, respectfully request that the 8% haircut be removed from the RTS. In considering this request we suggest that ESAs perform their own analysis of the correlation to different major currencies of the value of a number of representative portfolios to see if the 8% haircut approach is justified. We would be happy to assist in this if you wished.

6. Concentration Limits

We do not believe that concentration limits proposed in the Draft RTS[10] are necessary with respect to the assets provided to satisfy the initial margin and variation margin requirements in the Draft RTS. Our members and their counterparties are already incentivised to ensure a level of diversity in the type of collateral posted since this best ensures credit risk is adequately mitigated. Further, we believe the 50% concentration limit is especially problematic given the widespread practice of using high-grade liquid sovereign debt securities as collateral. We suggest that concentration limits should not apply with respect to all G-7 sovereign debt with a credit rating of AA- or above.

Conversely, we do not see why the RTS encourage at Article 6 LEC the use by a sovereign of its own debt to cover its collateral obligations by exempting this debt from wrong-way risk limits. This is clear wrong-way risk.

7. Legal Opinions

The Draft RTS requires counterparties to obtain legal opinions which confirm that the segregation arrangements meet the requirements laid out in the Draft RTS, specifically that: (i) cash initial margin is segregated from the proprietary assets of the counterparty where a fund has not opted for individual account segregation; (ii) initial margin is immediately available to the collecting party; and (iii) that the posting counterparty is sufficiently protected from the insolvency risk associated with its counterparty.[11]

We believe that further clarity is required from the ESAs on the provision of legal opinions.

First, it should be made clear that parties are able to rely on an industry standard legal opinion. We believe it would be far too costly and time consuming for parties to obtain specific legal opinions relating to their particular segregation arrangements. ISDA has previously provided such industry standard legal opinions with respect to the enforceability of close-out netting arrangements in certain jurisdictions. We believe that a similar approach of relying on industry-wide legal opinions could also be used with respect to segregation arrangements mandated by the RTS. Importantly, the RTS should permit participants to rely industry-wide standard opinions that are produced for segregation on a generic basis of key principles that must appear in a legal agreement in order to achieve segregation rather than to obtain opinions for individual agreements, as otherwise the cost of obtaining opinions will prove needlessly excessive. We anticipate that for EU parties such legal opinions should be gathered for the jurisdiction of the custodian following the PRIMA principles set out in the Settlement Finality Directive and Collateral Directive.

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9 *See* Annex II – Standard haircuts to the market value of collateral, Draft RTS.

10 *See* Article 7 LEC(1), Chapter 3, Draft RTS.

11 *See* Article 1 SEG(5), Chapter 4, Draft RTS.

Secondly, in relation to the time at which a legal opinion is adopted, we would encourage the ESAs to adopt an interpretation of "*at the inception of the transaction and on a regular basis thereafter*"[12] which refers only to the time at which the segregation arrangement has been adopted and implemented, rather than when each specific transaction has been entered into. The law on segregation of assets does not normally change rapidly. In many countries the law has not materially changed for decades. An obligation to check the legal situation for each jurisdiction of each counterparty more frequently than annual is a diversion of resources from productive uses.

12 *See* Article 1 SEG(5), Chapter 4, Draft RTS