

COMMENT LETTER

August 6, 2012

ICI and ICI Global Submit Comments to European Securities and Markets Authority on the Regulation of OTC Derivatives (pdf)

August 3, 2012 Mr. Steven Maijoor Chair European Securities and Markets Authority CS 60747 103 Rue de Grenelle 75345 Paris Cedex 07 France Re: Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories Dear Mr. Maijoor: The Investment Company Institute ("ICI")¹ and ICI Global² appreciate the opportunity to provide comments on the consultation paper issued by the European Securities and Markets Authority ("ESMA") on the draft technical standards for the regulation of OTC derivatives ("Draft Technical Standards").³ The Consultation Paper, which seeks input regarding the technical standards for the European Market Infrastructure Regulation ("EMIR"), covers (1) OTC derivatives, including the clearing obligation, risk mitigation techniques for contracts not cleared by a central counterparty ("CCP"), and exemptions from certain requirements; (2) CCP requirements; and (3) trade repositories. ICI and ICI Global members, as market participants representing millions of shareholders, generally support the goals of the G20 countries to provide greater oversight and transparency of the swap markets. Funds use swaps and other derivatives in a variety of ways. They are a particularly useful portfolio management tool in that they offer funds considerable flexibility in structuring their investment portfolios. Uses of swaps and other derivatives include, for example, hedging positions, 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.1 trillion and serve over 90 million shareholders. 2 ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US \$1 trillion. 3 Draft Technical Standards for the Regulation on OTC Derivatives, CCPs, and Trade Repositories, European Securities Markets Authority (June 25, 2012) ("Consultation Paper"). ICI/ICI Global Letter to Mr. Steven Maijoor August 3, 2012 Page 2 of 8 equitizing cash that a fund cannot immediately invest in direct equity holdings, managing the fund's cash positions more generally, adjusting the duration of the fund's portfolio, managing bond positions in general, or managing the fund's portfolio in accordance with the investment objectives stated in its prospectus. To employ OTC

derivatives in the best interests of fund shareholders, ICI and ICI Global members have a strong interest in ensuring that the derivatives markets are highly competitive and transparent. Given that many swaps businesses are conducted across multiple jurisdictions, ICI and ICI Global members engage in derivatives transactions in the EU or that involve an EU counterparty. Therefore, we support efforts to ensure a regulatory regime in the EU for OTC derivatives that encourages liquidity, fairness and transparency. Developing the appropriate regulatory framework for derivatives and avoiding unintended consequences, however, is a very difficult task. We appreciate ESMA's efforts to seek input from stakeholders, and we continue to urge the EU to conduct thoughtful and comprehensive analysis of the multitude of issues raised by EMIR and the Consultation Paper. We note that some key issues – in particular, cross-border application of EMIR and margin requirements for uncleared derivatives – that must be addressed by ESMA will be discussed in separate consultation papers. We believe these are critical issues that must be carefully considered and a rational approach must be developed among global regulators to avoid imposing unworkable regulatory requirements of multiple jurisdictions on transactions that may have a nexus or connection to different jurisdictions. We look forward to ESMA's draft technical standards and interpretations of the scope of application of EMIR to transactions between non-EU counterparties or transactions involving a non-EU counterparty. In this letter, we focus on several key issues for funds and their shareholders that are raised in the Consultation Paper. We hope that our recommendations (as set out in detail below) will assist ESMA in the preparation of its final report on the Technical Standards.

Customer Collateral Protection for Indirect Clearing Arrangements In the Consultation Paper, ESMA contemplates that, to comply with the clearing obligation, a counterparty must become a clearing member, a client, or establish indirect clearing arrangements. The Consultation Paper does not provide details regarding these "indirect clearing arrangements," and we are not certain at this early stage to what extent our members will engage in these arrangements to comply with the clearing obligation. We, nevertheless, believe that certain protections should be provided to indirect clearing arrangements, particularly if these arrangements facilitate the ability of non-EU market participants to conduct transactions in the EU or with EU counterparties. The Draft Technical Standards should be revised to provide indirect clients with an equivalent level of protection as direct clients, as required by EMIR. Although we appreciate ESMA proposing to provide an omnibus "client" account at the CCP level for the exclusive purpose of holding assets and positions of indirect clients, we request that indirect clients be provided the right to request that ICI/ICI Global Letter to Mr. Steven Maijor August 3, 2012 Page 3 of 8 individually segregated accounts be established at the CCP level.⁴ The ability of indirect clients to establish individual segregated accounts at the CCP level may afford greater protection for the assets of the indirect clients in the event of a default of a "direct client" or of a clearing member than an omnibus "indirect client" account. We believe further analysis of indirect clearing arrangements may be necessary, including the costs and operational challenges for market participants. Given the recent incidents in the United States involving a failure to safeguard customer collateral, however, strong protection for customer assets is critical for market participants to have the confidence necessary to engage in cleared derivatives transactions.

Risk Mitigation for Uncleared Derivatives For OTC derivative contracts that are not subject to the clearing obligation, financial and non-financial counterparties are required to mitigate risks by using different techniques to be specified by ESMA in the Technical Standards. We have certain concerns with these risk mitigation techniques as proposed in the Draft Technical Standards, which are described in more detail below.

Timely Confirmations ESMA proposes to require timely confirmation of transactions and specifies the timeframe for confirmations. We support efforts to mitigate counterparty risk by requiring parties to confirm transactions promptly via electronic means. We, however,

seek a clarification with respect to the parties responsible for the timely confirmations and have concerns with the timeframe imposed on all counterparties. First, we seek clarification regarding the practical aspects of how counterparties may comply with the obligation to provide timely confirmation. Specifically, given the meaningful and practical differences among market participants with respect to resources, readiness and expertise (as described below), we recommend that the confirmation obligation be required of the dealer (rather than the client) with respect to the key economic terms of the transaction. The parties can then negotiate and agree to the final terms of the confirmation to be signed by the parties without a specific time limitation on this process. Second, if ESMA disagrees with this recommendation, and instead intends to require both derivatives dealers and funds as counterparties to confirm and sign the confirmation, then ESMA should consider extending the timeframe from the end of the same business day to a more realistic period of time and/or applying this requirement on a “proportionality” basis. The speed of processing and agreeing to a confirmation often depends on the nature of counterparties. A derivatives dealer might have the resources and operational infrastructure to produce and execute same day confirmations. Funds and their managers are unlikely to have the operational systems in place to do the same. We also recommend that ESMA clarify that an investment manager that arranges for the establishment of an account with a clearing member (or a direct client of a clearing member) for the fund it manages is not a “direct client” providing “indirect clearing arrangements” to such fund. ICI/ICI Global Letter to Mr. Steven Maijoor August 3, 2012 Page 4 of 8 same. Mandating funds to be equally subject to the obligation to execute a confirmation of the transaction by the end of the same business day as a derivatives dealer would require funds and their managers to undergo significant and costly systems modifications that may not be feasible, particularly for a small to medium-sized investment manager. Under current market practices, the dealer will typically produce the confirmation and the client will then be allowed a sufficient amount of time to review and agree to this confirmation. In many cases, the confirmation might not be agreed to by the parties for several days or, in some cases, weeks. Moreover, although same day entry into confirmations may be possible with certain derivatives that are currently traded on electronic platforms operated by dealers, the same may not be achieved with respect to other (less frequently traded) types of derivatives. Therefore, we recommend that, if ESMA determines to require funds (in addition to their counterparties) to confirm and sign the confirmation, the obligation should apply as appropriate and proportionate taking into account the nature of the counterparties, the class of OTC derivative, and the scale and complexity of each counterparty’s operations. We recognize that timeliness is important to avoid uncertainty regarding the status of the trades and to promote prompt, efficient, and accurate processing of trades. We believe that immediacy of the confirmation should not override all other factors in mitigation of counterparty risk, including accuracy of the terms of the transactions. Indeed, we are concerned that setting too short of a deadline may result in less diligent checking of the confirmation by the counterparties (if, for example, one party confirms close to the deadline) and, as such, increase the operational risk. In addition, with respect to the provision allowing confirmation by the end of the following business day in the case of counterparties located in different time zones, counterparties should be permitted to confirm within this time period if the processing and confirming of the transaction (i.e. the back office or middle office function) of either counterparty are conducted in a jurisdiction in a different time zone. Many global counterparties to OTC derivative transactions operate with the relevant operational functions sometimes located in different jurisdictions (and time zones) from the functions responsible for the execution of trades. Portfolio Reconciliation and Portfolio Compression With respect to the risk mitigation practices of regular portfolio reconciliation and portfolio compression, ICI and ICI Global support the “proportionality” approach proposed by ESMA (e.g. that the frequency of

portfolio reconciliations should be appropriate to the characteristics of the portfolio) and generally agree with the proposed schedules for performing portfolio reconciliations and portfolio compression. ESMA should clarify that these practices and schedules (which are based on the number of outstanding contracts) should apply on an individual fund or portfolio level in recognition of the fact that the marketplace and that the regulatory requirements for regulated funds that are publicly offered generally apply at this level, treating individual funds and series funds as if the separate portfolios were ICI/ICI Global Letter to Mr. Steven Maijor August 3, 2012 Page 5 of 8 separate investment companies. For example, in the United States, in creating funds, a sponsor may establish each fund as a new, separately organized entity under state law or as a new “series company,” that has the ability to create multiple sub-portfolios (i.e., individual mutual funds), or series.⁵ The requirements under the U.S. federal securities laws safeguard the assets in an individual portfolio from market or other risks that may negatively affect another portfolio, and consequently the shareholders invested therein and the fund complex more broadly. For example, liquidation of one fund series is isolated to that series. Shareholders must look solely to the assets of their own portfolio for redemption, earnings, liquidation, capital appreciation, and investment results.⁶ We understand that similar considerations apply in the case of “umbrella” fund structures established in certain EU jurisdictions (such as Luxembourg). Therefore, we believe that contracts held across different funds under the management of a single manager must not be aggregated for the purposes of determining whether the relevant thresholds (e.g. 500 or 300 outstanding contracts) are met. Considering the number of contracts outstanding with respect to each fund separately will more accurately reflect the exposure to counterparty risk.

Dispute Resolution We note that, under the Draft Technical Standards, financial counterparties would be required to report to competent authorities any disputes outstanding for 15 business days or more. We believe that greater clarity should be provided as to when a dispute is considered to arise for the purposes of the 15 business day period. For example, the dispute could be seen to arise as early as the moment that the contract is entered into and yet for whatever reason it might not be apparent to either party that there is actually a dispute until much later. We would therefore suggest that the 15 business day period commences once one party notifies the other that it considers that there is a dispute for the purposes of the Technical Standards.

Marking-to-Model ICI and ICI Global members support ESMA’s goals to provide a robust framework for reliable and prudent marking-to-model in situations where market conditions would prevent marking-to-market. As a general matter, we would welcome more guidance on the criteria applicable to marking-to-model. In particular, we request clarification that the requirement that marking-to-model should be validated and monitored independently from the division taking the risk will be applied proportionately recognizing that firms may have different organizational structures. For example, some investment managers currently vest the responsibility for marking-to-model in their investment

⁵ Series funds are effectively independent in economic, accounting, and tax terms but share the same governing documents and governing body.

⁶ See Regulation of Series Investment Companies under the Investment Company Act of 1940, Joseph R. Fleming, Business Lawyer, August 1989. ICI/ICI Global Letter to Mr. Steven Maijor August 3, 2012 Page 6 of 8

committees. These committees typically include portfolio managers (i.e., the risk-taking unit) as well as senior management and representatives of other areas of the business (e.g., risk management and compliance). This committee structure is intended to mitigate against conflicts of interest that could occur if valuation were left solely to the discretion of the portfolio managers. For this reason, we do not believe that ESMA should prohibit this common type of arrangement under the independence requirement. We recommend that the criteria for using marking-to-model be applied on a proportionality basis, particularly in the case of smaller counterparties whose internal organizational structure might not allow

the validation and monitoring of the marking-to-model process by members of staff which are clearly separate and independent from the risk-taking unit. Such smaller counterparties should be permitted to put in place alternative arrangements for ensuring that the approval and monitoring of the models is carried out with adequate control and independence.

Central Counterparties Governance Arrangements We support the general principle incorporated in the Draft Technical Standards that stakeholder accountability should be a key component of sound governance arrangements for CCPs. As participants in OTC derivatives markets, ICI and ICI Global members have a strong interest in ensuring that these markets operate in a manner that treats all market participants fairly. To that end, we recommend that CCPs should include representatives of both sell-side and buy-side market participants on their boards of directors and/or supervisory or advisory boards. We note that to benefit from a diverse group of market participants, some equities clearing organizations and stock exchanges already include investor representatives on their boards. For example, the board of the Depositary Trust and Clearing Corporation is made up of 19 directors of whom 13 are from market participants, including international broker-dealers, custodian and clearing banks and investment institutions. ICI and ICI Global believe that stakeholder involvement in the governance of CCPs would minimize conflicts of interests by balancing the commercial interests of CCPs with the interests of stakeholders. Examples of such conflicts that may be checked by stakeholder participation include situations where CCPs seek to maximize their profits to the detriment of buy-side market participants. Given the importance of the board of directors of a CCP in monitoring and controlling conflicts of interest, it is imperative that the composition of boards of CCPs include stakeholder representatives. Guaranteeing stakeholder representation on the board also would level the playing field for all CCPs by creating a uniform governance structure in which all CCPs will operate under similar restraints on the influence of their owners. For similar reasons, we believe that the Technical Standards should require risk committees of CCPs to include a wide range of client representatives. As CCP risk committees will be responsible for making decisions capable of having profound effects on the OTC derivatives markets, market ICI/ICI Global Letter to Mr. Steven Maijoor August 3, 2012 Page 7 of 8 participants have a strong interest in ensuring adequate and diverse stakeholder representation on risk committees as well as transparency as to the committee's decision-making processes. We recommend that the Technical Standards should require adequate representation of each category of member of the risk committee included in Article 28 of EMIR and require CCPs to disclose the membership of their risk committees to the public.

Eligible Assets for Collateral and Valuation and Haircuts We note that the items included on the list of highly-liquid collateral are taken from EMIR. However, our understanding of EMIR is that these types of collateral were simply included as examples and not as a definitive list of highly liquid collateral. We request that ESMA clarify that the list is non- exhaustive. ICI and ICI Global recommend that ESMA require CCPs to publish any changes they make to their policy on accepting cash or financial instruments denominated in the relevant currency as collateral in advance of the changes to allow clearing members and clients a minimum transitional period (e.g. at least one month) to comply with the new requirements. We also note that CCPs are afforded a substantial amount of discretion in valuation of collateral and the applicable haircuts. ICI and ICI Global members are concerned that, in the absence of uniform criteria for CCPs on valuation and haircuts, CCPs may have an incentive to set collateral requirements in a very conservative manner which may, in turn, result in a significant increase of collateral required to be provided by investors. For investment managers, increased collateral requirements reduce the amount of assets that may be invested on behalf of clients. ICI and ICI Global recommend requiring CCPs to base their valuations on the generally accepted valuation sources available to CCPs, clearing members and clients. Moreover, consistent with current market practices,

clearing members and clients should have the ability to challenge or appeal collateral valuations and the Draft Technical Standards should provide for a mechanism for such appeals (e.g. the appointment of an independent valuation agent). Reporting Obligation We welcome ESMA's efforts to align the reporting obligations under EMIR with transaction reporting obligations under MiFID and to work towards the objective of a common reporting mechanism. In its discussion with trade repositories and EU competent authorities, ESMA also should take into consideration the fact that many counterparties will have reporting obligations in relation to derivative transactions under the laws of third country jurisdictions. In this respect, we believe that a global coordination of the data and the format for reporting would not only be consistent with the aims of G20 Pittsburgh declaration for achieving greater transparency but will also reduce a very significant burden on market participants. ICI/ICI Global Letter to Mr. Steven Maijoor August 3, 2012 Page 8 of 8 * * * * * If you have any questions on our comment letter, please feel free to contact the undersigned or Giles Swan at 011-44-203-009-3103, Sarah Bessin at 202-326-5835 or Jennifer Choi at 202-326-5876. Sincerely, /s/ Karrie McMillan /s/ Dan Waters Karrie McMillan Dan Waters General Counsel Managing Director Investment Company Institute ICI Global 202-326-5815 44-203-009-3101 kmcmillan@ici.org dan.waters@ici.org

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