Comment by

Union Asset Management Holding AG

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

*(ESMA/2012/379)*

Date: 3. August 2012

Dear Ladies and Gentlemen,

Union Investment welcomes the opportunity to comment on the ESMA consultation paper "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories". We are the asset manager of the German cooperative banking network holding more than € 180 bn. assets under management for retail and institutional clients.

We appreciate the efforts already undertaken by ESMA in order to draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories. The numerous regulatory alterations following the insolvency of Lehman Brothers and the developments on the financial markets are a challenge for all market participants including the relevant supervisory authorities.

With regards to this consultation paper, we especially would like to accentuate that UCITS and AIF are subject to specific statutory segregation requirements which are more strict than the segregation under EMIR. If ESMA would determine a class of OTC Derivatives clearing eligible, but no CCP offers a segregation model complying with the restrictions applicable to UCITS and AIF, such could mean a factual prohibition of the given standardized OTC Derivative. If the questions, whether or not a specific segregation model of a CCP is in compliance with the statutory segregation requirements (cf. Art. 8 para. 1 of Directive 2010/43/EC), is to be answered by the relevant national supervisory authorities rather than ESMA, a distortion of competition between the asset managers from different member states is to be expected.

Besides providing our comment on some of ESMA's suggestions, we would like to raise ESMA's attention on its measures published in July 2012 (Guidelines on ETFs and other UCITS issues (ESMA/2012/44)). We think there is a need to reconsider these guidelines as from our point of view some of its practical consequences seem to be contrary to the aims of G-20 and hampers UCITS and AIF in the further usage of standardized OTC Derivatives.

Please find our specific comments below.

Yours sincerely

Schindler Dr. Zubrod

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## A. Criteria to be assessed by ESMA under the clearing obligation procedure (Annex II, Chapter IV, CRI) and Public register (Annex II, Chapter V, PR)

### I. The degree of standardization of the contractual terms for the relevant class of OTC Derivatives: Different national master agreements governing OTC Derivatives

Union Investment supports the proposal made by ESMA to consider the degree of standardization of the contractual terms of the relevant class of OTC Derivative contracts when determining the criteria for the clearing obligation procedure. We think that the degree of contractual standardization of OTC products should not only refer to the ISDA master agreements. Market participants use different master agreements as the language of the documentation and the governing laws are different.

Therefore we would like to propose ESMA to incorporate in their assessment of the contractual standardization different national master agreements as well as their financial product related annexures respectively definitions. CCPs especially should be obliged to accept different master agreements (e.g. the German Master Agreement for Financial Derivatives Transactions).

In detail we propose the following amendments (Article 1 para 2 (a)):

2. *In relation to the degree of standardization of the contractual terms and operational processes of the relevant class of OTC Derivative contracts, ESMA shall take into consideration:*

   a. *whether the contractual terms of the relevant class of OTC Derivative contracts incorporate common legal documentation, including **different national** master agreements, definitions, standard terms and confirmations which set out contract specifications commonly used by counterparties;*

### II. The degree of standardization of the contractual terms for the relevant class of OTC Derivatives: Potential regulatory specifics regarding OTC Derivatives

There might be cases, in which regulatory specifics have impact on the legal terms of an OTC Derivative and make a class of OTC Derivatives a separate class of OTC Derivatives. ESMA should be aware of this fact and should either consider it under Article 1 CRI para. 2 lit. a of Annex II Chapter IV or should add a new sub para. lit. c covering this aspect.

The following should be provided as an example:

Based on a note form the German supervisory authority BaFin to one of the German Investment Management Companies, Managers of UCITS and AIF seem to be required to agree with their counterparty of each CDS on the exclusion of loans as deliverable obligations prior to agreeing on the individual CDS itself. Possibly this is the reason why there are two or three years lasting and still not finalized discussions between market participants (meanwhile including ISDA) whether or not there is a regulation applying to UCITS and AIF which requires this special provision for CDS having UCITS or AIF respectively their managers as counterparty.

It is our understanding that UCITS would only receive a loan under a CDS if (a) there is a credit event, (b) no auction takes place, (c) the physical settlement is being fallback, (d) the only available deliverable obligation is a loan. For that reason it is extremely unlikely that UCITS or AIF are provided with a loan under a CDS transaction. Foreign stocks are an eligible asset for a UCITS, as CDS are too. Even when the withholding tax reimbursement claim received by the UCITS respectively AIF in case of a dividend paid by the issuer of a foreign stock is not considered as an eligible asset and it is more likely that the issuer of a foreign stock pays a dividend than it is that a loan is being delivered under a CDS, nobody questions the eligibility of the foreign stock. The comparison shows that there are good reasons why UCITS and AIF should not consider specialties when entering into CDS. Nevertheless, market participants may have to consider regulatory requirements, if any.

Hence, if ESMA would not consider the above when determining a class of OTC Derivatives clearing eligible, it might mean in case of CDS a factual prohibition for UCITS and AIF to further use those:

As a result of the clearing of an OTC Derivative, a chain of OTC Derivatives comes into existence whereby each OTC Derivative of this chain corresponds with the other OTC Derivatives of this chain. If there would be specific provisions of the CDS only being applicable for UCITS, AIF or their managers, this would lead to the situation that the terms of one of the OTC Derivatives of this chain would not correspond with the terms of the other OTC Derivatives of this chain. Any loan being delivered from one end of the chain would not reach the other end of the chain. That might be crucial for the clearing process.

### III. The Segregation of assets and positions

The information provided by the competent authority to ESMA when it authorizes a CCP to clear a class of Derivative have to include a description about the capability of a central counterparty to provide a sufficient segregation of the accounts in order to avoid unintended effects.

It is our understanding of Art. 39 of EMIR that CCPs are obliged to offer a segregation via omnibus accounts <u>and</u> individual segregated accounts. Currently we have doubts that this structure will be offered by all CCPs. Furthermore, there seems to be a different understanding in the market about the conditions of an individual segregation.

If ESMA determines a class of OTC Derivatives as clearing eligible while the CCP offering the clearing of that specific class of OTC Derivatives is not able to provide a clearing model which especially is in compliance with the statutory segregation requirements (cf. Art. 8 para. 1 of Directive 2010/43/EC)[1] of investment management companies managing numerous investment funds established in accordance with contract law (article 1 para.3 of Directive 2009/65/EC) or an investment fund constituted in accordance with statute but having numerous partial funds (umbrella structure), this could for mean UCITS and AIF being established in the said structure a prohibition of this specific class of standardized OTC Derivatives. The relevant German supervisory authority has already announced its opinion in a public hearing which took place in July 2012 that investment management companies, contrary to the provisions of EMIR, do not have the free choice of the segregation model. This shows, that our apprehension is not causeless.

In order to avoid unintended effects like factual prohibitions of certain OTC Derivatives (with unpredictable consequences) respectively the discrimination of certain Financial Counterparties regarding the access to clearing, ESMA should take into consideration the segregation models provided by potential CCPs when determining the relevant classes of OTC Derivative that should be subject to the clearing obligation. If ESMA and the national competent authority assess that CCPs are not capable to provide a segregation model which is in compliance with the requirements of UCITS and AIF especially being established in accordance with contract law (article 1 para.3 of Directive 2009/65/EC), the relevant class of OTC Derivatives should not be qualified as clearing eligible. Both, ESMA and the national competent authority, shall ensure that the relevant class of OTC Derivatives is only determined as clearing eligible, if the relevant CCP is able to provide at least one segregation model which meets the statutory requirements of all market participants subject to the clearing obligation.

If ESMA prefers not to deal with the specifics of the different segregation models offered by the different CCPs respectively the different regulatory specifics of the different kind of Financial Counterparties, it shall declare all Financial Counterparties, regardless of any applicable national or EU regulation, free in their choice of the preferred clearing model. Especially, we consider it essential  to clarify whether or not EMIR supersedes all other European regulations applicable to any of the Financial Counterparties (e.g. the UCITS Directive).

We believe it is necessary  also be active in the aforementioned manner in order to achieve a homogenous treatment of all UCITS respectively AIF and their managers within the European Union.

Finally, it is worth emphasizing that any clarification and discussion between the investment management companies and the national competent authority regarding “ifs” and “buts” of offered clearing models could hamper the investment fund industry to implement the clearing

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[1] Directive to implement Directive 2009/65/EC: *“UCITS accounting shall be kept in such a way that all assets and liabilities of the UCITS can be directly identified at all time. If a UCITS has different investment compartments, separate accounts shall be maintained for those investment compartments.”*

obligation of the relevant class of OTC Derivatives in time and to adhere to the G-20 commitment to clear all standardized OTC Derivatives through central counterparties.

For the given reasons, we propose the following amendments.

Article 1 CRI para. 5 **new** of Annex II Chapter IV:

***5. In order to ensure a non-discriminatory access to the relevant CCP, ESMA shall take into consideration whether at least one of the segregation models offered by the relevant CCP is in compliance with the further statutory requirements for segregation applicable to the several kinds of Financial Counterparties.***

Art. 1 PR para 3e **new** of Annex II Chapter IV

***e. the segregation model(s) being in compliance with the statutory segregation requirements of all Financial Counterparties.***

## B. Risk mitigation for OTC Derivative contracts not cleared by a CCP (Annex II, Chapter VIII, RM)

### I. Timely confirmation

We disagree with the proposal made by ESMA that all not-centrally cleared OTC Derivative contracts with a financial counterparty or a non-financial counterparty should be confirmed by the end of the same business day at latest. We think that non-centrally cleared OTC Derivatives should be confirmed as soon as possible and could include the Fed target time frame as an alternative confirmation benchmark.

The intended time frame might not leave enough time reserves to resolve possible discrepancies in the confirmation process between the counterparties and could therefore damage the quality in the confirmation process.

Furthermore, the Technical Standards should consider the worldwide market practice regarding the party writing the confirmation. If the OTC Derivative is agreed between two banks, it is the “bigger” bank who is writing and sending out the confirmation. If the OTC Derivative is agreed between a bank and a UCITS or AIF or their manager, it is the bank who is writing and sending out the confirmation. While the role of banks in the confirmation process might switch, depending of their counterparty of the OTC Derivative, UCITS respectively AIF and their managers have a fix position in this confirmation system: Approving the confirmations received from the bank.

According to the worldwide market practice, it especially is not in the hand of UCITS and AIF respectively their manager to speed up the confirmation process. We believe that the Technical Standards, as a general principle, should consider the counterparties role when determining obligations and deadlines. In our understanding it would be in line with the worldwide market practice, if the confirming counterparty would have to send out the confirmation within a certain time frame while the re-confirming counterparty would have to re-confirm within a certain time.

Otherwise, UCITS and AIF as well as smaller banks might be obliged to establish a unit which is writing down confirmations. Such a unit would only be maintained as a fallback for the case that a confirmation is not received within a certain timeframe. A fallback of this kind would not only be expensive, it would also be source of new problems: If - contrary to the current situation - confirmations would be sent out by both parties, it would be unclear, which confirmation should be re-confirmed respectively there might be the situation that one and the same trade is confirmed twice but with different contents.

Finally, we would like to point out that the reporting of outstanding OTC Derivative transactions for more than five business days (on a monthly basis) to the competent authority should be made by the sell side and where appropriate by a third entity.

## II. Reconciliation of non-cleared OTC Derivatives

Picking up the current opinion of national supervisory authorities, we deem it necessary that ESMA should clarify that the suggested number of contracts to be reconciled with the counterparty should apply to the level of the individual investment fund and not to the level of the investment management company**.**

Such an approach would be compliant with EMIR, where each investment fund (UCITS and AIF, Article 2 para 6) is deemed to be a separate Financial Counterparty. A differentiation between funds established in accordance with contract law (which do not have a distinct personality) and those constituted in accordance with statute does not take place in EMIR. Moreover, due to a lack of a distinct legal personality of the funds established in accordance with contract law, it is the investment management company who agrees on OTC Derivatives acting for the joint account of the investor of the respective investment fund. Due to the applicable statutory segregation requirements, the basis for OTC Derivatives is a separate master agreement between the investment management company and the relevant counterparty with regard to each individual investment fund managed by the investment management company.

Besides it is not clear, why the dispute process being part of the collateral management should not be sufficient for fulfilling the reconciliation requirements (cf. page 79, margin note 79/80 of the Consultation Paper). The conditions of the OTC Derivative are reviewed and confirmed at the very beginning of the maturity of the OTC Derivative. Therefore, we do not see, in how far there could be a benefit of a daily reconciliation considering the terms of each single OTC Derivative.

During the lifetime of an OTC Derivatives there might only be different opinions of the contractual parties as to the value of the OTC Derivative as well as the collateral provided. Differences are based on different valuation times and price sources. As EMIR includes a mandatory collateralization, the parties will become aware of any essential differences in the valuation immediately and therefore would start the dispute process being agreed on basis of the applicable master agreement. In light of the expected costs of implementation, it should be sufficient having the dispute- and confirmation process as proper reconciliation.

We propose the following amendment (Article 2 RM para 4 sub para. c **new** of Annex II Chapter VIII):

> ***<u>c. for UCITS and AIF as defined in Article 2 para 6 EMIR the number of contracts shall apply on the level of the individual UCIT respectively AIF.</u>***

## C. Collateral Requirements (Annex III, Chapter XI, COL)

### I. Main market index equities

Union Investment generally agrees to the approach of letting the CCPs decide whether or not a financial instrument can be qualified as eligible collateral.

Nevertheless, we deem it necessary to clarify that also equities might fulfill the requirements laid down in Annex III, chapter XI, COL). It should also be clarified that main market index equities generally fulfill certain criteria, especially the criteria set out in no. 3 lit (b) sub para. (i), (ii), (vi) of Annex III, chapter XI.

Union Investment believes that the scope of highly liquid financial instruments being eligible as collateral has to include besides cash and bonds also main market index equities. The latter have improved their quality as collateral during the financial crisis as it was quite easy to sell those in a short time frame and appropriate haircuts have been considered by market participants. Investment funds are subject to numerous restrictions and therefore some investment fund might have a lack of assets eligible as collateral. According to such legal requirements, investment funds only a limited access to collateral being eligible for the clearing process at the CCP.

In this context we would like to draw your intention to the BCBS/IOSCO consultation which incorporates as eligible collateral equities in major stock indices for non-centrally cleared OTC Derivative contracts (page 22 of the consultation).

Open ended real estate investment funds will face problems to hedge existing currency risks via OTC Derivatives if those are determined to be clearing eligible. Open ended real estate investment funds are obliged to be invested in real estate and have to maintain liquidity for the daily redemption of fund units. Therefore these funds might not be able to provide highly liquid financial instruments as collateral to a CCP. We believe that in such circumstances an open ended real estate investment fund should be allowed to provide a bank guarantee as collateral.

We propose the following amendments.

Article 1 COL para. 3 (b) ix **new**:

***(ix) main market index equities fulfill the requirements laid down in sub para. (i), (ii) and (vi).***

Article 2, para 20 **new**

***(20) "financial instruments" means "transferable securities" and "money market instruments" specified in Section C of Annex 1 of Directive (new MiFID)***

**II. Cash Collateral**

We are very concerned by the Guidelines on ETFs and other UCITS issues (ESMA/2012/44) published in July of this year, as they consider cash revenues acquired from repurchase agreements ("repos") as equivalent to collateral from securities lending and submit both payments to the same limitations with regards to "re-investment and deposit". In consequence UCITS, respectively their managers, will not be allowed to use the purchase price received under repos for cash collateral contributions.

From the fund's perspective, repos are legally and economically not even familiar with securities lending. The liquidity gained from repos has to be qualified as purchase price and should therefore be available for cash collateral contributions. Any change in value of the securities subject of the repo are to be collateralized – as set out in the standard master agreements. This demonstrates that the amount paid under a repo is not a collateral and therefore should not be treated like if it was cash collateral provided for a security loan transaction.

The liquidity gained by UCITS from repos is required to meet the variation margin requirements of CCPs. The investors cash paid into the investment fund is being invested by the manager of a UCITS in order to reach the investment goal. In order to be able to redeem fund units and prevent liquidity problems, managers of UCITS are entitled to enter into credits (up to 10 % of the NAV) or to enter into repos. These are the only sources for liquidity.

EMIR requires UCITS and their managers to access CCPs and to clear OTC Derivatives eligible for clearing. Since the variation margin has to be provided by posting cash collateral, UCITS are subject to much higher liquidity requirements as they were prior to EMIR.

As UCITS unlike other financial counterparties are also not allowed to post cash collateral received from a third party as own cash collateral contribution to another party, the new ESMA guidelines lead to the consequence that UCITS and their managers only have access to credits limited at 10% of the NAV in order to access liquidity for any cash collateral contributions. The managers of UCITS cannot use these 10% completely for cash collateral purposes as they have to keep in mind that this source for liquidity might be required for the redemption of fund units.

UCITS will not be able to meet the rising need for cash on the one hand and to comply with the tighter ESMA requirements on the other hand. As a consequence ESMA takes away the ability of UCITS to hedge existing market risks via standardized OTC Derivatives. In the end the level of investor protection will be lower (even though ESMA wanted to reach the very opposite effect). Furthermore there will be a negative effect in terms of pricing because spreads will rise if UCITS as important buy side participants will be *de facto* excluded from participating in the process of central OTC Derivatives clearing.

The aforementioned consequences do not meet the goals set out by the G-20. According to recital 5 of EMIR the G-20 leaders agreed in Pittsburgh at September 26, 2009 that all standardized OTC Derivatives should be cleared through a central counterparty. In June 2010, G-20 leaders reaffirmed their commitment and also committed to accelerate the implementation in an internationally consistent and non-discriminatory way.

The restrictions for UCITS, implemented by the ESMA Guidelines on ETFs and other UCITS issues, dated July 25, 2012, have discriminatory character (unlike other financial counterparties, UCITS will not have the required access to CCPs).

We would like to highlight that using the liquidity gained from repos for cash collateral contributions especially does not mean any leverage or increase of risk but rather a better protection for investors:

If an OTC Derivative with a UCITS would be uncollateralized the counterparty would have a theoretical default risk at the volume which would be requested as collateral ("theoretical", as UCITS have to comply with the cover rule which makes them the most sound counterparties in the market). In case of a request for cash collateral, UCITS would agree on a repo in order to receive the amount required for posting the requested cash collateral. The UCITS' counterparty of the repo would have the purchased securities and any value movements are subject to collateralization. As a result neither the counterparty of the OTC Derivative nor the counterparty of the repo faces a counterparty risk of the UCITS. Compared to the initial situation, the investors of the UCITS are only facing the issuer risk of the security sold to the counterparty of the repo (because it is already agreed to buy back the same security for a fix price), but even this does not mean an increased risk, as the investors of the UCITS faced the identical issuer risk prior the execution of the repo transaction. As far as supervisory authorities are concerned about any additional OTC Derivatives which might be agreed by the UCITS and their managers, it needs to be pointed out that there are already limitations in place which limit the usage of Derivatives by UCITS (e.g. the cover rule, by which the UCITS is obliged only to enter into Derivatives which can be fulfilled with the assets belonging to the fund). Allowing the usage of liquidity gained from Repos would not lead to a higher leverage of risk. It would only allow UCITS and their manager to enter into standardized OTC Derivatives to the extent required for a prudential management of the investors' assets within the regulatory frame already set.

For the given reasons, we deem it necessary to amend para. 39 of the ESMA Guidelines on ETFs and other UCITS issues, dated July 25, 2012, especially in order to maintain UCITS' ability to hedge existing market risk by using standardized OTC Derivatives.

## D. Reporting Obligation(Annex V)

### I. Extent of the reporting obligation

The implementation requires some more certainty regarding the extent of reporting obligation. It seems to be still an open question, whether or not warrants and certificates are treated as Derivatives, subject to a reporting obligation, or as security. With regard to Derivatives traded on exchanges it should be clarified that only the parties to the Derivative shall be subject to the reporting obligation.

Furthermore it is an open question, if UCITS and AIF respectively their managers, who cannot become a clearing member and therefore cannot participate directly in trading Derivatives on an exchange, will be subject to a reporting obligation under EMIR, as they act as principal in an agency model (commission basis) without being party to the Derivative itself.

We believe that there should be a homogenous treatment of those matters within the European Union. Therefore, it would be highly appreciate if ESMA could clarify those aspects in their proposal of the Technical Standards.

Another aspect, ESMA should consider are the costs of the implementation of reporting. It should be avoided that market participants have to acquire the services of a TR with regards to a specific class of OTC Derivatives if other TR will cover the same class of OTC Derivatives a short time later.

Finally, we see a need for clarification in this regard, if market participants will have to supervise the services of TR worldwide or if ESMA will determine which TRs are eligible for fulfilling the reporting requirements under EMIR.