association of the luxembourg fund industry

European Commission
DG Internal Market and Services
B-1049 Brussels
Belgium

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Sent via e-mail to: markt-consultations-otc-derivatives@ec.europa.eu

ALFI's response to the European Commission's Public Consultation on Derivatives and Market Infrastructures

Dear Sirs,

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership over 1 350 funds and asset management groups from around the world and a large range of service providers. According to the latest CSSF figures, on 30 April 2010, total net assets of undertakings for collective investment were 1 796 bn euros.

There are 3 521 undertakings for collective investment in Luxembourg, of which 2 158 are multiple compartment structures containing 11 189 compartments. With the 1 363 single-compartment UCIs, there are a total of 12 552 active compartments or sub-funds based in Luxembourg.

According to March 2010 EFAMA figures, Luxembourg's fund industry holds a market share of 30.5% of the European Union fund industry, and according to 2010 PWC/Lipper data, 76.2% of UCITS that are engaged in cross-border business are domiciled in Luxembourg. As one of the main gateways to the European Union and global markets, Luxembourg is the largest cross-border fund centre in the European Union and, indeed, in the world.

ALFI appreciates the opportunity to respond to the European Commission's Public Consultation on Derivatives and Market Infrastructures.

The following feedback only focuses on legal specialties of fonds commun de placements (FCPs). For the avoidance of doubt, there are also legal specialties regarding société d´investissement à capital variable or à capital fixe (SICAV / SICAF) respectively umbrella structures (Sub funds), which should be considered in the intended

regulation of derivatives and market infrastructures. We believe that already our feedback regarding FCPs discloses that investment funds regardless of their particular legal structure include legal specialties which would result in gaps in the intended regulation or the breach of national law if not being considered.

I. CLEARING AND RISK MITIGATION OF OTC-DERIVATIVES

1. Clearing obligation, 2. Eligibility for the clearing obligation, 3. Access to a CCP

Questions:
What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivate contracts for mandatory clearing, and its application?

1. Clearing obligation

Generally, ALFI supports the proposed introduction of a clearing obligation. We understand that due to the developments on the financial markets and the many issues to be regulated, it is difficult to consider all aspects at once. Nevertheless, we appreciate the possibility to point-out a few aspects from the perspective of an investment management company, which we believe may be of support for the European Commission.

From our point of view, a statement regarding the clearing obligation cannot be made without considering the structure by which it is intended to fulfill a future clearing obligation at this point. Therefore, our review of the suggested regulations has not only been focused on the clearing obligation itself, but did also consider the aim of the European Commission to provide a broad number of market participants with a full access to the CCP as well as specialties related to the investment funds sector.

It is expected by the market participants that investment management companies respectively investment funds but also smaller banks will not be able to meet the requirements for a clearing membership at the CCP. In the proposed structure, we

suppose those market participants to be client of a clearing member. We share the opinion of the European Commission that the CCPs shall ensure that a client is protected from the default of the clearing member. In addition, from our perspective, the new regulations shall ensure that OTC-derivatives agreed between a clearing member and their clients are not being discriminated by any equity capital requirements.

In light of possible conflicts with local insolvency laws and the need for a reliable system, open to a wide spectrum of market participants, protecting those from the default of their counterparty, we suggest not only to focus on one market model.

a) Market model of contracting with a CCP

A key element of the market model, currently suggested by the European Commission is the approach that counterparty of a CCP shall only be a clearing member. Since it is more than likely that the requirements of a clearing membership will only be met by a small group of market participants, but the European Commission intends to give full access to the CCP to a wide spectrum of market participants, the segregation of positions and collateral is required.

The segregation of clients' positions and collateral from the clearing members' positions will be subject to local insolvency laws. In case of the insolvency of a clearing member, the appointed liquidator will always focus on increasing the volume of assets to be distributed to the creditors. Therefore, regardless of any amendments to the local insolvency laws, we especially suppose that the liquidator of a defaulted clearing member will offend the segregation.
We see the possibility to circumvent the described conflict with local insolvency law by implementing a different market model which as an additional effect increases the number of market participants having a direct access to OTC-derivatives with a CCP.

A first idea, how such a market model may look like, could be the following:
The CCP shall offer a non-clearing membership with participation requirements which can be met by most of the market participants, including investment management companies respectively investment funds.

Both, clearing members and non-clearing members would be entitled to add their orders into the respective electronic trading system, being subject to a matching process. The electronic trading system will match two corresponding offers to a trade (OTC-derivative), whereas one OTC-derivative comes into existence between Party A and the CCP and another OTC-derivative, corresponding with the first one, comes into existence between the CCP and Party B. For reaching the goal set by the European Commission, of reaching a full access to the CCP for a broad number of market participants, the described mechanism should also allow it a non-clearing member to be the counterparty of the CCP.

Any non-clearing member should be related to one clearing member. In case that the electronic trading system matches the order of a non-clearing member, automatically an additional assumption of debt of the relevant clearing member should take place. The CCP shall only ask the respective clearing member, but not the non-clearing member, to provide margin for collateralizing the claim of the CCP against the clearing member arising from the additional assumption of debt. Such system would ensure that the CCP is secured at the same level as if it would face the clearing member as its counterparty of the OTC-derivative.

The non-clearing member would be obligated e.g. in way of a respective claim for reimbursement to provide its clearing member with the assets being required for the fulfillment of the CCPs margin call.

In case of the insolvency of the clearing member, any claims of the non-clearing member arising from the OTC-derivative with the CCP would be protected from the access of the liquidator being appointed for the insolvent clearing member. Such is, because due to the fact that the clearing member is not counterparty of the OTC-derivative, the claims arising from an OTC-derivative between the CCP and the non-clearing member, at no point of time were part of the assets of the insolvent clearing member.

We believe that OTC-derivatives with a non-clearing member should not end with the insolvency of the respective clearing member. The non-clearing member should automatically be connected to a “fall-back clearing member”. An additional assump-

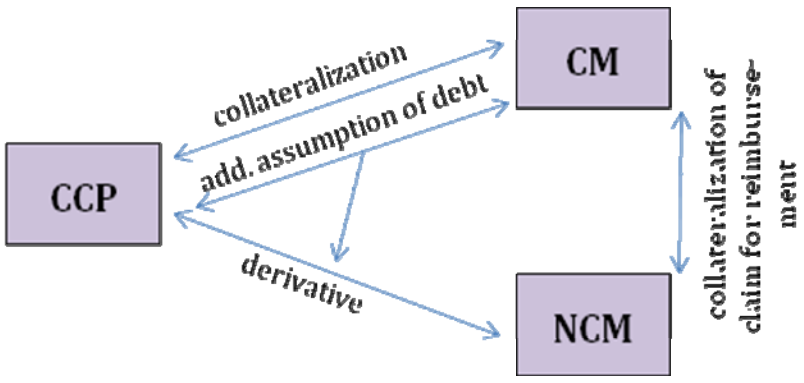
tion of debt of the fall-back clearing member shall take place and it will be the fall-back clearing member being contacted by the CCP regarding future margin calls.

If, due to market developments, the insolvent clearing member has a claim against the CCP for the redelivery of collateral posted, such claim e.g. could be pledged towards the relevant non-clearing member in order to secure the corresponding claim of the non-clearing member against its clearing member regarding the redelivery of assets.

The alternative market model described above,

- meets the intention of the European Commission to provide full access to a CCP for a broad number of market participants;
- ensures the protection of positions and collateral of a non-clearing member without the implementation of a segregation and without the need to adjust local insolvency laws;
- ensures that the CCP is secured at the same level as if it would face the clearing member as its counterparty of the OTC-derivative.

The following picture provides an overview on the basics of the market model described above. It only shows one of the two OTC-derivatives coming into existence as a result of the order matching process (the one with the non-clearing member):



b) Legal specialties regarding investment management companies

As far as the investment fund has no distinct legal personality, the investment management company agrees on OTC-derivatives in its own name but for the joint account of the investors of the respective investment fund. Therefore, it is the investment management company who is the contractual party of an OTC-derivative. Nevertheless, at the moment at which the counterparty of the investment management company has a claim arising from the OTC-derivative, a claim for reimbursement of the investment management company against the investors of the investment fund comes into existence and is fulfilled by a payment or delivery out of the assets belonging to the given investment fund. In light of this legal specialty, the investment management company by itself does not need own assets for the fulfillment of the claims arising from OTC-derivatives, which it has entered into for the joint account of the investors of a given investment fund.

According to article 42 paragraph 3 of the Law dated 20 December 2002 relating to Undertakings for Collective Investment[1] respectively CSSF Circular 07/308 Chapter IV.1, an investment management company only is allowed to enter into a derivative transaction, if it is able to fulfill the claims, which may arise from this transaction, with the assets of the investment fund being concerned. In other member states of the European Union, such rule is known as “cover rule” (see also CESR consultation 10-108). Such obligation is not limited to “clearing eligible” OTC-derivatives.

If the investment management company would (in active breach of the cover rule) agree on OTC-derivatives which cannot be fulfilled with the assets of the relevant investment fund, it would be liable with its own assets for any payment claims of its counterparty, even if the respective claim for reimbursement (against the investors of the relevant investment fund) would be worthless due to the fact that the liabilities would exceed the value of the assets belonging to the relevant investment fund. On the other hand side, any profits arising from an OTC-derivative being entered into even in breach of the cover rule, would automatically become 100% part of the investment fund.

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[1] The Law dated 20 December 2002 relating to Undertakings for Collective Investment has transposed into Luxembourg law the Directives of the European Union of 21 January 2002 (2001/107/EC and 2001/108/EC amending Council Directive 85/611/EEC).

For the reasons given above, with the investment fund, there are segregated assets for the fulfillment of OTC-derivatives and furthermore, an investment management company would have no reason for entering into OTC-derivatives, which cannot be fulfilled with the assets of the relevant investment fund.

In addition, it needs to be pointed-out that investment funds are subject to various obligations for diversification and regarding counterparty limits (in particular see CSSF-circular 07/308). Those already existing regulations intend the protection of the investors from the non-diversified risk and credit risk.

By defining undertakings for collective investments in transferable securities (as defined in Directive 2009/65/EC) as “Financial Counterparty”, the intended regulations do not consider the aforementioned material differences between investment management companies respectively investment funds and other market participants.

Even though there is already a mechanism in place with regard to investment funds, limiting the credit risk, a discrimination of OTC-derivatives not being concluded with the CCP by new equity capital requirements seems to be intended. Especially for hedging risks in the investment fund, an investment fund manager typically agrees on OTC-derivatives which are tailored for reducing the existing market risk in a portfolio. Therefore, it is likely that an investment management company will also agree in future on OTC-derivatives not being plain-vanilla and therefore not being offered by a CCP.

If the counterparty of an investment management company would be subject to additional equity capital requirements, it will forward the costs for equity capital to the investment management company, e.g. in case of an OTC-option by increasing the premium. Finally it is the investor of the investment fund who will have to carry the costs for equity capital requirements without having receiving any additional protection. If in addition, the investment management company insists on the collateralization of the OTC-derivative, the costs for the hedging transaction will further increase.

The higher the costs for the hedging transaction are, the more it is likely that an investment fund manager, who is in competition with the managers of other invest-

ment funds, would avoid those hedging transactions or would abandon the collateralization of the hedging transaction in order to maintain the performance of the investment fund being managed. From our point of view, the European Commission should avoid providing an incentive for not hedging existing market risks respectively the counterparty risk. It should recognize already existing legal mechanisms regulating the credit risk protection with regard to investment funds properly.

2. Eligibility

Typically, OTC-derivatives are customized to meet the specific needs of the parties. So for example, a party, who is not fluent in English, could be interested in having the transaction being 100% governed by the documentation issued by another Association rather than the ISDA documentation. Further aspects may be the underlying, settlement instructions, termination rules or the size of the transaction.

It is understood and agreed that a CCP cannot consider all of the aforementioned aspects.

It is our understanding of the proposed regulation, which finally ESMA determines, if an OTC-derivative is “clearing-eligible” or not. For us the meaning and consequences of such a determination are not clear enough yet. If ESMA would determine a “class of derivatives” being “clearing-eligible”, it is understood that OTC-derivatives of this class, not being agreed with the CCP, shall be subject to additional equity capital requirements. The proposed rules do not explain clearly, if OTC-derivatives of this class, which due to a lack of standardization cannot being agreed with the CCP, shall also be governed by the additional equity capital requirements.

We would appreciate if those OTC-derivatives would not be subject to the additional equity capital requirements, since such would lead to increased costs of hedging and market participants could have an incentive not to hedge an existing market risk or to relinquish a collateralization of those trades in order to reduce the costs of hedging. Both would increase risks at the market.
If it is being preferred by the European Commission, having those OTC-derivatives being subject to the additional equity capital requirements, we would suggest a

clarification that the determination of the clearing eligibility by ESMA should not only consider the wish of CCPs for more business or the "systemic risk reduction" (see page 4 of the consultation paper), but should focus on the grade of standardization. Requirements for a sufficient standardization should be at least that the CCPs would cover most of the transactions of this kind in the market and that the CCPs do not only consider on the ISDA documentation but also on national documentations e.g. like the product annexes to the German Master Agreement for Financial Derivatives Transactions.

3. Access to a CCP

We support the will of the European Commission to provide a broad number of market participants with a full access to the CCP. That is why we have suggested an alternative market model (see our statement with regard to "1. Clearing obligation"), which in addition also allows both, sufficient security of the CCP as well as the protection of positions and collateral of a non-clearing member without the need of adjustments to local insolvency laws.

Please see our comments above.

Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

Yes.

4. Non-financial undertakings

Question:

Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?

Generally, we welcome the approach of considering the hedging needs of non-financial undertakings. Hedging transactions are always limiting existing market risks, regardless of their volume. Therefore, from our point of view, it should be evaluated if a threshold really is required.

Due to the legal structure of FCPs, the investors of a FCP are the joint owners of the assets. As an investment management company, we are managing the assets of our institutional and private clients. Doing so, we are also mitigating existing market risks for the benefit of our clients. From our perspective, the *economic and financial hedging needs* of private and institutional end-users, who are invested through an investment fund, do not differ from the *economic and financial hedging needs* of non-financial undertakings. We would appreciate if the European Commission would take this aspect into its considerations.

It is not clear enough yet, how a party shall identify, if its counterparty has already exceeded an applying clearing threshold. Also it should to be considered by the European Commission, how OTC-derivatives are treated if the threshold has been exceeded by one of the parties not at the beginning but during the duration of the transaction. In both examples, the other party could be surprised by equity capital requirements not being considered at its initial pricing. Surprises as the described ones should be avoided.

5. Risk mitigation techniques for non-cleared contracts

Question:

Do stakeholders share the principle and requirements set out above on the risk mitigation techniques for bilateral OTC-derivative contracts?

We agree to the approach of section 5, but would like to point-out an existing gap to be closed, resulting from the definition of “financial counterparty” which currently includes undertakings for collective investments in transferable securities (as defined in Directive 2009/65/EC).

As far as a FCP is concerned, the investment management company agrees on OTC-derivatives in its own name but for the joint account of the investors of the respective FCP. Therefore, it is the investment management company who is the contractual party to an OTC-derivative. At the moment at which the counterparty of the investment management company has a claim arising from the OTC-derivative, a claim for reimbursement of the investment management company against the investors of the relevant investment fund comes into existence and is to be fulfilled via a payment or delivery out of the assets belonging to the relevant investment

fund. In light of this legal specialty, the investment management company in principle does not need any own assets for the fulfillment of claims arising from OTC-derivatives, which it has entered into for the joint account of the investors of a given investment fund.

For the reasons described above, the provisions of section 5 should consider that if counterparty of an OTC-derivative is an investment managing company, acting for the joint account of the investors of a FCP, the other party shall not focus on the capital of the investment management company, but on the volume of assets in the relevant FCP. Nevertheless, due to the applying national cover rule, applying to investment funds, a risk mitigation technique, focusing on the capital held may be dispensable. Therefore, the gap in section 5 could also be filled by releasing market participants from the obligation to focus on the capital held in the relevant FCP.

II. REQUIREMENTS FOR CENTRAL COUNTERPARTIES

1. Organisational Requirements, 2. Risk Committee, 3. Conflicts of Interest, 4. Outsourcing, 5. Participation requirements, 6. Transparency

Questions:
Do stakeholders share the general approach set out above on organisational requirements for CCPs? In particular comments are sought on the role and function of the Risk Committee; whether the governance arrangements and the specific requirements are sufficient to prevent and manage potential conflicts of interest; stringent outsourcing requirements; and participation and transparency requirements?
Do stakeholders consider that possible conflicts of interests would justify specific rules on the ownership of CCPs? If so, which kind of rules?

5. Participation requirements

In our answer to the first question of the European Commission, we have suggested an alternative market model which in particular would allow more market participants a direct access to a CCP.

If the European Commission joins the approach suggested by us above, it needs to be distinguished between the requirements for a clearing membership and a non-clearing membership. Since we do not see any additional risk for a CCP under the market model suggested by us, the participation requirements for a non-clearing membership should be arranged in a way that most of the market participants can meet them.

If the original market model which focuses on the "segregation-solution" is the only market model being considered by the European Commission, we would like to point-out, that it is very likely that only a few market participants will be able to meet the participation requirements. Such would mean a respective increase of the volume of trades being subject to the segregation rules of which it is unsure how those shall be protected efficiently from the local insolvency rules.

7. Segregation and portability

Questions:
Do stakeholders share the approach set out above on segregation and portability?

We generally appreciate the efforts of the European Commission regarding the segregation and portability of client positions and collateral. A reliable system will be for the benefit of all market participants and will strengthen capital markets.

As described above, we would appreciate a market model which considers clearing members as well as non-clearing members as possible counterparties of the CCP. Under the market model suggested by us, it would not be necessary implementing rules for the segregation of client positions and collateral. We expect this to be the safest option for market participants with respect to local insolvency rules.
Nevertheless, if a CCP focuses on a market model which requires the segregation, there is a gap in the proposed regulations which needs to be closed.

Especially in accordance with articles 6 and 14 paragraph 1 of the Law of 20 December 2002, a rule which is also subject to the law of other member states of the European Union, it is necessary also to segregate the assets from the investment

management company from those of the investment fund, as well as to segregate the assets of one investment fund from those of each other investment fund.

8. Prudential Requirements

Questions:
Do stakeholders share the general approach set out above on prudential requirements for CCPs? In particular: what should be the adequate level of initial capital? Are exposures of CCPs appropriately measured and managed? Should the default fund be mandatory and what risks should it cover? Should the rank of the different lines of defence of a CCP be specified? Will the collateral requirements and investment policy ensure that CCPs will not be exposed to external risks? Will the provisions ensure the correct management of a default situation? Are the provisions above sufficient to ensure access to central bank liquidity without compromising central banks' independence?

Default fund

We agree the approach in principle establishing a default fund to ensure the soundness of the CCP and the stability of the market.

We expect market participants to face high costs regarding the realization of the proposed regulation. The CCP gains earnings from the clearing membership- and transaction fees. Before any parts of those incomes are being distributed to the shareholders of the CCP, they should be used for establishing the default fund, rather than asking the clearing members for additional contributions.

Since it is unlikely that investment management companies will be able to meet the requirements for a clearing membership, no additional rules for investment management companies respectively investment funds are required.

Default Waterfall

Generally, we agree to the system of a default waterfall, even if such may mean an unknown risk for the clearing members which possibly cannot be reduced by the non-defaulting clearing members.

It is our understanding of the current proposal that non-clearing members and clients shall not be subject to any default waterfall rules. For the avoidance of doubt, if also non-clearing members and clients of clearing members shall be liable with respect to a default waterfall system, we have to point out, that investment management companies are prohibited by law from using the assets of an investment fund for the fulfillment of liabilities not being connected to the respective investment fund.

Investment policy

Generally agreed. For the avoidance of doubt, it should be avoided that at least clearing members are liable for the soundness of the CCP (see above), while the CCP invests its assets into various financial instruments.

9. Relations with third countries

Questions:
Do stakeholders share the general approach set out above on the recognition of third country CCPs? Are the suggested criteria sufficient? Do stakeholders consider that additional criteria should be considered?
Do stakeholders agree with the extension of the clearing obligation to contracts cleared by third country CCPs to ensure global consistency?

Yes.

III. INTEROPERABILITY

Question:
Stakeholders' views are welcomed on the general approach set out above on interoperability and the principles and requirements on managing risks and approval.

The terms and conditions applying to all clearing members of the CCP (respectively non-clearing members if the market model allows transactions between non-clearing member and the CCP) should not refer to a specific Master Agreement. Otherwise, the choice would limit the possibility of the CCP to connect with other CCPs who have decided referring to terms of a differing Master Agreement.

IV. REPORTING OBLIGATION AND REQUIREMENTS FOR TRADE REPOSITORIES

1. Reporting obligation, 2. Requirement for Registration of a Trade Repository

Questions:
What are stakeholders' preferred options on the reporting obligation and on how to ensure regulators' access to information with trade repositories? Please explain.

As far, as clearing eligible OTC-derivatives, which an investment management company agrees for the joint account of the investors of an investment fund, are to be reported separately for each relevant investment fund, such data should only be available for the supervisory authorities to protect existing business secrets of the investment management company, managing the relevant investment fund.

For the avoidance of any possible insider knowledge advantages, the data stored at a TR especially is to be protected from the shareholders of the TR.

Requirements for Trade Repositories

1. Operational reliability, 2. Safeguarding and recording, 3. Transparency and data availability

Questions:

Do stakeholders share the general approach set out above on the requirements for trade repositories? In particular, are the specific requirements on operational reliability, safeguarding and recording and transparency and data availability sufficient to ensure the adequate function of trade repositories and the adequate protection of the data recorded?

Yes.

The governance arrangements of a TR shall ensure that it covers all Master Agreements (if it is necessary to have a Master Agreement in place between the CCP and each of the clearing members). Furthermore, it should consider investment funds without a distinct legal personality.

The information stored in a TR shall be maintained at least as long as the parties to the relevant OTC-derivatives would be obligated to maintain the data.

V. TECHNICAL REFERENCE GLOSSARY OF DEFINITIONS

Questions:

Do stakeholders agree with the definitions set out above?

Financial counterparty

Generally we agree to a mandatory clearing system. As explained above, we see legal specialties with regard of investment management companies respectively investment funds which need to be considered in the proposed regulations at least in order to avoid the breach of the applying national laws.

For the reasons explained in our statement for this consultation, we assume it being the most effective way to have special provisions dealing with investment man-

agement companies respectively investment funds. Such makes it necessary to remove *undertakings for collective investments in transferable securities (UCITS, as defined in Directive 2009/65/EC)* from the term "*financial counterparty*".

Non-financial counterparty

With regard to the suggested separate regulation of investment management companies respectively investment funds it may be necessary also to adjust the definition of "*non-financial counterparty*". We suggest the following definition:

"[…] means a legal entity established in the European Union other than financial counterparties and other than *undertakings for collective investments in transferable securities (UCITS) as defined in Directive 2009/65/EC*.".

Clearing member

If the market model of the CCP would also allow OTC-derivatives between the CCP and a non-clearing member, as suggested by us, this definition is to be adjusted properly.

Non-clearing member

If the market model of the CCP would also allow OTC-derivatives between the CCP and a non-clearing member, as suggested by us above, this definition is to be added.