Alternative Investment Management Association

MANAGED FUNDS ASSOCIATION

EUROPEAN SECURITIES AND MARKETS AUTHORITY
103 Rue de Grenelle
Paris
75007
France

30 September 2015

Dear Sirs,

Joint Response to ESMA Discussion Paper on the Review of Article 26 of RTS No 153/2013 with respect to client accounts

The Alternative Investment Management Association (**AIMA**)[1] and Managed Funds Association (**MFA**)[2] (together, **we**) are grateful for the opportunity to respond to the European Securities and Markets Authority (**ESMA**) 'Discussion Paper on the Review of Article 26 of RTS No. 153/2013 with respect to client accounts' (**Discussion Paper**).[3]

Our hedge fund manager members are extensive participants in the global exchange-traded derivative (**ETD**) and cleared over-the-counter (**OTC**) derivative markets. Our members use these derivative instruments for the purposes of both hedging and establishing directional exposures. Our members access each central counterparty (**CCP**) as direct clients of one or more clearing members (**CMs**) of that CCP. Under such clearing arrangements, the initial margin (**IM**) that our members post as collateral is maintained in client accounts held at either the CM or CCP level. Such IM is held using either: (i) an omnibus segregated account (**OSA**) structure (where the IM is calculated on a net or gross basis),[4] or (ii) an individually segregated account (**ISA**) (where the required IM is calculated on a gross basis). We, therefore, have a strong interest in regulators' development of robust and proportionate clearing and margin rules that provide flexibility as to the amount of margin that clients must post in relation to different derivatives instruments, and whether clients' margin must be held at the CM or CCP level.

We praise the European Commission (**Commission**) and ESMA for seeking further public feedback as to the optimum minimum margin period of risk (**MPOR**) to be applied under EU rules for margin held in client accounts for different categories of derivative contracts under Article 26 of Delegated Regulation No. 153/2013 (**RTS**). Both AIMA's and MFA's members support the development of well

[1] Founded in 1990, the Alternative Investment Management Association (AIMA) is the global representative of the hedge fund industry. Our membership is corporate and comprises over 1,500 firms (with over 9,000 individual contacts) in more than 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members collectively manage more than $1.5 trillion in assets. See www.aima.org.

[2] 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.

[3] Available online at: http://www.esma.europa.eu/system/files/2015-1295_dp_on_review_of_article_26_of_rts_153-2013.pdf

[4] *See* US Commodity Futures Trading Commission (**CFTC**) final rule on 'Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions', 77 Fed. Reg. 6336 (Feb. 7, 2012), requiring market participants subject to the CFTC's swap rules to segregate collateral posted on cleared swaps using the legally segregated with operational commingling model (**LSOC**), available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2012-1033a.pdf. We note that the US Securities and Exchange Commission has not finalized its segregation rule for cleared security-based swaps.

formulated and globally consistent regulation, which is particularly important for the derivatives markets due to their truly global nature.

However, we believe fundamentally that the key priority for the Commission at this time should be ensuring the swift and reciprocal recognition of US CCPs and the determination of equivalence with respect to the CFTC's OTC derivative and ETD clearing rules. The importance of the Commission reaching an agreement with the CFTC on these issues has become even more critical due to the formal adoption by the Commission of final RTS for the mandatory central clearing of G4 currency OTC interest rate swaps (**IRS**),[5] which are due to be published in the Official Journal of the European Union and enter into effect next year, as well as the impending clearing obligation for ETDs under Regulation (EU) No.600/2014 on markets in financial instruments (**MiFIR**),[6] the latter of which enters into effect on 3 January 2017.[7]

We consider that it is vital to the ongoing liquidity of ETD and OTC derivative markets that participants that transact on a cross-border basis have certainty that they will be subject to a single set of non-conflicting rules. We recognise, of course, that there are certain differences between the US and EU regimes – such as the US rules' one-day gross margin requirement and the EU rules' two-day net margin requirement, as discussed in the Discussion Paper. However, we believe that these differences are minor and should not form a barrier to US equivalence. Rather, we consider that both EU and US rules appropriately and robustly implement the G20 commitments to make the derivatives markets safer and are compliant with the relevant IOSCO Principles for Financial Market Infrastructures.[8]

Nonetheless, we look forward to the Commission and ESMA's work, following the Discussion Paper and the conclusion of equivalence negotiations, to harmonise the MPOR and other margin rules between the EU and US.

Our detailed response to the Discussion Paper contained within the Annex, below, makes the following key points:

- The Commission and ESMA should undertake further empirical research to reach definitive conclusions as to the superiority of either one-day gross or two-day net margining;
- For larger CMs, we expect that more margin would be held at the CCP level if it utilised a one-day gross model, rather than a two-day net OSA model;
- OSA structures offer stability benefits to the CCP, but we do not believe that the RTS should make ISA structures less attractive for clients;
- We disagree with the suggested increase of the MPOR for cleared OTC derivatives using net OSA structures, and would instead recommend maximising flexibility for CCPs to calculate margin as is appropriate to the particular characteristics of the relevant cleared OTC instrument;
- The RTS should not facilitate intra-day margin calls becoming standard practice, because such calls should be used only as an emergency tool during stressed market conditions; and

[5] *See* Commission Press Release on 'Financial stability: new Commission rules on central clearing for interest rate derivatives', dated 6 August 2015, available at: http://europa.eu/rapid/press-release_IP-15-5459_en.htm.

[6] Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0600.

[7] Without an agreement, a transaction between two in-scope counterparties located in the EU and the US would be forced irreconcilably to comply with both sets of rules. Of course, a contract can be cleared only in one jurisdiction and subject to one set of rules. It is vitally important that transactions between US and EU counterparties be cleared according to the most relevant rules to the particular contract.

[8] Available at: http://www.bis.org/cpmi/publ/d101a.pdf

- It would not be practical to oblige each client to maintain arrangements with one or more back-up CMs to guarantee acceptance of its cleared positions should the a CCP need to port the client's positions to such back-up CM due to the failure of the client's primary CM. Therefore, instead of introducing such a back-up CM obligation, we recommend that the Commission and ESMA focus on maximising the likely success of porting through clear and automated processes and practical experience before a CM's failure.

If you have questions on any aspect of our response or would like to discuss further, please contact Oliver Robinson (orobinson@aima.org) or Adam Jacobs (ajacobs@aima.org) of AIMA, or Carlotta King (cking@managedfunds.org) or Stuart J. Kaswell (skaswell@managedfunds.org) of MFA.

Yours faithfully,

/s/

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Deputy CEO
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/s/

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cc: Maria Teresa Fabregas Fernandez, Head of C2 Financial markets infrastructure, European Commission

Annex

Q1: ESMA welcomes views on the assumption that client margins maintained at CCP level on a OSA gross margining with one-day liquidation period would generally be higher than margin held at the CCP under an OSA net with a two-day liquidation period. Please, provide quantitative analysis on the effect of the reduction of margin on the basis of 2 vs. 1 day MPOR and of the net (between clients' positions) margining vs gross margining. Please also consider the potential impact of the case in which a one-day OSA gross is considered equivalent to the EU system and the RTS are not changed and the impact for the whole system if the MPOR at CCP level is reduced.

Overall, **we would suggest that insufficient work has been undertaken to date to demonstrate empirically whether a one-day liquidation period for gross OSA margining results in a CCP holding higher margin than if the CCP utilised a two-day liquidation period for net OSA margining**. In particular, ESMA notes at page 6 of the Discussion Paper that, in a preliminary comparison conducted by the CFTC, margin requirements calculated using the gross margining method and a one-day liquidation period were typically higher than margin calculated using a net margining method with a two-day liquidation period. However, ESMA also notes that the CFTC based this comparison on a restricted sample of just one EU and one US CCP. We do not consider such a sampling and comparison of CCPs to be sufficient to draw any conclusion. Therefore, we would strongly encourage ESMA and the Commission to undertake their own quantitative impact study, similar to that of the CFTC to obtain a robust and effective conclusion as to the different model structures.

Due to the nature of our membership, we are not in a position to conduct such quantitative analysis ourselves. **However, based on our understanding, it appears reasonable to assume that more IM would be held by a CCP using a one-day gross rather than two-day net calculation, *for large CMs***. The reason that the amount of collateral held at the CCP level may be lower when a CCP uses a net calculation is because the portfolio effect of different clients' transactions offset the market risk of one another.[9] These offsetting risks means that the CCP has a reduced economic exposure to the CM's clients than would have been the case if all of the CM's clients were individual credit risks to the CCP. Essentially, the CCP is able to treat all clients under a net OSA structure as a single netted exposure, therefore, require less IM from the CM. We understand anecdotally that this outcome means that, for large CMs, approximately half of the collateral collected by the CM is delivered to the CCP under a net margin arrangement.

Of course, **if a CM is not large enough to have a sufficient volume of client transactions for the portfolio effect to result in these offsetting positions, then the IM called by a CCP using a net calculation will be similar to that under a gross calculation**. For example, hypothetically, if a CM had only a single client, it would have no offsetting transactions of other clients. Thus, the amount of collateral delivered to the CCP by the CM would be exactly the same under both a net and a gross calculation.

Assuming netting is not possible, such that all client positions are gross for the purposes of IM calculation, differences in the MPOR will also lead to differences in the IM requirement.

Under typical portfolio management risk procedures, it is common for market participants to estimate multiple-period volatility - measured using standard deviation (**SD**) – by taking the volatility of a single period and multiplying that figure by the square root of the total number of time periods over which volatility is to be estimated.[10] Using this very basic approach, increasing the MPOR for IM from one day to two days will increase the amount of IM required by 40% (*i.e.*, one

[9] For example, if one client is long the April 2016 Eurostoxx future and a different client in the same OSA is short the April 2016 Eurostoxx future.

[10] Certain assumptions underlie this calculation, including that the variance of each sub-periods is the same (*i.e.*, *homoscedastic*) and that the volatility of each of the sub-periods is independent through time (i.e., no autocorrelation). If the sub-periods exhibit perfect correlation, the calculation would simply involve multiplying the single period volatility by the number of periods.

day IM x 1.41 (which is the square root of two)). Conversely, the IM for a one-day MPOR should be around 70% of that required for a two-day MPOR.

Using a stylised example that takes into account the numerous assumptions and highly simplified approach to volatility and CCP margin calculations noted above, we can demonstrate how one-day gross and two-day net OSA structures can theoretically result in more or less margin being held at the CCP.

Based on an assumption of a net OSA structure that involves a 50/50 split of client collateral between the CCP and CM (50% of client IM being posted to the CCP and 50% being retained by the CM), a CM that has taken €100m IM from its clients using a **one-day MPOR** calculation will need to post around €50m of that to the relevant CCP. Should a gross OSA structure be used, all €100m would need to be posted to the CCP. **Thus, the gross structure in our example would result in an extra €50m being held at the CCP.**

If the CCP were to move to a **two-day MPOR** calculation, then using our simplified approach to volatility, the CM would call €140m IM from its clients ($100 x 140%). Assuming the same 50/50 split under the net OSA structure, the CM would post **€70m** to the CCP. Whereas, the gross OSA structure would require the full **€140m** to be posted to the CCP; again, resulting in the CCP holding more margin than under the net OSA model.

ASSUMING AN OSA STRUCTURE AND 50/50 SPLIT OF COLLATERAL				
	One-Day Net MPOR	**One-Day Gross MPOR**	**Two-Day Net MPOR**	Two-Day Gross MPOR
IM Amount Collected by CM from Clients	€100m	€100m	€140m	€140m
IM Amount Retained by CM	€50m	€0m	€70m	€0m
IM Amount Posted by CM to CCP	€50m	**€100m**	**€70m**	€140m

When comparing the results of our highly simplified and stylised example, we can see that the amount of margin collected from the client under a two-day net OSA structure, would be greater than the amount of margin collected from the same client under a one-day gross OSA structure. However, once the split of collateral is adjusted so that 70% of the margin collected from clients is posted to the CCP, **more margin would in-fact be posted to the CCP under a gross OSA structure using a one-day MPOR, than would be posted to the CCP under a net OSA structure using a two-day MPOR**.

From the perspective of the EU financial system, we, therefore, do not consider that reducing the minimum MPOR for gross OSA structures from two days to one day is likely to have a detrimental impact.

As noted at pages 10 and 11 of the Discussion Paper, we agree that OSA models – both net and gross - provide greater freedom to CCPs to utilise margin to manage the default of a CM when compared to ISAs. We suggest that this flexibility results in OSA structures having a greater euro-for-euro stabilising effect on the whole financial system when compared to ISA and the US LSOC model for non-ETDs. One benefit of OSA structures to CCPs, above LSOC and ISAs, is the fact that when one client's derivatives are ported post-default of its CM, that client's collateral remains behind with

the CCP. The collateral continues to provide the CCP with a buffer for the remaining clients' derivatives in the OSA, thus reducing the likelihood that the collateral held by the CCP for the remaining derivatives is exhausted. Of course, from a client's perspective, we support the client's right to have their margin held in an ISA account due to the numerous collateral protection benefits. Thus, **we agree strongly with ESMA at page 10 of the Discussion Paper, where ESMA notes that making ISAs less attractive would be counter-intuitive bearing in mind the many positive benefits of ISAs for clients, including improved portability**. During the CFTC's regulatory development process, we have consistently advocated for the CFTC to allow clients the option of an ISA model under US clearing rules.[11]

In specific response to the above question on the impact of deeming the one-day gross OSA model equivalent without amending the RTS, we are certain that the impact would not be significant. We would suggest that a far greater market impact would be felt should the EU and US authorities fail to reach an agreement with regard to US and EU CCPs before the relevant EU ETD and OTC derivative clearing obligations under EMIR and MiFIR enter into effect because such lack of agreement would result in duplicative and conflicting requirements. **We believe strongly that the process to amend the RTS should not delay the adoption of an equivalence determination with respect to US rules and *vice versa*.** We would encourage ESMA to undertake amendments deemed necessary after this formal review process on an *ex post facto* basis.

We note the Commission's concern raised at page 6 of the Discussion Paper as to the possibility that market participants would use the EU and US regulatory differences to engage in regulatory arbitrage. However, **in practice, we do not believe that the deliberate structuring of transactions to avoid EU margining rules is a likely outcome.** We believe that counterparties will continue to do business with those venues and counterparties that are most appropriate for the overall economics of the particular transaction, with the applicable margin requirements being only one of many considerations. Therefore, in our view, the application of one-day MPOR or two-day MPOR for gross OSAs would not be a principal concern that would overrule such venue considerations and lead to regulatory arbitrage.

Q2: If the RTS were modified to allow one-day gross margin collection for ETDs, should this be extended to financial instruments other than OTC derivatives? What are the costs and benefits of either approach?

No comment.

Q3: If a differentiation of MPOR is made for ETDs depending on the gross or net collection of margins, should this differentiation be made for OTC derivatives as well? Would seven days MPOR for OTC derivatives be appropriate for net OSA? Please, provide quantitative analyses in support of your answer.

We do not agree in principle that any differentiation of the MPOR for ETDs based on the net v. gross collection of margin should lead to differentiation for OTC derivatives as well. We would value ESMA's further elaboration upon the specific objective of an extension of the minimum MPOR for OTC derivatives before ESMA issues any formal proposal in any future ESMA consultation containing draft amendments to the RTS.

[11] *See* MFA letter to CFTC on its advanced notice of proposed rulemaking on "Protection of Cleared Swap Customers Before and After Commodity Broker Bankruptcies", filed with the CFTC on Jan. 18, 2011, available at: http://www.managedfunds.org/wp-content/uploads/2011/06/1.18.11-CFTCANPRClearedSwapSegregationFinalMFALetter.pdf; and MFA letter to CFTC on its proposed rules on "Protection of Cleared Swap Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions", filed with the CFTC on Dec. 2, 2011, available at: https://www.managedfunds.org/wp-content/uploads/2011/12/CFTC-Cleared-Swap-Segregation-Rules-MFA-Final-Supplemental-Letter.pdf.

Overall, our members believe in maximising the flexibility available to CMs and CCPs to adjust the MPOR for the margining of particular instruments according to each instrument's particular liquidity characteristics. By way of a practical example, after the collapse of Lehman Brothers in 2008, many OTC derivative instruments - such as equity, interest rate and liquid credit derivatives - could be closed out within a day, whereas others – such as particularly complex credit derivatives – took far longer to value and close out.

As CMs and CCPs have both the fundamental economic interest in the transactions and substantial knowledge about the most efficient margining practices, we believe it is reasonable and beneficial to provide CMs and CCPs with the flexibility to adjust the MPOR as needed to account for the nature of the derivative transaction. We think that providing this flexibility is particularly reasonable given that the OTC derivatives that are commonly cleared are the most standardised and liquid, and so least likely to need lengthy periods to close out.

Q4: Should ISA and gross OSA be treated equally in terms of MPOR? Please provide quantitative evidence to support your arguments.

We believe that ISA and OSA should be treated equally in terms of MPOR. We agree with the Discussion Paper at page 11, which states that reducing the MPOR for gross OSA but not ISA structures would make ISAs significantly less attractive. We strongly believe that encouraging clients to enter into account structures that are less protective of their assets would be counter to the objectives of EMIR and global mandatory central clearing.

Q5: Do you consider that specific conditions should apply in order to ensure that margins are called intraday in case the MPOR is reduced to 1-day under a gross client margins collection?

We note that an intraday margin call is a risk mitigation tool that is open to CCPs and CMs. Therefore, any client could be subject to such a call at any time.

Nonetheless, **we have concerns about making the intraday calling of margin a standard practice**. From an operational standpoint, we believe that it would be cumbersome on clients and would result in the less efficient use of assets as clients would need to reserve additional assets to have assets available at all times to meet any such intraday margin calls.

Furthermore, if the results of the EU's quantitative study of one-day gross margin indicates that CCPs are, in-fact, more protected under a one-day gross margin regime than under a two-day net regime, we feel strongly that the introduction of mandatory intraday margin calls would be disproportionate and unnecessary.

Q6: Do you agree that entities of the same group as clearing members should not be allowed to benefit from a lower MPOR even if they chose an OSA gross or ISA account? What are the costs and benefits of either approach?

No comment.

Q7: Do you consider that specific conditions (e.g. compulsory pre-existing arrangement with a back-up clearing member) should apply in order to enhance the portability of client positions in order to benefit for the gross margining with one-day liquidation period? What conditions in your view would enhance the portability of client accounts? What are the costs and benefits of the suggested condition? Is it feasible that each client in an OSA would nominate a back-up

clearing member or could this be a practical impediment to the establishment of gross margining? Is it feasible to expect an alternative clearing member to guarantee to accept porting of a client's positions in the event of the primary clearing member's default?

In principle, the possibility of all clients being able to access a back-up CM upon their principal CM's default or other operational issues would be valuable. However, in practice, due to the significant costs involved with onboarding with a CM as a direct client combined with the undersupply of CM client clearing offerings, it is not realistic to envisage such a requirement to be placed on clients or CMs.

We would note that, for larger fund managers, operational and risk management best practice means that they use several CMs in the ordinary course of business. Such CM diversification has the indirect consequence of providing larger clients with a pre-existing relationship with one or more back-up CM(s). However, **to place an obligation on <u>all</u> clients to maintain such pre-existing arrangements with a back-up CM would not be appropriate or viable in practice**. The operational due diligence and other negotiations required to onboard with multiple CMs would be disproportionately expensive for the majority of smaller managers or those managers that make more limited use derivative contracts. In addition, CMs would likely charge costly fees to such smaller clients or clients with smaller trading volumes (if the CM is willing to enter into a relationship with these clients at all).

In direct response to the final sub-question of Question 7, other than for exceptional relationships, **we do not believe that CMs would be willing to <u>guarantee</u> to accept porting of another CM's client positions in the event of the primary CM's default.** Without a buy-side entity using a CM to trade a sufficient volume of transactions, there is very little economic incentive for a CM to onboard that buy-side entity into its client clearing systems. Basel III imposes substantial capital costs on CMs such that the Basel III rules have greatly reduced the incentives for a CM to accept a direct client who trade through them only *in extremis*. Therefore, to onboard such buy-side entities would require the CM to accept certain operational losses or would necessitate the client paying a significant fee to the CM for the service.

It is true that, during the collapse of Lehman Brothers in 2008, surviving CMs <u>voluntarily</u> accepted the majority of another CM's outstanding client positions. However, **while firms may be willing to take on clients at the time of a default, if they are able to assess the situation and get comfortable with the client at the time, obtaining a CM's firm commitment to do so *ex ante* is difficult**.

We believe strongly that the best way to enhance portability of client accounts is to ensure that: (i) the **relevant tools and processes are in place** to enable CCPs to transfer client positions from one CM to another in an automated and predictable manner; ***and*** **(ii) CCPs test those tools and processes to the greatest extent possible <u>prior</u> to a CM's failure**. It would not be advisable for a CCP to wait until a CM's failure to utilise a porting mechanism for the first time.

Q8: Is there any other aspect or concern that ESMA should consider when reviewing Article 26 with respect to client accounts?

No comment.