association of the luxembourg fund industry

ALFI comments

on

European Securities and Market Authority (ESMA)

Consultation PAPER
Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories

25 June 2012/ESMA/2012/379

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership asset management groups from various horizons and a large variety of service providers. According to the latest CSSF (Commission de Surveillance du Secteur Financier) figures, on 31 May 2012, there are 3 874 undertakings for collective investment in Luxembourg (UCITS and non-UCITS), representing 13 412 active compartments representing a total, in terms of net asset value EUR 2 212.027 billion.

ALFI welcomes the European Securities and Markets Authority Consultation Paper (hereafter, the "Consultation Paper") and welcomes the opportunity to provide its comments and expertise to the ESMA work stream on this issue.

To provide context to our response thereon, we would like to stress the following points.

- **Annex II – Draft regulatory technical standards on OTC derivatives**

  In a general matter, we would like to point out that the draft regulatory technical standards on OTC derivatives (the "Technical Standards") do not take sufficiently into account the specificities of UCITS as investment vehicles made available to the public.

  We assume that UCITS will typically act as indirect clients as referred to in Article 2 Paragraph 1 of the Technical Standards. The Technical Standards aim, in particular, to ensure that indirect clients benefit from equivalent protection as clients. Pursuant to number 4 of the recitals of the Technical Standards an indirect clearing arrangement should ensure that appropriate safeguards are in place against client failure. Nonetheless, in an event of a default of the client / clearing member, UCITS do not seem to be sufficiently protected by an indirect client arrangement as provided in Chapter II of the Technical Standards. On the one hand there are on national level some important laws, such as, for

example, insolvency laws which have different requirements and different scopes of protection. UCITS structures come typically in contact with a large number of different national laws. As particular, UCITS can enter into OTC derivatives contracts with counterparties / clients in different jurisdictions. It seems to be difficult to take all these aspects from the national laws of all involved resident states into account.

On the other hand it has to be questioned if the protection which is intended to be ensured by the Technical Standards can be extended to indirect clearing arrangements with clients or clearing members domiciled outside of the EU.

- Article 4 ICA – Obligations of clearing members and clients

In Paragraph 7 the Technical Standards determine that the client shall provide sufficient information for the clearing member to evaluate and manage the counterparty risk that could reasonably expect to incur in view of indirect clearing arrangements. Regarding the required extent of the sufficient information number 5 of the recitals of the Technical Standards mentions the identity of each indirect client as one element of the required information. Nonetheless it is unclear which information would be required in addition.

- Article 1 RM – Timely confirmation

The Technical Standards stipulate in Article 1 RM Paragraph 2 the obligation for the acting entities to report the conclusion of OTC derivative contracts to the authorities at the latest by the end of the same business day. Even if the exceptions under Paragraph 3 apply a confirmation at the latest by the end of the next business day the timing would be difficult to achieve in practice.

- **Annex III – Draft RTS on CCP requirements**

As a general comment to the Annex, and more specifically on Chapter XI - Collateral, we regret that the rules do not take into consideration the specificities of UCITS as investment vehicles made available to the public. UCITS collect investor's monies and are highly stable investment vehicles that invest into securities and OTC derivatives for the benefit of retail and institutional investors. OTC derivatives are only used for efficient portfolio management purposes in UCITS, in particular to cover the credit, interest rate or other similar risks linked to the investments held by the funds. We therefore think that the low risk levels of UCITS should be reflected in the regulation and we suggest that UCITS benefit from more flexible rules regarding collateral requirements.

Collateral requirements for UCITS should therefore be adapted to lower the extra-cost this would generate for them and also enlarge the types of acceptable collateral. UCITS usually are fully invested and do not hold cash at sight. Eligible collateral should therefore include corporate bonds and equities as an example. UCITS have diverse investment strategies and restricting collateral types would increase the cost of funding appropriate eligible collateral. In case a UCITS does not hold appropriate collateral as part of its investment strategy, the cost of funding eligible collateral will be high and would potentially impact end investors.

- **Annex V – Draft regulatory technical standards on trade repositories**

  As a general comment, we would like to point out that the level of information required is huge and will require deep system adaptation by the industry participants. The information required sits in various specialised systems and not one single system can aggregate all the data. This will therefore require massive system developments and therefore high investment costs. The ESMA should analyse the possibility to request more synthetic information and think about the frequency at which the trade information should be refreshed, especially on collateral and valuation elements.

  - Article 7 – Reporting log

  Since the market value and other information of the OTC derivatives positions will change on a daily basis, does that mean that updated information will have to be sent to the Trade Repositories on a daily basis as well? If this is the case, this would constitute a heavy process for the participants and would suggest to update certain data fields at a less frequent basis (for example monthly update for valuations and collateral for UCITS trades).

- Annex 1 to re regulatory technical standard on the details to be reported to trade repositories Article 9 of EMIR

  - *Table 1 – Counterparty data*

    Please refer to the "Memorandum on Co-Managed Investment Funds" enclosed herewith explaining the Luxembourg Fund Industry's proposal on how best to proceed with the opening of the LEI for investment fund structures using such type of pooling structures.

  - *Table 2 - Common data - section 2c – item* 20 Confirmation

    Question: In case the contract is not confirmed at reporting time, should the trade be reported again when confirmation has taken place? This would need further clarification.

  - *Table 2 - Common data - section 2c – item 31Collateral amount*

    Question: Since collateral might change on a daily basis, does that need to be amended as well? This would need further clarification.

    Question: In case collateral is posted against several trades, what amount of collateral has to be reported? This would need further clarification.

- **Annex VI - Draft implementing technical standards on trade repositories**

  - Article 2 - some words seem to be missing in the sentence. Do you mean "The information contained in a "report" made under..."?

- Article 3 - point 2 - there should be a word missing "Where a legal entity “identifier” is not available...."
- Article 4 - who will be responsible for determining the UPI? This is critical as various CCP could clear the same product and will have to use the same UPI? This would need further clarification.
- Article 5 - point 2: what do you mean by "contracts". Are you referring to the UTI of each transaction held within the portfolio or any other type of information? This would need further clarification.

Contact

For further information, do not hesitate to contact Antoine Kremer (mailto:Antoine.kremer@abbl-alfi.lu) or François Drazdik, Senior Industry Affairs Advisor at ALFI’s headquarters in Luxembourg (francois.drazdik@alfi.lu; 00352 22 30 26-42).

Enclosure:

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MEMORANDUM ON CO-MANAGED INVESTMENT FUNDS

Under the European Market Infrastructure Regulation (EMIR) adopted by the European Parliament on 29th March 2012, Article 9 introduces the reporting obligation (the **Reporting Obligation**). The Reporting Obligation will require counterparties to derivatives contracts to report certain details of derivatives transactions as indicated therein, although a counterparty may delegate such reporting to another party.

The current scope of the Reporting Obligation includes the following requirements:

- Each counterparty to a derivatives transaction must report to a trade repository the details of any derivatives contracts that have been concluded and any modification, or termination of those contracts;
- Such reporting must be completed no later than the working day following the conclusion, modification or termination of the relevant contract;
- The report must contain at least the parties (counterparty data) to the contract and, where different, the beneficiary of the rights and obligations arising from it, and information on the transaction (common data); and
- A coding system will be implemented by which each counterparty will be identified by a unique identifier.

1. Legal Entity Identifiers (LEIs)

The industry is working towards implementing a global standardised system of assigning an identifier to each counterparty to financial transactions, known as the Legal Entity Identifier (**LEI**). If implemented, the LEI is intended to be used by trading counterparties, central counterparties (**CCPs**) and Trade Repositories with respect to transaction reporting, including information reported under the Reporting Obligation. On 8th June 2012, the Financial Stability Board (FSB) published a report on A Global LEI for Financial Markets (the **LEI Report**), in which it proposed recommendations for the development and implementation of the global LEI system.

Recommendation 8 (Scope of Coverage) of the above-mentioned FSB recommendations, proposed that eligibility of 'legal entities' to apply for an LEI should be broadly defined, in order to identify the legal entities relevant to any financial transaction. In this context, the FSB recommended that the term "legal entity" as used in the context of LEIs should take into account the possibility that in some jurisdictions asset pools or other segregated parts of a legal entity may carry sufficiently independent rights that would make such asset pool eligible for an LEI and recommended further study of the scope of application with respect to umbrella funds and similar entities to ensure that the above is addressed.

2. Issue

This letter relates to investment management companies that conduct trading for and on behalf of their Luxembourg regulated mutual funds, including UCITS. A regulated mutual fund can be set up under an umbrella fund structure. This structure can be then sub-divided into sub-funds, with investors buying

shares in each segregated sub-fund as a separate "Fund". While the umbrella fund is a legal entity, the sub-funds are segregated compartments of that legal entity but not separate legal entities.

In addition, several investment management companies manage funds that are **co-managed using a pooling technique**. Where a regulated umbrella fund is set up with a pool structure, OTC derivatives transactions conducted by that fund (and/or its sub-funds) are generally executed, settled and reported at pool level. An explanation of the pooling structure and details of pooled trading are set out in the Annex hereto.

We understand that there is widespread awareness regarding umbrella funds that are segregated into sub-funds and that these are expected to be accounted for under the EMIR technical standards and as part of the LEI framework (and that it will for example be possible for sub-funds to apply for LEIs). However, we understand that the position with respect to funds or sub-funds using a co-management technique under which pools make investments and enter into derivatives may be less familiar. **Consequently, this letter only addresses issues affecting funds organised under structures that use co-management by way of pooling**.

The current draft technical standards for the Reporting Obligation and central clearing and, as a consequence, the draft clearing house rules and related template documentation, all fail to contemplate counterparties that are set up with a pool structure. As these proposals do not address regulated co-managed funds (including UCITS), there is a great deal of uncertainty currently causing concern, both to asset managers and their trading counterparties, as to whether and, if so, how those entities conducting pooled trading will be able to comply with trade reporting and central clearing, when implemented.

We note that, in the LEI Report, the FSB stated that the Expert Group supports the view that in certain jurisdictions an asset pool would be eligible for an LEI and that the FSB recommends further study should be done in this area[1]. Until we are aware of the outcome of these recommendations and whether such further study will be undertaken, the position is similarly uncertain with respect to the LEI framework.

Consequently, there is a concern amongst asset managers that, if (i) the current draft proposals for the EMIR technical standards are not revised to refer to and take account of co-managed funds and (ii) the LEI Expert Group's view regarding pool eligibility for an LEI is not followed, then the above-mentioned legislation and regulations will cause an unintended bar to trading for the co-managed funds that they manage.

3. Requests and proposals

We hereby request that modifications be made to the draft technical standards for regulatory reporting and, where applicable, central clearing for umbrella funds, including those that are co-managed using pooling and on whose behalf asset managers engage in pooled trading.

[1] As set out below, we strongly support this view.

Furthermore, we support the recommendation by the LEI Expert Group that asset pools and other segregated parts of a legal entity may carry sufficiently independent rights that would make such asset pool eligible for an LEI. To the extent that the FSB's recommendation to explore the applicability of LEIs to these types of structures is taken forward, we hereby request that we are involved and consulted closely during any such analysis of how to apply LEIs to pooled structures.

4. Proposals with respect to funds that trade at pool level[2]:

In respect of trades conducted at pool level, we propose the following approach:

1. The LEI is provided at pool level, so that each pool is assigned an LEI.
2. OTC derivatives continue to be traded at pool level using the pool LEI;
3. Each CCP should offer client accounts at pool level;
4. Each Trade Repository maintains OTC derivative positions at pool level; and
5. The reporting requirements for OTC derivatives (including as to holdings and collateral) are applied at pool level.

5. Reasons for the above proposals

In some jurisdictions like Luxembourg, regulated co-managed funds (including UCITS) enter into trades at pool level, so it makes sense to report such trades also at pool level and to consider pools as beneficiaries of the transactions for reporting purposes. Technically, it would be extremely complicated (if, in fact, possible) to enter into trades at pool level but to have to report those trades either (a) at the level of the relevant legal entity (being either the management company in respect of FCPs or the umbrella fund in respect of SICAVs) or (b) at the level of the participating sub-funds.
Furthermore, the LEI should be attributed, margin collateral should be posted and reporting should be made at pool level, in each case in order to take into account the operational constraints linked to running a co-managed fund and pooled trading.

We do not believe that the intention of legislators and regulators with respect to EMIR and LEIs has been to implement legislation or an LEI system, as the case may be, that has the effect of removing access of UCITS regulated funds to derivative investment. If the outcome of the relevant regulations and initiatives for funds which trade at pool level were that the LEI, collateral requirements and reporting would have to be implemented at sub-fund level, then it would be highly unlikely that administrative agents would be in a position to support pooling any longer. All existing pooling structures would have to be dismantled. Dismantling existing pooled structures would be a complex, time-consuming and costly process for all funds involved and their promoters and service providers. In Luxembourg more than 320 pools, representing more than 420 sub-funds, with assets of more than € 130 billion as of June 30th, 2012)

[2] This letter focuses on the issues of funds that trade at pool level only and trading at sub-fund level has not been addressed herein. However, for the avoidance of doubt, when trading occurs at sub-fund level, we consider that an LEI should be allocated at sub-fund level.

would be impacted, including many UCITS flagships, and, as a consequence, retail investors would be affected.

If, despite the above proposals and recommendations, pooling were effectively required to be unwound due to the regulatory changes, dismantling existing pooled structures would be a complicated and lengthy process, which would expose funds and their investors to high operational risks if operated under time pressure.

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ANNEX

Part 1: Co-management technique and pool structure

Description of co-management used in Luxembourg

In Luxembourg and other EU jurisdictions, investment managers and fund service providers have developed techniques enabling an investment manager to co-manage the assets of two or more investment funds (or sub-funds thereof) having analogous or overlapping investment policies. These techniques are sometimes referred to as co-management or globalisation techniques. Some of these techniques (e.g., master-feeder structures) involve the creation of an entity pool with legal personality, but those techniques are excluded from the scope of this letter. This letter only refers to co-management techniques which do not entail the creation of an entity pool with legal personality. A common type of co-management technique is pooling[3], which is widely used in the Luxembourg fund industry since the early 1990s. The main features of the pooling technique are outlined below.

Funds domiciled in Luxembourg (including UCITS) that are co-managed on the basis of pooling represent assets under management of more than € 130 billion as of June 30th, 2012 . These funds are managed by large international asset management companies.

Pooling technique

The pooling technique may be implemented either between several sub-funds of the same fund ("intra-pooling") or between two or more funds ("extra-pooling"). Under the pooling technique, the assets of two or more funds or sub-funds are pooled together in one or several portfolios. These portfolios do not have legal status and are pools of assets held on behalf of the participating funds or sub-funds. The participating funds or sub-funds contribute all or part of their assets (the **co-managed assets**) to one or more portfolios in compliance with their investment policy. In exchange for their contribution, they have a proportion holding in the relevant pool (commonly referred to as **notional units** in the pool).

The pooling technique is not governed by any express Luxembourg laws or regulations. However, the implementation of the pooling technique by Luxembourg funds is authorised by the Luxembourg supervisory authority (the Commission de surveillance du Secteur Financier, the **CSSF**). The use of the pooling technique is disclosed in the relevant funds' prospectus and the auditors of the participating funds run checks on a regular basis on the systems used for the implementation of the pooling technique.

Advantages of pooling

Pooling enables a fund manager to co-manage all or part of the portfolio of several funds or sub-funds together as a single unit. This offers, inter alia, the following advantages:

- Efficiencies and economies of scale;

[3] For the avoidance of doubt, it should be noted that such pooling techniques have nothing in common with so-called "dark pools" but are transparent techniques used by funds for efficient portfolio management and are disclosed in the relevant fund documentation.

- Centralised deal placing (larger pools increases capacity to net flows and reduce transaction costs); and
- Efficient and maximised use of expertise, where several fund managers can each manage a pool of assets matched to his/her expertise rather than managing e.g. a multi-national mixed asset fund.

Part 2: Derivatives trading by funds co-managed on the basis of pooling

As explained above, pooling enables investment managers to manage each pool as a cohesive unit and, consequently, investments, including derivatives investments are entered into at the pool level, rather than at the level of each fund or sub-fund participating in the pool[4].

Entities participating in a pool may be:

- Sub-funds of one or more Luxembourg regulated investment companies with variable capital (sociétés d'investissement à capital variable, **SICAVs**) and/or common funds (fonds communs de placement, FCPs);
- One or more Luxembourg regulated stand-alone SICAVs or FCPs (i.e., SICAVs and FCPs which are not established as umbrella funds and do not have the ability to create sub-funds/compartments); or
- A combination thereof (i.e., a combination of sub-funds and stand-alone SICAVs/FCPs).

The fact that a trade would be entered with respect to an entity (i.e., a pool) which is deprived of legal personality is not specific to fund entities co-managed on the basis of pooling, as neither sub-funds nor FCPs have a legal personality. Therefore, the only situation in which counterparties to these funds face an entity with legal personality is when entering into transactions with standalone SICAVs.

Although sub-funds have no legal personality, they generally constitute a separate economic entity under an umbrella fund (i.e., the SICAV), as their assets and liabilities are legally segregated.

In order to comply with the principle of segregation between the assets and liabilities of sub-funds, when umbrella funds enter into derivatives documentation (e.g., ISDA Agreements) for the account of the individual sub-funds, the ISDA Agreements will also include contractual segregation so that the counterparty's recourse to each sub-fund is limited to the assets of such sub-fund.

Where one or more umbrella funds engage in pooled trading (i.e., trade at the pool level), the ISDA Agreement is drafted such that the counterparty's legal recourse under the ISDA Agreement is to each sub-fund participating in the relevant pool, but is limited in proportion to the interest of each such participating sub-fund in the pool. In other words, if a transaction is entered into in respect of a pool, the counterparty will not have recourse against all the assets of all the sub-funds participating in the pool, but rather to each participating sub-fund to the relevant pro-rata portion of the assets of the pool that is

[4] As mentioned on above, this letter focuses on funds that trade at pool level and hence derivatives trading at sub-fund level has not been addressed in Part 2 of this Annex

allocated to the relevant participating sub-fund. Therefore, the legal exposure of counterparties is towards each participating sub-funds, rather than towards the pool.

In order to enable counterparties to monitor their credit exposure to each participating sub-fund, counterparties generally request to be provided either (i) upon request, (ii) at a specified frequency or (iii) on a real-time basis through a web-based reporting system (where possible) (a) the net asset value of each sub-fund and (b) the proportional interest of each sub-fund to each pool. Based on this information, the counterparty is in a position to measure its credit exposure to each fund entity participating in a pool.

Similarly, the fund, management company or investment manager has the capacity to breakdown each position held at pool level across each participating sub-fund using the daily ownership ratios calculated by the administrative agent. Therefore, in case of default of a counterparty, being buy-side or sell-side counterparty, the prompt identification of the legal entities' holdings is possible.