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European Securities and Markets Authority
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Purpose: Consultation Paper ESMA

AFG comments to ESMAǒs consultation paper on the Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

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The Association Française de la Gestion financière (AFG)[1] welcomes ESMAǒs consultation paper on Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories.

General Comments

We believe regulators should strike a balance between improved transparency and the possibility for non-speculative investors to carry on their business without excessive costs. Our members would like to stress the following points:

[1] The Association Française de la Gestion financière (AFG)1 represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups. AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes ï beside UCITS ï the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

- Credit standing of CCPs: the mandatory use of CCPs will reduce the diversity of counterparties and hence may increase risks if CCPs are not totally safe for investors, who will mandatorily access them through clearing brokers; we would appreciate that CCPs be identified as SIFIs (systemically important financial institutions), with specific capital requirements and controls that it implies, and have access to central bank money;

- Reporting to TRs: the list of items to be reported to TRs as it stands in the annex of the discussion paper looks very long and burdensome when compared to the items necessary to confirm a trade through a confirmation platform for example. It seems not necessary to have so many criteria to properly identify trades and for the regulators to be able to conduct appropriate controls. Also, it is highly desirable to seek consistence with other reporting requirements under MIFID or Dodd Frank and operational requirements of various clearing platforms for example. We believe that asset management companies and insurance companies should be exempted from reporting obligations as their counterparts/clearing members would perform the reporting. In general, for information to be reported, it would be useful to make use of standards already present in the market (like the Legal Entity Identifier" (LEI) or "Unique Product Identifier" (UPI), etc.).

- Clearing obligation: we understand an eligible derivative product is not supposed to be treated OTC any more, however our members would like to keep the possibility for the funds to quit the transaction at any time, especially if liquidity is needed to pay redemptions.

- Clearing obligation procedure: Eligibility criteria could include prospective data on expected volumes by the CCP or the standardization of the instrumentôs operational model (for instance technical norms like those of ISDA could be useful).

We would also like to note the short deadline for market participants to implement these news rules the difficulty to evaluate the real costs of all these measures. Indeed, the deadline of 31 December 2012 may be too tight to implement this entirely new market structure.

Finally, the Discussion Paper implements a new contract chain between a CCP, direct clients and indirect clients. We would like to draw ESMAôs attention on the fact that **this contract chain should not affect the provision set out in article 50 of UCITS Directive 2009/65/EC** on the coordination of laws, regulations and administrative provisions relating to UCITS, which allows UCITS to sell, liquidate or close any OTC derivative by an offsetting transaction at any time at its fair value.

Many questions will not be commented as our members do not feel they have a strong view to express on the point they raise and are globally satisfied with ESMAôs position.

Please see our detailed responses below:

III OTC Derivatives

III.I Clearing Obligation:

<u>Type of indirect clearing arrangements (ART. 4 of EMIR and Annex II, Chapter II, ICA)</u>

Direct and indirect clients should benefit from exactly the same level of protection, which means that indirect and direct clients should have the same rights particularly vis-à-vis the CCP.

From an asset manager point of view we find the definition of indirect client being a ñclient of a client of a clearing memberò (see Annex Chapter I Art. 2 (1)) not sufficiently clear to determine the relevance of the indirect clearing rules in respect to our set-up.

We understand that the rulemaking was essentially made to cover regional banks, cooperative structures or saving banks which get clearing access only via a roof financial institution, which qualifies as direct client. Nevertheless the definition leaves room for interpretation with respect to its application to fund structures and asset management companies.

Where an asset manager acting in the name and on behalf of its funds is not able to get directly access to a clearing member and have to establish clearing relationship via a financial institution we support the protective approach of ESMA to ensure similar treatment as if its funds under management would be direct clients.

For the avoidance of doubt, we think it is not adequate to apply this architecture to an asset manager acting in the name and on behalf of the funds it manages. The asset manager should not be considered as direct client as he has no self interest in the clearing relationship with the clearing member. From discussions we had with different clearing members we also understand that each fund would be considered as a direct client.

III.II Clearing obligation procedure:

Criteria used by ESMA to pronounce a mandatory clearing are rightly different from those used by the local authority to authorize clearing by a CCP. It then belongs to ESMA to regularly assess that the criteria are still met in order to reaffirm or dismiss the mandatory clearing. This point, if correct, should be mentioned in the text and a proper procedure defined in the RTS or in each RTS relevant to any new derivative submitted to mandatory clearing.

Standardisation includes a reference to both common legal documentation and (automated) post trade common practices. Legal templates should be able to be developed under different national laws provided they are sufficiently adaptable to common international dealings and accepted by the relevant CCPÕs. It should not be considered as a requirement to execute all trades under one unique law. More specifically use of French FBF contracts should be accepted if compliant with the rule book of a CCP.

We understand that Foreign Exchange Transactions are out of scope of the clearing obligation at this stage. It is also the point of view taken by BCBS and IOSCO in their consultation on Margin requirements for non-centrally-cleared derivatives[2]. We would appreciate if ESMA could confirm our understanding, in light of the position taken by BCBS/IOSCO, as it is crucial that the three entities are in phase on this topic.

III.V Non-financial counterparties:

[2] BCBS / IOSCO Consultative document ñMargin requirements for non-centrally-cleared derivativesò issued in July 2012 for comment by 28 September 2012

The existence of a threshold for foreign exchange derivative contracts prompts a question about the degree of inclusion of FX transactions within the scope of EMIR. If spot transactions are clearly out of scope and if options are clearly within the scope some uncertainty remains on forward transactions embedding a currency swap. It is of prime importance that international standards apply in this matter and EMIR and Dodd Frank should converge for the sake of fair international competition.

III.VI. Risk Mitigation for OTC derivative contract not cleared by a CCP

Timely confirmation

When describing the confirmation process (p 73, Chapter VIII, article 1, item 2) the mention ñwhere available via electronic meansò suggests an obligation to use electronic means as soon as they exist. It seems advisable to delete that phrase which might be misleading. What was meant is more likely a general statement that a better process includes the use of electronic means. Incidentally, the fact that the use of electronic means would imply a reduced delay for confirmation was rightly deleted from the proposed regulation.

So, we propose to write :

ñ(é *) 4. An OTC derivative contract concluded with a financial counterparty or a non-financial counterparty that meets the conditions referred to in Article 10(1)(b) of Regulation (EU no xxx/2012 [EMIR] and which is not cleared by a CCP shall be confirmed,* ~~*where available*~~ ***if relevant*** *via electronic means, as soon as possible and at the latest by the end of the sane business day.****ò***

ESMA took into consideration the remarks expressed by the profession to extend the delay for confirmation of non-cleared contracts. ñConfirmationò is defined in annex V on page 138 of the Paper as ñthe moment when the full terms of the contract and any relevant master agreement are agreed between both counterparties to the contractò. The definition is more positive in annex II. In practice, ñconfirmationò is materialized by the exchange of e-mail or fax mentioning all terms of the derivative which has been negotiated. There will be a necessity to add reference to contractual context and specifically master agreement to be compliant as it is not a common practice today. The exchange of fax or e-mail takes usually place within a couple of hours of the negotiation over the telephone, even if the signature of the paper documents will obviously be achieved days or weeks later. Thus a ñconfirmationò on the same day, except for late trading or time lag, seems possible. However we suggest that the definition of ñconfirmationò as it appears in Annex V be transferred to Annex II.

The number of pending contracts for a daily or weekly reconciliation and applying for other thresholds relates to contracts between counterparties, which means a fund and a specific counterparty irrespective of the capital links that exist between different entities of the same group. The inclusion of such a comment in a rationale would be helpful for clarification.

We would suggest that the monthly report should comply with the FED requirement: financial counterparties shall report on a monthly basis to the competent authority the number of unconfirmed OTC derivative transactions that have been outstanding for more than 30 business days (instead of 5 business days). Such reporting is appropriate to support authorities in supervising market participants.

A sufficiently long phase-in period would be needed to create an operational environment allowing parties to comply with requirements for timely confirmation and reporting of unconfirmed trades.

Portfolio reconciliation

Our members do not share the view that a distinction should be made between larger and smaller market participants when determining the frequency of reconciliation.

We broadly agree that the portfolio reconciliation should cover key trade terms that identify a particular derivative transaction as set out in the Discussion Paper and can be performed each business day when the counterparties have 300 or more OTC derivatives with each other. This is subject to the condition that the threshold shall take into account the number of OTC derivatives traded by a fund (and not at the level of its Investment Manager). The 300 figures for mandatory daily reconciliation seems appropriate as it would concentrate in the fund industry mainly on hedge funds very active on derivatives.

Normal practice at some bigger players is to reconcile on a weekly basis, but we consider that introducing a third category with quarterly reconciliation makes sense to protect very small participants from excessive administrative requirements. Maybe a number of transactions limited to 20 would be appropriate in this case.

Portfolio Compression

We broadly support that the counterparties should regularly assess whether portfolio compression should be undertaken, as trades that are not suitable for clearing could hardly be compressed, due to their complex and non-standardised structures.

Dispute Resolution

We believe that counterparties must have the possibility to develop the procedure over a flexible time period if there is a dispute that is not resolved in a timely manner is. It should be left to the discretion of each firm to decide on the necessary procedure to ensure that disputes are resolved in a timely manner.

We support rapid resolution of disputes at the portfolio level, but in practice resolution on a 5 day horizon is difficult, especially where it requires discussion of complex issues between parties located in vastly different time zones. A more flexible approach would enable market participants to adjust their processes to their specific environment.

Reporting of disputes

ESMA suggests that financial counterparties shall report to the competent authority any dispute relating to an OTC derivative contract, its valuation or the exchange of collateral for an amount or a value higher than EUR 15 million and outstanding for at least 15 business days. We believe that reporting to the competent authority on disputes should occur on portfolio level, not on individual trade level.

Marking to market and marking to model

It is referred to circumstances under which valuation will move from a marked to market to a marked to model approach. Its wording in very general terms is not a concern for an asset manager who is daily confronted with valuation issues. We insist that regulators should take a coherent approach between requirements for valuation of a derivative with a view to compute a NAV and in order to determine margin calls and adjust collateral. For example, under AIFM Directive an asset manager is required to refer to market prices, which might be produced by the counterparty for OTC derivatives, and challenges them by an independent valuation, generally based on internal models.

Intra group exemptions

Intra group exemption has not much relevance for an asset manager as portfolios are independent entities, except for mandates where the final client is the counterparty. However if the negotiation of derivative contracts is centralized for practical reasons (expertise, legal documentation, counterparty risk management...) it is clear that the transaction initiated by a fund and contracted for by a subsidiary or a department of the management company with an outside counterparty is a pure back to back transaction in the books of this intermediary interposed between the fund and the market counterparty: it does not create specific risk and could benefit from the intra group exemption.

IV. CCP REQUIREMENTS:

IV.II Recognition of a CCP:

The usual two principles that prevail in international affairs should apply when recognising third countryộs CCPs: equivalence of regulation and surveillance on one hand and reciprocity in terms of recognition of a European CCP abroad on the other hand.

IV.III Organisational requirements:

The key point of stakeholders participation in CCPộs Governance is commented in rationale 134 (p26) but concludes to the absence of regulation on the topic. We believe that there are many issues in the organisation of a CCP where interests of end users, i.e. investors, and clearing members are not convergent, not to say they are conflicting. For example the balance to be reached between default fund and initial margin is very critical in that respect. Thus, it would be advisable for the regulator to demand that end users have a say not only in the risk committee but also at the Board.

We agree with the global approach inspiring the risk management provisions as they appear in article 2. It points especially out the comprehensive view of relevant risks and their interdependencies (as mentioned in item 2) and the necessity to demonstrate that procyclical effects are suitably limited (item 7).

IV.V Business continuity:

The attention brought to communication in a period of crisis appears to be of prime importance to avoid rumours and have a credible account of the situation.

IV. VI Margins

If we do not disagree with the approach taking as look back period the average of two 6 months periods, it finds difficult to accept the proposed 99.5% confidence interval suggested for OTC derivatives and the 2 and 5 day liquidation periods. The presumption that OTC derivatives are more illiquid and riskier than other ones is not true, for many OTC derivatives are very actively traded, especially those which will meet the criteria to be centrally cleared. Anybody may find listed derivatives that are far less liquid than OTC vanilla contracts that will be the bulk of centrally cleared OTC derivatives. This evidence leads to the conclusion that the criterion of differentiation based on OTC versus listed contracts is not appropriate to determine confidence interval and liquidation periods. We suggest that there should be for the confidence interval only one minimum requirement of 99%,level that appears in the text of EMIR and in the consultation on ñmargin requirements for non-centrally-cleared derivativesò conducted by IOSCO and the Basel Committee. As far as liquidation periods are concerned the same idea of a single uniform minimum period established at 2 days seems acceptable, even if one may argue that many transactions can be liquidated within one day.

Furthermore, ESMA should reconsider its very restrictive view with regard to offsetting risks when portfolio margining: 80% offset limited to 70% minimum correlations is rather demanding and not adapted to, for example, the same proxy hedging that was accepted for Non Financials. Especially so if one does not overlook the requirement, justified as there is no provision for mutualisation of split default fund, that contracts should be covered by the same default fund to offset.

The article 5 is an anti procyclicality provision that we totally agree with. We think that among the keys to solve that issue there is the need to greatly diversify the eligible collateral (and include funds to the list) and to manage progressive changes in haircuts instead of abruptly exit one issuer from the list of eligible collateral.

IV.IX Default waterfall:

The discussion about the level of the default fund, although interesting and wise, misses a key point: the fact that CCPs are authorized to split the fund in separate sub funds. Thus, the proper approach should be to identify both capital needs and default fund on the basis of each fragment of the total activity of the CCP instead of having a common global view. We find that it is now time to determine with certainty whether capital and default fund are totally available as ñskin in the gameò or should be considered as elements of different ñgamesò. Financial stability resulting from CCPs capital structure is directly threatened by the current uncertainty on the level of mutualisation, if any, of these two components of CCPôs steadiness.

IV.X Collateral requirements

Collateral is designed to allow an alternative to cash deposit for both initial margin and default fund contributions. It is highly questionable that the default fund should not be deposited in cash in the hands of the CCP, then fully available without delay nor procedure and totally controlled in terms of risk and investments.

CCPs should give a large choice on a systematic basis on the collateralôs nature. Collective investment funds do not always possess cash or ñgoviesò at hand, nor do they have in all cases the right to convert their assets and reuse the securities received. Thus, funds should have the possibility to post their own securities, be it emerging market ones. Indeed, it should be taken into account two facts: 1) funds have a very limited default risk, their assets are covered by 100% investorsô equity; and 2) the recent trends of flight to liquidity may create a capacity issue in collateral matters and in a certain sense become procyclical.

We reiterate our view that larger is the eligible collateral, lower are the market impact and the procyclicality. This implies however an adequate policy of haircuts and a strict monitoring of market conditions to act immediately, but progressively, through higher level of haircut and not discontinuously through a ban from the eligibility list. It should be clearly specified that equity are eligible collateral.

The inclusion of covered bonds within the list of eligible collateral is another positive move. But the ban of real estate companies seems too severe as it stigmatises a type of companies on conjunctureøs and not structureøs considerations.

Funds, UCITS or AIFs should also be eligible. We insist that funds shares or stakes be accepted as collateral if the fund invests only in instruments that are themselves individually accepted as collateral. The level of haircut for the fund would be the highest applicable to any instrument the fund may invest in. Using funds as collateral helps dealing with concentration and liquidity issues about collateral and indirectly procyclicality.

When assessing concentration limits in article 4, item 4, p 115 the proposed draft mentions money market funds in the list of instruments included in the total exposition on an issuer and its group. This sounds absurd to a fund manager as funds are independent entities and are constitutive of an exposure only on a look-through approach or in the case of a guarantee. A proper wording should be ñfunds benefitting from a guarantee and CNAV MMFs if implicitly guaranteed by the promoterò. The current wording is not acceptable.

We would like to draw regulatorsô attention on the fact that additional chain risks may be introduced through the practice of ñtransformation servicesò that would be offered by intermediaries to funds instead of the latterøs ability to directly post their assets in full transparency.

IV.XI Investment policy:

The risks of the investment policy of a CCP should be accounted for in the level of required capital on the basis of the most aggressive possibility. The absence of any reference to credit ratings in the proposed draft is perceived as a positive step.

We suggests that funds presenting all the required characteristics in terms of level of credit risk and duration such as Money market funds or short term denominated bond funds should be eligible for investment by the CCPs.
When discussing in article 2 the ñhighly secured arrangements for the deposit of financial instrumentsò one may wonder why there is no provision to prevent the CCP belonging to a financial group to use as depository or custodian a bank of the same financial group.

We consider that direct access of the CCP to the Central Bank for deposit and refinancing facilities is the utmost of security and should be promoted.

IV.XII Review of models, stress testing and back testing

The last article (15 SBT p 126) is of great significance as the public should be totally aware of the default procedures of each CCP. The way it would cope with a default should not leave room for interpretation and last minute decisions, under pressure. As members of the public, end users should be able to assess the quality of these procedures prior to establishing direct contact with a CCP.

V. TRADE REPOSITORIES:

We stress the necessity to converge towards a common (or at least highly comparable) type of reporting on both sides of the Atlantic. As G20 is an international initiative, a common approach worldwide should be achieved at least for what concerns the reporting obligation. Furthermore, a review of other existing reportings (under MIF for example) should be conducted to try and harmonize the requirements.

V.I Reporting obligation

We are strongly of the opinion limiting the table of fields to the main characteristics of the contracts, including at least the parties to the contract, the beneficiaries, instrument type, underlying, maturity, notional, value, price and settlement date, is the most adequate solution. The more granular the information has to be, the more expensive necessary developments will be. This cost impact is not only expected at the counterparties level, but as well as for trade repositories and regulators to effectively analyse additional complex data with respect to potential systemic risks.

We do not see to what extent the inclusion of a reporting field giving the information that the contract was concluded with a counterparty not located within the EEA will bring anything more to monitor the systemic risk that could be built up between non-EU and EU entities. As the trades are reported, the TR has already all the information needed to monitor the risks with non-EEA counterparties. Adding this field creates higher reporting implementation costs for market participants.

We are of the opinion that the reporting to the regulator must not include information held within a master agreement. The information which is necessary for regulators is about confirmation, not about ISDA or master confirmation agreements. We do not see any added value of the reporting of such information. It would definitely create unnecessarily higher costs for the market participants.

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If you need any further information, please donॆt hesitate to contact Eric Pagniez, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr) or Stéphanie Saint Pé at +33.1.44.94.96.69 (s.saint-pé@afg.asso.fr) or Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr).

Sincerely Yours,

(signed)

Eric PAGNIEZ

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