MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

April 2, 2012

Via Electronic Submission: www.esma.europa.eu

Joint Committee of the European Supervisory Authorities
c/o European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris, France

Re: ESA Joint Discussion Paper on Draft Regulatory Technical Standards on Risk Mitigation Techniques for OTC Derivatives Not Cleared by a CCP

Dear Sir or Madam:

Managed Funds Association[1] welcomes the opportunity to provide comments to the Joint Committee of the European Supervisory Authorities (the "**ESAs**")[2] in response to their Joint Discussion Paper (the "**Discussion Paper**")[3] on "Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories".[4] Throughout the EMIR legislative process, MFA engaged with policy makers in the European Union ("**EU**") to provide what we hope was thoughtful and constructive input on a number of important issues related to regulation of over-the-counter ("**OTC**") derivatives. MFA strongly supports measures to reduce risk in the OTC derivatives markets and incentivize central clearing, including the imposition of appropriate risk-based margin requirements. As a result, MFA would like to take this opportunity to provide comments on a number of the questions set out in the Discussion Paper. We hope that our comments will assist the ESAs in preparing technical standards for risk mitigation techniques

[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] The European Supervisory Authorities include the European Banking Authority, the European Insurance and Occupational Pension Authority and the European Securities and Markets Authority ("**ESMA**").

[3] Available at: http://www.esma.europa.eu/consultation/Joint-Discussion-Paper-Draft-Regulatory-Technical-Standards-risk-mitigation-techniques-.

[4] The Discussion Paper addresses the requirements set forth in the European Commission's "Proposal for a Regulation of the European Parliament and of the Council on OTC derivative transactions, central counterparties and trade repositories" ("**EMIR**"), available at: http://register.consilium.europa.eu/pdf/en/12/st07/st07509-re01.en12.pdf.

that will balance the need to minimize risk with maintaining liquidity in the OTC derivatives markets.

Executive Summary

While MFA's responses cover several important issues, below we highlight some key points that we raise in this letter.

- A critical piece of the risk mitigation framework is an appropriate segregation regime for posted initial margin ("**IM**"). Specifically, the regime must ensure that, in the event of the receiving party's default or insolvency: (i) the posting party's IM is segregated in a manner that is bankruptcy-remote under the local insolvency laws of the relevant Member State; and (ii) it allows for the efficient return of the posting party's collateral.

- Where the technical standards provide an appropriate level of IM segregation and protection, MFA believes that Option 1 (*i.e.*, the posting of IM by all parties) may be too costly to implement without commensurate benefit. Instead, in conjunction with such segregation, the ESAs' proposed Option 2 (*i.e.*, collection of IM by prudentially regulated financial counterparties ("**PRFCs**")[5] only) for posting of IM coupled with the Option 3 threshold[6] would provide sufficient protections to all parties, complement current practice in the derivatives markets and represent a more suitable basis for the technical standards.

- Where the technical standards do not provide appropriate segregation, then MFA submits that Option 1 is necessary because it would provide an acceptable means for each party to manage its counterparty credit risk. MFA acknowledges that such an option may significantly increase costs to market participants and reduce liquidity in the market, particularly where the technical standards do not permit legally enforceable netting arrangements. Therefore, MFA urges the ESAs to draft technical standards that allow such legally enforceable netting, if the ESAs adopt Option 1.

- In calculating IM, MFA is of the view that margin methodologies must be transparent and replicable in a manner that allows both parties to determine independently the applicable margin. Such transparency and replicability is fundamental to conducting effective capital planning and promotes margin practices that are fair and understood by all market participants.

As the ESAs draft technical standards, MFA appreciates their efforts to consider and evaluate the effects of posting of margin on clients and the level of segregation that will

[5] Discussion Paper at 9, paragraph 12, which defines "prudentially regulated financial counterparties" to include: investment firms, credit institutions, insurance undertakings, assurance undertakings, reinsurance undertakings and institutions for occupational retirement provision.

[6] *Id*. at 11, paragraph 19. Under Option 3, PRFCs would not be required to collect IM if the exposure is to certain counterparties and below a certain threshold.

adequately protect clients' assets, as the requirements mandated by the technical standards will materially affect clients when entering into non-cleared derivative contracts for hedging and investing purposes.

MFA Reponses to the ESAs' Discussion Paper Questions

Options for Initial Margin (Q2-Q13)[7]

Option 1- posting of initial margin by all counterparties

Q2. What are your views regarding option 1 (general initial margin requirement)?

MFA's views on Option 1 depend on whether the ESAs have drafted technical standards that ensure appropriate segregation of IM.[8] MFA recognizes that there is currently asymmetry in the derivatives markets with respect to the delivery of IM (*i.e.*, PRFCs collect IM from their client counterparties but do not concomitantly post IM to them), and this asymmetry results in a high degree of interconnectedness and systemic risk.[9] We respectfully submit that the most effective way of dealing with these risks is ensuring appropriate segregation of IM by receiving parties, so that the posting parties have certainty that upon the receiving party's default or insolvency, the posting party can recover its posted IM promptly and in full.

MFA acknowledges that implementation of Option 1 would represent a significant change to market practice, and therefore, could result in increased administrative burdens and additional costs for all market participants. In addition, the posting of IM by all parties could adversely impact liquidity in the derivatives market as market participants will need to set aside additional capital to meet their IM requirements. This outcome is undesirable, especially since ensuring an appropriate segregation regime with sufficient levels of protection for all parties would eliminate the need for Option 1.[10]

Notwithstanding the foregoing, MFA notes that should the ESAs determine not to mandate effective segregation protections, then we believe that Option 1 is necessary.

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[7] *Id*. at 10-14, paragraphs 19 to 34, which sets out three proposals for the provision of IM discussed in the "Executive Summary" above.

[8] By "appropriate segregation", we mean that the regime must ensure that, in the event of the receiving party's default or insolvency: (i) the posting party's IM is segregated in a manner that is bankruptcy-remote under the local insolvency laws of the relevant Member State; and (ii) it allows for the efficient return of the posting party's collateral.

[9] *See* MFA's comment letter to the U.S. Prudential Regulators on their notice of proposed rulemaking on "Margin and Capital Requirements for Covered Swap Entities", dated July 11, 2011, available at: http://www.managedfunds.org/wp-content/uploads/2011/09/Prudential-Regulator-Capital-Margin-Letter-Final-MFA-Letter.pdf ("**MFA Prudential Regulator Letter**"). *See also* MFA's comment letter to the U.S. Commodity Futures Trading Commission ("**CFTC**") on its notice of proposed rulemaking on "Margin Requirements for Uncleared Swaps and Capital Requirements for Swap Dealers and Major Swap Participants", dated July 11, 2011, available at: http://www.managedfunds.org/wp-content/uploads/2011/09/CFTC-Capital-and-Margin-Requirements-Letter-Final-MFA-Letter.pdf ("**MFA CFTC Letter**").

[10] *See* MFA's response to Q27 below.

Specifically, in the absence of appropriate segregation, the posting of IM by all parties recognizes that both parties assume some measure of counterparty credit risk when entering into derivatives transactions and adequately compensates for that risk by ensuring that each party holds sufficient assets to offset its potential exposure. MFA members have expertise, technical proficiency and understanding of the risks inherent in trading derivatives that is comparable to their PRFC counterparties, which would enable our members to manage such bilateral IM arrangements.[11]

Although MFA believes that Option 1 is only preferable where the technical standards do not require appropriate segregation, if the ESAs consider adopting Option 1, MFA is of the view that certain measures would lessen its adverse impact on market liquidity. In particular, we suggest that the ESAs ensure that the technical standards permit legally enforceable netting of both IM and variation margin ("**VM**").[12] Effective netting arrangements lower systemic risk by reducing both the aggregate requirement to deliver margin and the trading costs for market participants. Moreover, permitting netting across a wide variety of offsetting exposures, in addition to reducing aggregate counterparty credit risk and lowering trading costs, would: (i) allow entities to make efficient use of their capital; (ii) provide market participants and regulators with better transparency as to the overall amount of counterparty risk between two parties, which is informative of risk in the derivatives markets; and (iii) reduce complexity and settlement risk.

Many market participants currently have netting agreements that allow them to net IM and VM amounts across many different exposures and assets. Thus, permitting counterparties to net margin when they have a legally enforceable netting arrangement allows market participants to continue current "best practices" with respect to the collateralization of non-cleared OTC derivatives. In contrast, without adequate allowances for netting, liquidity will drain from the derivatives markets as participants seek other execution strategies to prevent the over-collateralization of otherwise offsetting positions. Therefore, MFA submits that, if the ESAs adopt Option 1, they must also permit legally enforceable netting to create an IM model that is workable in the derivatives market.[13]

[11] Although MFA recognizes that some clients may have less expertise at managing the bilateral exchange of IM and might view such arrangements as too burdensome without commensurate benefit, we think that without appropriate segregation, it is necessary for market participants to incur the costs of developing such expertise in order to protect market participants generally and the market as a whole against another financial crisis.

[12] *See* MFA Prudential Regulator Letter at 8 and MFA CFTC Letter at 7-8, where in each, we provide examples of the kinds of netting that we might suggest, including netting of margin for: (i) OTC derivatives of the same or similar asset classes; (ii) OTC derivatives with highly correlated assets or other financial products (*e.g.*, a credit default swap with referenced bond or an interest rate swap and Eurodollar futures); (iii) OTC derivatives exposures of one asset class with margin for OTC derivatives of another asset class (*e.g.*, interest rate swaps and commodity swaps); and (iv) OTC derivatives exposures with margin for other financial product types (*e.g.*, physically-settling forwards, repurchase agreements, security lending agreements).

[13] Although we believe that such arrangements will lessen the adverse impact of Option 1 on derivatives market liquidity, we emphasize that MFA's preferred approach is Option 2 coupled with the Option 3 threshold requirement. *See* MFA's response to Q5 and Q6 below.

Q3. Could PRFCs adequately protect against default without collecting initial margins?

MFA believes that there may be circumstances in which PRFCs can adequately protect against default of their counterparties without the collection of IM, such as by using other risk mitigation techniques (*e.g.,* the imposition of capital requirements on PRFCs or the exchange and regular valuation of VM). Specifically, if PRFCs exchange VM daily with their counterparties, the VM should protect the PRFC in the event of any counterparty's default because the PRFC should not have counterparty credit exposure on any transaction. In addition, in the event that there is an intraday change in the value of the transaction, such that the exchanged VM is insufficient, to the extent that the PRFC has sufficient capital, that capital should insulate the PRFC from defaulting on its own obligations.

However, MFA emphasizes that where the ESAs determine to impose an IM requirement, they should either: (i) ensure that where the technical standards require only PRFCs to collect IM, they also require such PRFCs to provide appropriate segregation of counterparty assets; or (ii) mandate the exchange of IM by all parties.

Q4. What are the cost implications of a requirement for PRFC, NPRFC[14] and NFCs+[15] to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.

The delivery of IM will directly affect the costs to clients when entering into non-cleared derivatives, if the ESAs apply any of the proposed options. Where the technical standards change current market practice, many of the costs associated with posting IM will be incremental to buy-side firms, which already regularly post IM and VM and collect VM for non-cleared OTC derivatives transactions. However, imposing new or additional IM requirements for PRFCs, NPRFCs and NFCs+ may result in buy-side firms incurring costs beyond the higher margin amounts and related operational costs. For example, buy-side firms may incur increased trading costs in the form of adverse pricing as their counterparties seek to pass costs associated with new margin requirements along to their clients. In addition, if buy-side firms can no longer use legally enforceable netting arrangements, their overall funding costs for delivering margin will increase. Although we do not have detailed cost estimates to provide to the ESAs, in the aggregate, these incremental costs might be quite large. If the additional costs are excessive, they may effectively limit buy-side firms' access to the non-cleared OTC derivatives markets, which will likely adversely affect the OTC derivatives markets as they lose liquidity and depth.

MFA acknowledges the risk that requiring all parties to post and collect IM will draw liquidity from the market, but we submit that allowing legally enforceable netting arrangements (as described in our response to Q2 above) will mitigate this risk. Although we appreciate and

[14] Discussion Paper at 9, paragraph 13, which sets out that "non-prudentially regulated financial counterparties" would include undertakings for collective investments in transferable securities and their managers and alternative investment funds managed by alternative investment fund managers.

[15] *Id*. at 7, paragraph 2, which defines NFCs+ as Non Financial Counterparties above the clearing threshold, as referred to in Article 7 of EMIR.

support the ESAs being mindful of the increased costs that margin regulation may impose upon market participants, we strongly believe that, in the non-cleared market, it is important that all parties have sufficient protection from their counterparties' default or insolvency. Thus, despite our cost concerns, in the absence of appropriate segregation protections, we would support Option 1 coupled with netting to reduce systemic risk and protect all market participants.

Option 2- collection of initial margin by PRFCs only[16]

Q5. What are your views regarding option 2?

Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?

In the event that the ESAs mandate appropriate segregation,[17] MFA would support proposed Option 2 for posting of IM coupled with the Option 3 threshold as our preferred choice.[18] We recognize that by not requiring all parties to post IM, Option 2 allows a certain amount of asymmetry to exist in the protection offered to different market participants. However, as noted above, this asymmetry reflects current market practice whereby PRFCs collect IM from their client counterparties but do not concomitantly post IM to them, and thus, the ESAs would not be disrupting the markets by adopting this option.

MFA advocates combining Option 2 with an Option 3 threshold requirement as a suitable basis for the technical standards because it would result in greater flexibility for market participants by allowing PRFCs to take on a certain amount of credit risk in respect of their counterparties. Therefore, we believe that this combination would strike the desired balance by providing sufficient protections to all parties while also complementing current market practice. We note, however, that for Option 2 to provide adequate protections to NPRFCs and NFCs+ trading with PRFCs, it is critical that the ESAs require appropriate segregation, which will enable NPRFCs and NFCs+ to recover all of their collateral on a timely basis.

Option 3 - PRFCs would not be required to collect initial margin if the exposure is to certain counterparties and below a certain threshold[19]

Q7. What is the current practice in this respect, e.g.

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[16] *Id*. at 11, paragraph 25, where the ESAs consider that this option would take into account the perceived systemic relevance of the counterparties.

[17] *Supra* note 8.

[18] We note that the ESAs designed Option 2 to consider the systemic importance of PRFCs and to protect the wider financial system. *See* Discussion Paper at 11, paragraph 25.

[19] *Id*. at 13, paragraphs 29 to 34. This option would allow potential future exposures to certain counterparties to be uncollateralized, where those exposures remain below a given threshold amount (and, in this case, the relevant party would need to cover its uncollateralized exposure with capital). The ESAs think that they would allow only PRFCs to use this approach for their counterparties because they are subject to capital requirements. The counterparty of a PRFC would only have to post IM when it exceeds the threshold.

- If a threshold is currently in place, for which contracts and counterparties, is it used?

- Which criteria are currently the bases for the calculation of the threshold?

Throughout the OTC derivatives market, counterparties currently agree to thresholds in their trading documentation below which the parties do not have to collateralize their exposures. PRFCs use such thresholds for a number of different types of counterparties, since they are prepared to assume a certain amount of credit exposure to their counterparties. In addition, due to the Basel rules,[20] market practice is moving towards lower thresholds, and in certain cases, even to eliminating the use of thresholds altogether.

In calculating the threshold, PRFCs apply general credit assessment criteria, which means that there will be situations where PRFCs will take on some level of unsecured risk (*e.g.*, in the case of loan transactions) in return for accepting the resultant capital charge. We note that ability to net margin requirements (both IM and VM) is a helpful feature of current market practice.

Q8. For which types of counterparties should a threshold be applicable?

Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?

Q10. How – in your opinion - would a threshold change transactions and business models?

As discussed in our response to Q7 above, under current market practice, market participants already use a number of similar thresholds in other contexts, and thus, MFA does not believe that the use of a threshold would change transactions or business models. However, MFA submits that if the ESAs apply any threshold, such threshold should apply to all types of counterparties and the ESAs should base any threshold on objective, risk-based criteria (*i.e.*, the threshold should not vary simply because of the type of counterparty involved), which will ensure uniformity of application and minimize disruptions in the derivatives market.

Moreover, the ESAs should allow counterparties to determine the appropriate IM threshold and the related criteria (*e.g.*, in-depth due diligence using internal models) that they will use to govern their trading relationships in line with current market practice. Allowing counterparties to set the applicable threshold is important because to be most effective, the threshold must take into account a number of party-specific factors (*e.g.*, the size of a particular

[20] The Basel Committee on Banking Supervision ("**BCBS**") is responsible for the international prudential framework for capital requirements, known as Basel II. Basel II, which the BCBS adopted in June 2004, amended the Basel Capital Accord of July 1988. In July 2006, the BCBS published a comprehensive version (BCBS128) of Basel II, incorporating the June 2004 Basel II framework, with certain amendments made after June 2004. The BCBS cannot require firms to comply with its standards but must rely on national bodies to implement its standards in applicable legislation and regulation. Basel II sets out the regulatory framework relating to the quality and quantity of capital and the Basel III reforms will significantly amend this framework. The key Basel III reforms deal with increasing the quality and consistency of capital, increasing counterparty credit risk charges, higher capital requirements for exposures to other financial entities and reducing procyclicality through capital buffers.

transaction, the type of derivative involved, the risk appetite of the PRFC and the creditworthiness of the counterparty).

Although MFA supports allowing counterparties to determine what the threshold will be, we urge the ESAs to mandate expressly that parties apply thresholds to all types of counterparty in a non-discriminatory manner so that thresholds are not determined by the type of counterparty involved but by reference to considerations that are relevant to effective risk management.

On all (other) options:

Q12. Are there any particular areas where regulatory arbitrage is of concern?

At present, there are significant differences between the proposals in the Discussion Paper and the current proposals on the same topics in the U.S.,[21] such as:

- the U.S. Proposals require the collection of IM by certain entities classified as "major swap participants" that in the EU would fit within the NFC classification;[22]

- the U.S. Proposals propose different approaches for the IM calculation requirements;[23]

- the U.S. Proposals draw eligible IM collateral from a limited set of assets for which there are "deep and liquid markets", whereas the current ESA eligibility criteria could potentially be much broader;[24] and

[21] *See* CFTC notice of proposed rulemaking on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants", 76 Fed. Reg. 23732 (April 28, 2011), available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf (the "**CFTC Proposal**"). *See also* the Prudential Regulators' notice of proposed rulemaking on "Margin and Capital Requirements for Covered Swap Entities", 76 Fed. Reg. 27564 (May 11, 2011), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf ("**Prudential Regulators Proposa**l" together with the CFTC Proposal, the "**U.S. Proposals**"). Each rulemaking proposes to require only swap dealers and major swap participants to collect IM from their counterparties for non-cleared swaps.

[22] Discussion Paper at 11-12, paragraph 25. We note that under EMIR, the NFC category is based solely on the type of a market participant, whereas in the U.S., the "major swap participant" category applies to all types of market participants based on whether they maintain a "substantial position" in swaps, create "substantial counterparty exposure" that could seriously and adversely affect U.S. financial stability or are highly leveraged relative to the amount of capital that they hold.

[23] *See Id*. at 15-16, paragraphs 38 to 42, where the ESAs propose to provide a standardized approach (*See* MFA's responses to Q16) for all counterparties to calculate their IM requirements, and consider allowing the use of appropriate internal models, subject to further specified minimum requirements. The CFTC Proposal is similar to the ESAs' current thinking in that §23.155 does not allow entities to use internal models, and instead mandates the use of either: (1) margin models currently in use by clearinghouses or prudentially regulated entities or available for licensing by a vendor; or (2) a comparative approach where entities calculate IM using a multiplier and the cleared product that most closely approximates the terms and conditions of the non-cleared swap. In contrast, the Prudential Regulators Proposal combines the ESAs options by permitting entities to select from the following alternatives: (1) a standardized ''lookup'' table that specifies the minimum IM requirement based on the notional amount of the swap; or (2) use of a Prudential Regulator approved, internal IM model that meets certain specified criteria.

- the U.S. Proposals propose different requirements for the exchange of VM.[25]

Inconsistency of global regulation in this area will lead to discrepancies as to the obligations of, and protections available to, market participants around the world, and will make it difficult and costly for market participants to comply with differing regulatory frameworks. Therefore, MFA emphasizes the importance of consistent global regulation and we encourage regulators to continue harmonizing and aligning margin and segregation requirements across jurisdictions because such alignment is crucial to avoid regulatory arbitrage.[26] We also strongly encourage the ESAs to liaise with other regulators and to consider the proposals of international standard setting bodies when drafting the technical standards on these issues.

Variation Margin (Q14-15)[27]

Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

Q15. What would be the cost implications of a daily exchange of collateral?

MFA strongly supports measures that require daily exchange of collateral, and thus, we urge the ESAs to mandate such an obligation. As a general matter, we have strongly encouraged the bilateral exchange of VM as crucial to the proper functioning of the derivative markets.[28] In particular, the daily, bilateral exchange of VM: (i) is current market "best practice" for collateral management; (ii) reduces counterparty and systemic risk by preventing either party from accumulating substantial unsecured exposures; (iii) increases market transparency; and (iv) facilitates central clearing by creating symmetry between the margin posting requirements for cleared and non-cleared derivatives. Therefore, we believe that it is consistent with the goals of

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[24] *See Id*. at 17, paragraphs 46 to 49, where the ESAs consider linking the requirements to ESMA's criteria-based collateral requirements under EMIR or setting out a prescribed list of eligible collateral (*e.g.*, by referring to the list of financial collateral eligible under Article 193 of the proposed Capital Requirements Regulation ("**CRR**"), which includes cash, government debt securities, debt securities issued by institutions which are appropriately rated by external credit assessment institutions and equities included on a main index). In contract, both U.S. Proposals (*see* CFTC Proposal §23.157 and Prudential Regulators Proposal Section 6) set out a prescriptive list of eligible collateral that includes, broadly, cash and highly liquid instruments such as government debt securities.

[25] *See* MFA Prudential Regulator Letter at 5-7 and MFA CFTC Letter at 4-7, where in each, we strongly support the ESAs proposed approach to the bilateral exchange of VM. The U.S. Proposals require "covered swap entities" ("**CSEs**") to collect (but not post) VM when they enter into transactions with financial entity counterparties. Consistent with our comments in this letter, MFA strongly urged the CFTC and the Prudential Regulators to require CSEs to post and collect VM with all non-financial entities because such bilateral exchange of VM is crucial to the proper functioning of the derivatives markets and the reduction of counterparty and systemic risks in that market.

[26] Discussion Paper at 6.

[27] *Id*. at 14, paragraphs 35 and 36.

[28] *Supra* note 25.

EMIR for the ESAs to impose such a mandate.[29] In addition, to the extent the ESAs determine to provide any exceptions to this requirement, we recommend that the ESAs draw such exceptions narrowly, set the threshold for any *de minimis* exception very low and apply it consistently to all counterparties.

With respect to the issue of cost, since daily, bilateral exchange of VM is current market "best practice", MFA believes that mandating such exchange would not significantly increase costs. Although we acknowledge that it is difficult to quantify set up costs, we believe that the costs of the transfers themselves are insignificant.

Initial Margin- Calculation (Q16-26)[30]

MFA agrees with the ESAs that it is important that the methods for calculating IM are transparent and consistent in order to provide certainty.[31] We also note that it is important that the ESAs' technical standards promote margin practices that are fair and understood by all market participants. IM should be determined in a transparent way that allows both parties to a transaction to determine independently the applicable margin. The ability of clients to replicate IM models enables them to anticipate how margin obligations might change over the life of the contract and how much they should hold in reserve. Such replicability is fundamental to conducting capital planning and underlies a party's ability to devote its resources strategically to other investments or obligations.

MFA also supports the flexibility envisaged by the ESAs in both providing a standardized approach and allowing the use of internal models in appropriate circumstances.[32] The parties should negotiate the selection of a calculation tool that is best suited to them, and having multiple options from which to choose will aid that process. However, we also support the ESAs setting minimum standards that all calculation tools used must meet because it is important that calculation methods are transparent and objective.

Q16. Do you think that the "Mark-to-market method"[33] and/or the "Standardised Method"[34] as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?

[29] EMIR, Recital 14, which sets out that where a central counterparty does not consider an OTC derivative transaction to be suitable for clearing, the transaction creates operational and counterparty credit risk, and thus, rules should be established to mitigate those risks, including rules that require the appropriate exchange of collateral.

[30] Discussion Paper at 15, paragraphs 38 to 42.

[31] *Id*., paragraph 38.

[32] *Id*.

[33] *Id*., paragraph 39, which describes the "Mark-to-market method" as an approach for calculating financial derivative exposures where the potential future exposure is calculated by multiplying the notional amount of a contract with a given multiplier (add-on) that varies according to the product type and the maturity.

[34] *Id*., which describes the "Standardised Method" as a model-based approach for calculating financial derivative exposures which is more risk sensitive than the "Mark-to-market method", and allows bucketing of risks at a more

Q17. Are there in your view additional alternatives to specify the manner in which an OTC derivatives counterparty may calculate initial margin requirements?

Between the two methods provided, we support the adoption of the "Mark-to-market method" over the "Standardised Method" because that method uses a multiplier that varies according to product type and maturity, and thus, offers more flexibility than the "Standardised Method". However, as mentioned above, MFA's recommendation is that the ESAs allow parties to negotiate the appropriate IM calculation method to reflect market conditions, risk appetites and creditworthiness assessments. Thus, we believe that it is not appropriate for the technical standards to adopt either standard method since both are too prescriptive in mandating how parties make their IM determination.

Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?

MFA strongly believes that the ESAs should not limit the scope of entities allowed to use an internal model. Rather, the ESAs should permit all parties to develop and use their internal models subject to the approval of the relevant competent authorities (such approval based on qualitative and quantitative criteria). We agree with the ESAs that use of internal models may give rise to potential competitive advantages for parties with sufficient resources to build internal models, but we believe this result is appropriate where parties are better able to assess risk.[35]

We acknowledge that allowing entities to use internal models to determine IM requirements introduces a potential impediment to transparency because such entities' counterparties will not have insight into how the entities calculate the IM requirements. To resolve this concern, we recommend that the ESAs' technical standards require that, for those entities that the ESAs permit to use such internal models, the functionality of such models be available to, and replicable by, those entities' counterparties (see our response to Q20 below). In addition, the ESAs should prohibit those entities that use their internal models from varying their IM requirements based solely on the identity of their counterparties. For example, the ESAs should not permit a PRFC to use different models to calculate IM for transactions with other PRFCs than to calculate IM for transactions with NPRFCs or NFCs+. We believe such a prohibition is necessary to prevent discriminatory distortions in the market and to eliminate unfair competitive advantages among market participants.

Q20. Do you think that the "Internal Model Method" as set out in the CRR is a reasonable internal approach for the calculation of initial margin requirements?[36]

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granular level and the risk position to be derived more accurately rather than simply using the notional value of the contract.

[35] *Id.*, paragraph 40.

[36] An internal model under the CRR is typically based on an effective expected positive exposure method, which is a risk-sensitive approach that aligns with an entity's internal risk management practices. Entities must demonstrate that they meet certain quantitative and qualitative minimum criteria to use the model.

MFA believes that the "Internal Model Method" is a useful starting point for the calculation of IM, but we encourage the ESAs to consider carefully two important requirements in developing the technical standards.

First, as mentioned above, allowing entities to use internal models to determine IM requirements introduces a potential impediment to transparency. Transparency into the IM model used directly correlates to a market participant's ability to replicate any determination of IM amount. This ability is critical to a market participant's capacity to anticipate and adjust to changes in its obligations. If market participants do not have the information necessary to predict with reasonable certainty potential changes in IM requirements, there are two possible outcomes. Under the first outcome, market participants would hold excess capital to account for an unanticipated IM change, which would necessarily limit market participants' ability to invest capital elsewhere or meet other cash flow needs. Under the second outcome, market participants would hold additional capital in reserve, and then an unanticipated change in an IM requirement could result in a series of defaults, which could have procyclical effects if a class or multiple classes of participants have the same undisclosed margin models and must close or cover their positions at the same time. Requiring transparency with respect to IM will allow counterparties to model for and anticipate margin changes and to avoid these two outcomes.

Secondly, MFA strongly believes that IM models should be objective (*i.e.*, a model should arrive at the same IM amount for identical contracts regardless of the counterparty's identity), although the ESAs could allow entities to use a multiplier that is distinct from the base IM model to address any concerns about a counterparty's creditworthiness. We are concerned that, without legally required transparency: (i) parties may alter their models to produce a more favorable output when determining IM requirements for a particular counterparty or class of counterparties; and (ii) parties will not have the information necessary to anticipate potential changes in IM requirements. Neither potential outcome is desirable. Therefore, MFA recommends that the ESAs' technical standards allow entities to use the "Internal Model Method" to determine IM amounts, but require such entities to make the basic functionality of their IM models available to, and replicable by, their counterparties.

Q22. What are the incremental compliance costs (one-off/on-going) of setting up appropriate internal models?

MFA notes that many PRFCs already have internal models for the calculation of IM. Therefore, we would anticipate limited compliance costs where the ESAs require only PRFCs to collect IM. However, where the technical standards require all parties to post and collect IM, the costs to other market participants that do not currently have these internal models would be significant and it would take considerable time for them to develop such models.

Q23. To what extent would the "Mark-to-market method" or the "Standardised Method" change market practices?

Market practice currently allows parties to agree to a variety of IM determination methods, and thus, the imposition of either of these standard methods would alter market

practice. As noted above, it is important that the ESAs preserve flexibility as to the methods parties can use to calculate IM, and such flexibility is consistent with the U.S. Proposals.[37]

Q24. Do you see practical problems if there are discrepancies in the calculation of the IM amounts?[38] If so, please explain.

Discrepancies as to calculations are a consistent issue arising between parties in the OTC derivatives market. MFA submits that, in the event of an IM discrepancy or dispute between the parties, the posting party should post the undisputed margin amount and dispute resolution procedures agreed between the parties should resolve the issue with respect to disputed amounts. We also note that implementing transparency requirements as to IM calculation models, as suggested above, should reduce the number of discrepancies, since parties will be able to replicate and verify independently the calculations.

Q25. Would it be a feasible option allowing the party authorised to use an internal model to calculate the IM for both counterparties?

MFA is of the view that this option would be feasible; provided that, the parties have agreed to this approach and the relevant internal model is transparent and replicable.

Initial Margin – Segregation and Re-use (Q27-31)[39]

Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?

MFA supports measures aimed at increasing protections for counterparty assets posted as collateral for non-cleared derivative contracts, and we note at the outset that the effectiveness of any segregation model in protecting the interests of counterparties will depend on the local insolvency laws in each Member State. Thus, it is important for the ESAs to consider this issue when preparing the technical standards to ensure that the types of segregation permitted or mandated are appropriate and effectively protect counterparties' assets. In particular, MFA respectfully urges the ESAs to mandate: (i) the appropriate segregation of collateral, unless the posting party opts out (*i.e.*, the default position is that the posting party must receive the highest level of protection); and (ii) that the posting party has a definite right to, and an appropriate mechanism to ensure, prompt return of all posted IM upon the receiving party's default or insolvency. To the extent that the ESAs provide options within the segregation framework, it is critical that the ultimate choice between those options remain with the posting party, including

[37] *Supra* note 23.

[38] The ESAs set out that, in the case of transactions where the counterparties calculate different IM requirements (*e.g.*, where one counterparty uses a standardized approach and the other counterparty uses an internal approach), in the ESAs' views the following treatments are conceivable: (i) either both counterparties actually require different IM amounts for the same transaction or set of transactions; or (ii) one of the counterparties may be designated to calculate the IM requirements for both counterparties (*e.g.*, the one that uses the internal model).

[39] Discussion Paper at 16, paragraphs 43 to 45.

the right to segregate in a manner that ensures the posting party's IM is bankruptcy-remote from the receiving party's insolvency estate.[40]

Q28. If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?

As noted above, the effectiveness of any segregation regime in protecting the interests of counterparties will depend on the local insolvency laws in the relevant Member State. This issue is particularly sensitive where the party receiving the cash collateral is a depository holding segregated cash in a pooled account. In such circumstances, upon the receiving party's default or insolvency, a posting party may not be able to assert a claim for a portion of that segregated pool and will instead have to undertake a tracing exercise with its related evidential difficulties. This outcome is clearly undesirable, and thus, MFA urges the ESAs to draft technical standards that provide at least the option for segregation of cash collateral in a separate named account.

Q29. What are the practical problems with Tri-Party transactions?

MFA is of the view that maintaining posted collateral pursuant to tri-party custodial arrangements is helpful in protecting the posting party's assets in the event of the receiving party's default or insolvency. We believe that the markets are able to overcome any practical problems in this regard, and indeed, a number of stakeholders are endeavoring to simplify the administration of tri-party custodial arrangements by standardizing the necessary documentation.

Q30. What are current practices regarding the re-use of received collateral?[41]

Q31. What will be the impact if re-use of collateral was no longer possible?

In the OTC derivatives market, tri-party arrangements currently prohibit the receiving party from re-using IM posted by its counterparty, since the third party custodian holds the collateral in an account under the name of the posting counterparty. Therefore, any prohibition on re-use would have minimal impact on such arrangements. In contrast, under bilateral arrangements, the parties to the agreement determine the re-use of collateral. Thus, a prohibition in this context would have an impact by restricting the choices of the counterparties and potentially increasing costs. Consistent with our view that parties have some flexibility to negotiate the terms of IM requirements, MFA submits that the technical standards should leave the parties to a bilateral arrangement free to negotiate this point.

[40] *Id.*, paragraph 44. The ESAs are of the opinion that collateral received has to be segregated, at least in the case of an exchange of collateral (*i.e.*, where both counterparties provide collateral), and that for transactions where only one party posts collateral, the receiving party is only required to segregate the collateral if the posting party requests such segregation.

[41] *Id.* at 17, paragraph 45. The ESAs are currently of the view that the technical standards should not permit re-use of collateral.

Eligible Collateral (Q32-35)[42]

Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?

Q34. What consequences would changing the range of eligible collateral have for market practices?

Q35. What other criteria and factors could be used to determine eligible collateral?

MFA is of the view that the parties to the transaction should agree as to what constitutes eligible collateral, and that the ESAs should permit parties to exchange a wide range of assets. We are concerned that restricting "eligible collateral" to a list will result in an additional premium on such collateral, and that technical standards that restrict the range of eligible collateral will adversely impact liquidity because market participants will be exchanging a finite set of instruments. Therefore, MFA respectfully suggests that, if the ESAs set out criteria for determining what constitutes eligible collateral, such criteria should include that the collateral: (i) have a determinable market value; (ii) be capable of accurate revaluation; (iii) be susceptible to frequent valuation; and (iv) be readily transferable so that the relevant party or administrator can liquidate it promptly. We believe that these criteria will ensure appropriate protection in a default scenario without being unduly restrictive.

Collateral valuation / haircuts (Q36-40)[43]

Q36. What is the current practice regarding the frequency of collateral valuation?

Q37. For which types of transactions / counterparties should a daily collateral valuation not be mandatory?

Q38. What are the cost implications of a more frequent valuation of collateral?

MFA understands that current practice is for the parties to a transaction to agree to the frequency of collateral valuation. However, in most cases, the parties agree to daily collateral valuations, and we note that without the daily valuation of collateral there can be no appropriate daily exchange of collateral. Thus, given current market practice and the importance of daily valuation, MFA believes that the ESAs should not provide exceptions to a daily collateral valuation requirement for any eligible collateral (see our response to Q35 above). Where posted

[42] *Id*., paragraphs 46 to 49, where the ESAs consider two options for defining the types of eligible collateral that parties can use to satisfy margin requirements. Under Option 1, the collateral requirements could be linked to ESMA's criteria-based collateral requirements as defined in Article 43 of EMIR, and hence, allow the same types of collateral that are also eligible for central clearing. Under Option 2, the ESAs could provide a prescribed list of eligible collateral (*e.g.*, by referring to the CRR list of financial collateral eligible), and PRFCs could deviate from this list for eligible collateral recognized by the specific regulation to which they are subject (*e.g.*, Solvency II).

[43] *Id*. at 18, paragraphs 50 and 51, where the ESAs express their initial view that the valuation of collateral be done daily, but acknowledge that there may be conditions under which the valuation could occur less frequently.

collateral consists of assets with relatively high liquidity (*e.g.*, regularly traded financial instruments), the cost of more frequent valuations should not be significant since daily valuation is currently commonplace. In any event, MFA submits that risk mitigation benefits associated with the frequent valuation of collateral justify some additional costs where these arise.

Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?[44]

Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?

Current market practice allows parties to use their own estimates of haircuts. MFA believes that parties should be able to use their own estimates; provided that, the parties apply these haircuts on a consistent and transparent basis and do not vary them according to the type of counterparty involved. MFA does not generally support limiting use of an entity's own estimates of haircuts to PRFCs, unless the parties to the transaction agree that such a limitation is permissible. Such a limitation implies that other parties are not able to estimate the volatility of collateral, and we believe such an assumption is incorrect. Rather, the ESAs should permit all parties that are able to assess accurately fluctuations in collateral values to use their own estimates; provided that, the parties make their calculations in a transparent way.

Risk Management (Q41-44)[45]

Q41. In your view, what criteria and factors should be met to ensure counterparties have a robust operational process for the exchange of collateral?

Q42. What incremental costs do you expect from setting up and maintaining robust operational processes?

MFA agrees with the ESAs that counterparties' should have robust operational processes for the exchange of collateral and counterparties' arrangements should include appropriate documentation and processes, including appropriate systems and controls.[46] The ESAs should ensure that counterparty operational processes are clear, comprehensive and address key events and issues including, but not limited to: (i) margin calculations (*e.g.*, require parties to calculate margin in a timely fashion using accurate measures); (ii) daily valuation of collateral and the applicable methodology; (iii) data protection, both in terms of records kept (*e.g.*, contract terms) and information transmitted (*e.g.*, margin calls); (iv) dispute resolution procedures, including provisions dealing with the retention and recall of records as well as steps to ensure timely

[44] *Id.*, paragraph 51. For the determination of the respective haircuts, the ESAs are currently considering two options: (i) all counterparties have to use standardized haircuts; or (ii) allowing those counterparties that meet certain minimum requirements to use their own estimation of haircuts.

[45] *Id.* at 19, paragraphs 53 to 55. The ESAs highlight that the exchange of collateral is an important risk mitigation technique for non-centrally cleared OTC derivatives. Therefore, the operational process for the exchange of collateral should be robust, incorporating appropriate documentation, systems and controls.

[46] *Id.*, paragraph 54.

resolution and/or appropriate escalation to senior personnel; and (v) systems to ensure transaction failures are detected, resolved and, where appropriate, reported promptly.

Q43. What are your views regarding setting a cap for the minimum threshold amount? How should such cap be set?[47]

Q44. How would setting a cap impact markets, transactions and business models?

MFA agrees with the ESAs that parties should agree as to the minimum transfer amount. Moreover, we believe that there should a cap for minimum threshold amount, but that the parties should determine that amount between themselves because we think that the ESAs drafting technical standards to set such a cap is unduly prescriptive in this context. Specifically, because such a determination must allow for a number of party-specific variables (*e.g.*, the creditworthiness of the parties, the types of collateral they are posting and the other risk mitigation techniques to which they are subject), we submit that it would be more efficient and effective for the parties to determine the minimum threshold amount.

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MFA thanks the ESAs for the opportunity to provide comments regarding the proposals in the Discussion Paper. We strongly support the efforts of the ESAs to develop technical standards in response to the mandates given to them in EMIR. We would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact Carlotta King or the undersigned at (202) 730-2600 with any questions the ESAs or their staff might have.

Respectfully submitted,

/s/ Stuart J. Kaswell

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[47] *Id*., paragraph 55. In order to avoid heavy back office work and to limit operational costs, the ESAs are considering setting a cap to the minimum transfer amount below which a party need not transfer collateral. The ESAs believe that the minimum transfer amount should be subject to agreement by the counterparties, but that the draft technical standards should set forth a cap that such minimum should not exceed.