MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
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# MFA UPDATED RESPONSE ON PROPOSED REGULATION ON OTC DERIVATIVES, CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES

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Managed Funds Association[1] strongly supports the European Union's (the "**EU**") efforts to promote central clearing and thereby: (i) increase transparency of the derivatives market; (ii) reduce counterparty and operational risk in trading; and (iii) enhance market integrity and oversight. MFA is a strong supporter of the goals and efforts of the EU to reduce systemic risk in the derivatives market, including by transitioning the over-the counter ("**OTC**") derivatives market to greater central clearing. In addition, MFA continues to support measures that enhance transparency in the derivatives market as well as uniformity and consistency of regulation. The issues raised in this response reflect MFA's updated views[2] on changes made to the European Commission's 2010 Proposal for a "Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories" (the "**2010 Proposal**")[3] as set forth in the European Parliament's draft text adopted on 5 July 2011 (the "**Parliament Text**")[4] and the Council of the European Union's draft text agreed on 4 October 2011 (the "**Council Text**")[5].

## I. Governance - CCP Boards and Risk Committees

MFA submits that balanced central counterparty ("**CCP**") governance is critical to promoting competition in the derivatives market and that clients have an interest in sound governance requirements that foster fair and objective risk-based access, broad product offerings and competitive pricing.

The 2010 Proposal provides composition requirements for the boards and risk committees of CCPs[6], but gives CCPs the option not to include clients as members of the risk committee, and

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[1] Managed Funds Association ("**MFA**") represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

[2] *See* "MFA's Response to Proposed Regulation of OTC Derivatives, Central Counterparties and Trade Repositories" dated November 11, 2010 ("**MFA 2010 Response**"), available at: https://www.managedfunds.org/wp-content/uploads/2011/11/Final-MFA-White-Paper-EC-Derivatives-Proposed-Regulation.pdf.

[3] Available at: http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf.

[4] Available at: http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2011-0310+0+DOC+XML+V0//EN&language=EN.

[5] Available at: http://register.consilium.europa.eu/pdf/en/11/st15/st15148.en11.pdf.

[6] Articles 25 and 26 of the 2010 Proposal.

instead allows CCPs to establish only "appropriate consultation mechanisms that ensure that the interests of the clients of clearing members are adequately represented".[7] The 2010 Proposal does not specify what constitutes "adequately represented".[8] The Council and Parliament texts continue to track the 2010 Proposal in this regard.[9] While the Parliament Text also provides this alternative at Article 26(b), it sets out additional requirements concerning the composition of CCP risk committees at Article 26(1). The Parliament Text provides that: (1) a CCP must have clients of clearing members represented on its risk committee; (2) client representatives must be different from clearing member representatives; and (3) none of the groups of representatives may have a majority in the risk committee.[10] In contrast, the Council Text provides only that the CCP shall allow clients to attend meetings in a non-voting capacity.[11]

MFA supports the intent of the three texts to balance representation on CCP boards and risk committees, but we believe that the final Regulation adopted by the Parliament and Council (the "**Regulation**") should eliminate the consultation alternative and should affirmatively mandate the inclusion of non-dealer, client representatives on CCP boards and risk committees. As a significant proportion of the trading volume in the OTC derivatives market, clients are important stakeholders, and thus, they should have their views reflected in the critical decisions of these bodies and should be entitled to attend and vote at meetings (not merely be consulted). We are concerned that without such a mandate, narrow interests will dominate and CCPs may not adequately take into account the views of all market participants. In addition, we believe that to completely effect fair representation and balanced governance of CCPs; no single group of market participants should constitute a controlling majority of any boards or risk committees. MFA supports the additional requirements set out in Article 26(1) of the Parliament Text.

In addition to the changes suggested above, MFA suggests that the Regulation allow CCP employees to have representation on risk committees. Such employees are motivated to expand the scope of CCP products and services, offer optimal capital, margin and cost management and maintain CCP risk management procedures, which prevent losses to the CCP, clearing members and the market. Moreover, such employees provide further counterbalance to the potential conflicts of interest of other constituencies represented on risk committees.

## II. Portability

MFA supports measures that facilitate a client's ability to transfer freely all or part of its portfolio and related margin between clearing members. We were pleased that the 2010 Proposal requires CCPs to ensure that they are able to port derivatives contracts to another clearing member

[7] Article 26(6) of the 2010 Proposal.

[8] By way of illustration, CCPs currently have "buy-side client advisory boards". While these boards may beneficially provide CCP management with input on client concerns, these boards have no governance effect, and their recommendations are typically subject to risk committee approval. MFA is concerned that these boards, which serve a purely "advisory" function, would constitute "adequate" representation when they do not give clients meaningful input into CCP governance.

[9] Article 26 of the Council and Parliament texts.

[10] Article 26(1) of the Parliament Text.

[11] Article 26(6) of the Council Text.

without the consent of the defaulting clearing member.[12] MFA believes that clients should be able to negotiate transfers of their positions to another clearing member at any time, whether prior to or following the default of their current clearing member.

Both the Council and Parliament texts have amended this language to clarify the position. The Parliament Text provides that a CCP shall structure its arrangements so that where full segregation applies it can transfer the positions and collateral of clients to one or more other participants.[13] The Council Text is more prescriptive in that it provides that where a CCP records the assets and positions as being held for a defaulting clearing member's clients, the CCP must contractually commit to transfer the assets and positions held by the defaulting clearing member for the accounts of the clients to another clearing member designated by those clients.[14] Moreover, such transfer will occur at the client's request and without the consent of the defaulting clearing member.[15] The Council Text further obliges the other clearing member to accept the assets and positions only where it has previously entered into a contractual relationship with the clients by which it has committed to do so.[16] MFA supports the adoption of the procedures set out in the Council Text.

MFA further urges the Regulation to make clear that ceding clearing members must affect such transfers: (1) as promptly as technologically feasible;[17] and (2) without imposition of fees or other conditions (*e.g.*, additional documentation requirements) that could act as an unwarranted barrier or deterrent to portability and competition in the provision of clearing services. We acknowledge that if a CCP transfers only part of a portfolio, the untransferred portion must be appropriately margined, in accordance with the margining methodology agreed between the clearing member and client, or absent express agreement, as previously applicable to the client's portfolio.

## III. Portfolio Margining and Netting

MFA believes that explicitly permitting robust netting practices for initial and variation margin will enhance incentives to offset risk and centrally clear derivatives transactions generally, as well as reduce borrowing costs by maximizing capital efficiencies. As a result, we think it important for the Regulation to permit netting arrangements that allow parties to net initial and variation margin amounts across a broad range of exposures and assets, including across cleared and uncleared exposures, as well as across related legal entities.[18] Such netting will reduce aggregate

[12] Article 37 of the 2010 Proposal requires that depending on the level of segregation chosen by a client, the CCP must ensure that it is able to port such positions "on request at a pre-defined trigger event". The 2010 Proposal also provides that the other clearing member shall only be obliged where it has previously entered into a contractual relationship for that purpose.

[13] Article 37 (3b) of the Parliament Text.

[14] Article 45(4a) and (4b) of the Council Text.

[15] *Id*.

[16] *Id*. *See also* Article 37(3) of the 2010 Proposal.

[17] In the current futures market, clearinghouses usually affect transfers within 48 hours of a futures commission merchant's default, and clearinghouses have indicated that similar timeframes should be feasible for swaps.

[18] Many market participants have existing netting agreements in place that allow them to net initial margin and variation margin amounts across many different exposures and assets, including across cleared and uncleared exposures, whether held in one or multiple related legal entities of the dealer, prime broker or clearing member.

counterparty credit risk, lower trading costs, allow for efficient use of capital, provide better transparency as to counterparty risk and reduce complexity and settlement risk. Without permitting robust netting arrangements, liquidity will drain from the derivatives market as participants seek other execution strategies to prevent over-collateralization.

The Council and Parliament texts at Article 39 each address margin requirements generally and require a CCP to impose, call and collect margins to limit its credit exposures from clearing members. The European Securities and Markets Authority ("**ESMA**") will draft technical standards specifying the minimum margin standards, including the percentage of margin that CCPs must collect as well as the related time horizons. MFA emphasizes that in developing those standards ESMA should be mindful of the increased costs that margin regulation may impose on clients both in terms of the margin amount and of the increased administrative costs associated with collecting margin and verifying calculations.

## IV. Real-Time Clearing

MFA supports the imposition of regulatory requirements that require clearing in real time, and strongly urges that the Regulation require immediate acceptance or rejection of a trade upon submission for clearing by both CCPs and clearing members. Providing open access to real-time clearing of trades will promote market efficiency by enabling participants to reduce their counterparty credit risk without delay, and by ensuring unrestricted access to the broadest range of executing counterparties, more liquidity and competitive pricing. Real-time clearing will also enhance market transparency and protect the anonymity of a client's executing counterparties and will avoid the imposition of additional credit limits, fragmentation of liquidity, delays in acceptance of trades and/or the imposition of barriers to access to clearing such as inappropriate execution documentation.

Real-time clearing registration requires that both CCPs and clearing members maintain automated clearing acceptance capability, including in respect of client transactions. The Regulation should explicitly require that both CCPs and clearing members maintain such automation. Real-time acceptance is commonplace in other established cleared derivatives markets, including futures, listed equity derivatives and energy swaps, and thus, such automation is well understood and scalable for cleared OTC derivatives. In addition, such automation serves a critical systemic risk mitigation function in permitting immediate capping of trading by any client or direct clearing participant when its clearing member or CCP views it as posing risk of losses.

The Council Text at Article 32a provides that CCPs' communication procedures must accommodate open industry communication procedures and standards to facilitate efficient recording, payment, clearing and settlement. The Parliament Text provides more prescriptive language at Article 32a(1) that: "[w]ith the aim of promoting straight-through processing (STP) across the entire transaction flow, CCPs shall use or accommodate in their systems to the participants and market infrastructures they interface with, in their communication procedures with participants and with the market infrastructures they interface with, the relevant international communication procedures and standards for messaging and reference data in order to facilitate efficient clearing and settlement across systems". To ensure consistent application of the Article 32a(1) requirements, ESMA will draft technical standards specifying the process for defining which international communication procedures and standards for messaging and reference data are to be

considered relevant for the purposes of Article 32a(1). [19] While the Parliament Text addresses MFA's concerns in part, MFA recommends that the Regulation or ESMA's standards set out that real-time acceptance timeframes are required for all trades submitted for clearing.

## V. Segregation of Collateral at the CCP

MFA has consistently advocated for the protection of client collateral in cleared and bilateral trades.[20] Segregation protects investor positions and margin from clearing member insolvency. The Council Text (Article 37) provides clients with the option of "individual client segregation", defined as keeping "separate records and accounts enabling each clearing member to distinguish in accounts held by the CCP, the assets and positions held for the account of a client from those held for the accounts of other clients."[21] Furthermore, the Council Text provides that CCPs must offer to keep separate records and accounts. [22] The Council Text also provides that clearing members must offer clients the right to segregate their assets through individual client segregation with the CCP.[23] The 2010 Proposal merely requires CCPs to *allow* clients to have a more detailed segregation.[24]

The Parliament Text provides greater protections for clients than the Council Text as there is a positive segregation requirement with an opt-out in the Parliament Text as opposed to a requirement to offer an opt-in. Specifically, the Parliament Text requires that a clearing member must distinguish in separate accounts with the CCP the positions of the clearing members from those of it clients.[25] The Parliament Text also requires a clearing member to distinguish the positions of each client in separate accounts.[26] The Parliament Text allows clearing members to record their clients positions in omnibus accounts with the CCP but only when clearing members request (in writing) that the CCP so record their positions.[27] MFA strongly supports providing clients with a robust level of protection for both their positions and assets that also promotes efficient portability.

## VI. CCP Default Waterfall

Both the Council and Parliament texts specify which clearing member resources and default contributions each CCP may use, and the order in which the CCP may use them, as part of its default waterfall.[28] MFA believes it is preferable to exclude non-defaulting client collateral and

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[19] Article 32a(2) of the Parliament Text.

[20] *See* Sections IV.B and VIII, MFA 2010 Response

[21] Article 37(3) of the Council Text.

[22] *Id*.

[23] *Id*.

[24] Article 37(2) of the 2010 Proposal

[25] Article 37(2) of the Parliament Text.

[26] Article 37(2a) of the Parliament Text. Article 2(22b) of the Parliament Text defines "segregation" as meaning "at least that the assets and positions of one person shall not be used to discharge the liabilities of or claims against any other person from whom it is intended that he is segregated, and shall not be available for such purposes, especially in the event of a clearing member's insolvency".

[27] Article 37(2a) of the Parliament Text.

[28] Article 42 of both the Council and Parliament texts.

assets from each CCP's default waterfall. In our view, the elimination of such client risk mutualization is warranted, since clients do not have the necessary information about the risks posed by their counterparties' other clients to determine and mitigate any "fellow client risk" to which they are exposed.[29] MFA therefore considers it important that Article 42 explicitly excludes non-defaulting client assets from the CCP default waterfall. Such an exclusion means that clients are not exposed to a shortfall in the waterfall in the event that the default of another client triggers their clearing member's default. This protection is appropriate as clients cannot know the identity, financial strength or risk profile of their clearing members' other clients.

## VII. Indirect Clearing

MFA recommends that the Regulation prohibit CCPs from adopting rules that require one of the executing parties to a transaction to be a clearing member in order for a transaction to be eligible for clearing. Furthermore, MFA believes that the Regulation should prohibit CCPs from adopting rules, policies or procedures that disadvantage clients or other indirect clearing members as compared to direct clearing members, with respect to, for example, participant eligibility and the timing of clearing trades.

The Parliament Text allows for "indirect clearing" whereby a client faces an intermediary broker (which is not a clearing member) and such intermediary broker then passes the client's trade onto the clearing member for clearing (*i.e.*, the client does not have a direct relationship with the CCP). The Parliament Text contemplates that market participants may satisfy their clearing obligations by clearing through an investment firm or credit institution subject to the requirements of the Markets in Financial Instruments Directive.[30] The Parliament Text (at Article 2(12)) defines a "client" as "an undertaking with a direct or indirect contractual relationship with a clearing member of a CCP or one of its affiliates which enables that undertaking to clear transactions through that clearing member's use of that CCP." This definition allows for indirect clearing and for the varied structuring of the relationship with the intermediary (*e.g.*, an intermediary broker could enter into an agreement with the clearing member as agent of its clients).

MFA believes that the Parliament Text is valuable in that it recognizes that facilitating indirect clearing is important while remaining flexible in allowing intermediary relationships to be structured appropriately. The Council Text does not have equivalent provisions. Although MFA does not believe that it is necessary for the Regulation to set forth a model structure for indirect clearing, we believe that it is important for financial clients to have the options offered by the Parliament Text, and thus, we support its adoption in the Regulation.

## VIII. Eligibility Criteria for Clearing (Participants)

Article 35 of both the Council Text and the Parliament Text require that admission criteria for clearing members be non-discriminatory, transparent and objective to ensure fair and open access to CCPs. The texts permit criteria restricting access to clearing membership only to the

[29] Clients do not know (and indeed should not know) the identity of their counterparties' other clients or the nature of the trading activity or positions of those fellow clients. Without this information, which dealers properly keep confidential, no client can assess the creditworthiness of its fellow clients.

[30] Article 3(2) of the Parliament Text.

extent that the objective of the criteria is to control risk for the CCP. CCPs may only deny clearing membership access based on a comprehensive risk analysis. In addition, the Parliament Text goes further by prohibiting CCPs from uncompetitively or unreasonably restricting financial institutions from becoming clearing members.[31] The exclusion of market participants from clearing membership through imposition of requirements not reasonably related to a clearing member's capacity to discharge its responsibilities will delay the adoption of clearing and stifle competition for clearing services, and thus, MFA strongly supports the changes set forth in the Parliament Text.

## IX. Eligibility Criteria for Clearing (Products)

MFA supports the combined "top down" and "bottom up" approach in the 2010 Proposal relating to clearing eligibility, but believes that it requires greater clarity. As a result, we appreciate that the eligibility criteria set out in the Council and Parliament texts at Article 4 are much more detailed than the criteria set out in the 2010 Proposal. It is particularly helpful that the Council and Parliament texts require ESMA to maintain a public register of the derivatives subject to the clearing obligation. In particular, the Council Text provides that ESMA must make the register publicly available on its website to identify correctly and unequivocally the classes of derivatives subject to the clearing obligation.[32] The Parliament Text has a similar requirement.[33] In addition, the Council Text requires that the register be kept "up to date", whereas the Parliament Text requires that ESMA "regularly update" the register.

Although we appreciate these clarifications, MFA believes that still greater clarity is necessary in the Regulation with respect to the eligibility criteria. As discussed herein, there is a lack of certainty as to the technical standards that ESMA will adopt, and because of this uncertainty, there may continue to be issues around identifying whether a particular contract is subject to the clearing obligation or identifying whether a counterparty is subject to mandatory clearing. Since predictability is necessary for the continued flow and risk management of trading activity, MFA requests that ESMA draft the relevant technical standards clearly and with precision so that market participants can easily apply such standards and it is clear which products are (or will be) eligible. In addition, whatever text the European Commission eventually adopts, MFA submits that it is important that ESMA effectively maintain the public register of derivatives so that CCPs, clearing members and their clients can access it readily and rely on it.

## X. Recognition of Third Country CCPs

MFA supports the recognition of third country CCPs. The three criteria for the recognition of third country CCPs set out in the 2010 Proposal[34] remain in the Council and Parliament texts but with certain amendments. In particular, the Council Text reflects MFA's suggestion that coordination with non-European regulators on the approval procedures would be an important way to ensure that the equivalency test applied is reasonable and not unduly restrictive towards the

[31] Article 35(1) of the Parliament Text.

[32] Article 4b of the Council Text.

[33] Article 4(4) of the Parliament Text.

[34] Article 23 of the 2010 Proposal.

regulatory frameworks of third countries.[35] In addition, both the Council Text and the Parliament Text contain a reciprocity requirement, which provides that ESMA may only recognize a CCP established in a third country where ESMA deems the legal framework of that third country to provide for an effective equivalent recognition of CCPs authorized in the EU.[36] This restriction would be difficult to implement in practice, does not significantly increase the protections available to EU entities and is likely to have the effect of unduly restricting the ability of EU entities to access third country CCPs. As a result, MFA respectfully recommends eliminating this reciprocity requirement.

## XI. Exchange of Collateral in Bilateral Trades

Consistent with MFA's support for collateral segregation, we also support the bilateral exchange of collateral between counterparties, which is a critical risk-mitigating tool and longstanding practice in the derivatives market. In the MFA 2010 Response, we expressed the view that clarity is necessary to ensure thoughtful application.[37]

The Parliament and Council texts differ in how they address this concern. The Parliament Text provides that counterparties must be offered "the option of segregation of initial margin at the outset of the contract",[38] whereas the Council Text requires only that counterparties "shall distinguish in accounts, in accordance with their agreements, the assets provided by the other party" if requested before the time of execution.[39] Therefore, the Parliament Text may be preferable as the Council Text may result in unnecessary and costly segregation of variation margin, which are assets that are exchanged between counterparties daily as a reflection of their profits on the transaction (*i.e.*, it is their own money). MFA's view is that the Regulation should reflect that only initial margin (which is meant to cover counterparty exposure and is held for the life of the trade) needs to be segregated, not variation margin (which is intended to cover market exposure on any given valuation day as if the trade had been terminated).

## XII. Dealer Capital and Collateral Requirements in Bilateral Trades

Further to the distinction between capital and collateral, MFA believes that the requirement to exchange collateral in bilateral trades should be separate from, and imposed regardless of whether there is also, a requirement to hold capital. The 2010 Proposal seems to suggest that dealers would be able to choose to either exchange collateral or hold capital, rather than be required to exchange variation margin and hold capital, as is current market practice.[40] MFA feels that changing current market practice[41] would disadvantage clients and pose market-wide risks. The Parliament Text

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[35] Section XIV, MFA 2010 Response.

[36] Article 23(3) of the Council Text and Article 23(2)(be) of the Parliament Text.

[37] Section IV.B, MFA 2010 Response.

[38] Article 8(1) of the Parliament Text.

[39] Article 6(1b) of the Council Text.

[40] Article 8(1) of the 2010 Proposal.

[41] Current market practice is for the client counterparty to an OTC derivatives transaction to post initial margin with its dealer counterparty at the outset of a trade and for the client and dealer to exchange variation margin throughout the life of a trade to reflect any mark-to-market changes. In addition, while dealers post variation margin (but not initial margin)

retains the same optionality that exists in the 2010 Proposal as it provides that risk management procedures will require the "exchange of collateral or capital-backing".[42] The Council Text however amends the 2010 Proposal by stipulating that counterparties will have risk management procedures requiring the appropriate exchange of collateral with respect to OTC derivative contracts and the Council Text also sets out that that "financial counterparties" will hold capital to "manage the risk not covered by appropriate exchange of collateral".[43] Therefore, MFA believes that the Council Text is more appropriate as it makes it clear that collateral exchange is appropriate and requires capital only to cover risk not addressed by collateral exchange.

## XIII. Proportionate Holding of Capital in Bilateral Trades

MFA appreciates the option for market participants to either exchange collateral or hold appropriate capital for bilateral swaps as set out in Article 8 of the 2010 Proposal. We note, however, that capital requirements are misplaced in the case of alternative investment funds ("**AIFs**") and that only collateral is appropriate. We believe the Regulation would benefit from recognizing this distinction. The Council Text amends the 2010 Proposal by stipulating that "financial counterparties" will hold capital to manage risk not covered by the exchange of collateral.[44] The definition of "financial counterparties"[45] includes AIFs; therefore, it does not resolve our concern in this regard. The Parliament Text does make a distinction by providing that risk management procedures will require the exchange of collateral or capital-backing in accordance with the "applicable regulatory capital requirements".[46] Thus, MFA supports the position set out in the Parliament Text.

## XIV. Timing

MFA strongly supports an approach to implementation that will enable an orderly transition to the new regime. A firm timetable will give market participants confidence to commit resources to the new market structure, and will encourage market participants to develop competitive services that will overcome the current structural and economic barriers to clearing. Further, a properly sequenced implementation plan will provide market participants with the appropriate time to evaluate relevant final rules and make any necessary adjustments to their business models or portfolio composition. Additionally, such an implementation plan will provide market participants with the time required to resolve outstanding operational issues and documentation prior to compliance with the new requirements.

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to their client counterparties, dealers also hold capital to mitigate the risk of loss their clients may bear in the case of their default.

[42] Article 8(1) of the Parliament Text.

[43] Article 6(1bb) of the Council Text.

[44] *Id*.

[45] Article 2(6) of the Council Text.

[46] Article 8(1) of the Parliament Text.