NATIXIS
ASSET MANAGEMENT

International Organization of Securities Commissions
C/Oquendo 12
28006 Madrid
Spain

Sent by email to wgmr@iosco.org

Natixis Asset Management
Legal Department
Email address:
service.juridique.structuration.et.operations.de.marche@am.natixis.com

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Re: Second Consultative Document on Margin Requirements for Non-Centrally-Cleared Derivatives

Natixis Asset Management (NAM) thanks the Basel Committee on Banking Supervision and the International Organization of Securities Commissions for giving it the opportunity to respond to the Second Consultative Document on the Margin Requirements for Non-Centrally-Cleared Derivatives.

With assets under management of 295 billion Euros (31/12/2012), NAM ranks among the leading European asset managers. It offers a wide range of effective management solutions, based on extensive expertise in European and specialized asset management including mandates, and regulated or unregulated collective investment schemes comprising Undertakings for the Collective Investments of Transferable Securities ("UCITS") regulated by the UCITS' Directive[1] and Alternative Investment Funds ("AIF") regulated by the AIFM Directive[2]. NAM provides services to a diverse client base: institutional investors, large companies, distributors, and clients of Banques Populaires and Caisses d'Epargne.

For more information about NAM, please visit www.am.natixis.fr.

NAM has actively participated in discussions with the "*Association Française de Gestion*" (AFG) and the European Fund and Asset Management Association (EFAMA) on the Consultative Document, but wishes to express its own views separately.

[1] Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast)
[2] Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers

In addition to our responses to IOSCO's questions in this second consultative document, we would like to highlight specific concerns with the principles and requirements set out in this document, some of which are not expressly open for comments.

GENERAL COMMENTS:

On the definition of "consolidated group" for the calculation of thresholds:

We understand that thresholds for initial margin requirements as defined in elements 2 & 8 of the consultative document (the "Thresholds") are to be calculated at the consolidated level of a group.

As asset managers, we are concerned that the scope of consolidation as envisaged in this document may lead to the calculation of consolidated Thresholds in specific cases for collective investment schemes (CIS) such as some "dedicated CIS" (CIS which are not offered to the public and dedicated to one institutional investor) and UCITS with compartments.

To avoid any doubt, we would like IOSCO to expressly exclude CIS from the scope of the definition of "consolidated group" for margining purposes. Each CIS should calculate Thresholds at its own individual level and if the notion of "consolidated group" does not expressly exclude CIS, it may result in an implicit ban for CIS to enter into non-cleared derivatives transactions.

1 – Dedicated CIS
Please note that some of the dedicated CIS managed by NAM are consolidated into the accounts of the client who holds the CIS.
Such client may also be part of another entity, which is itself part of a group and thus the CIS may wind up being subject to several levels of consolidation.
In this case, it is both unrealistic and unjustified to apply the notion of "consolidated group" to the CIS in order to include transactions directly concluded by its client or any entity such client is consolidated with.

Indeed, from a practical point of view, the CIS will not be able determine whether the Thresholds are reached on a consolidated basis as the CIS is not informed of the derivatives transactions entered into by the client. This will be unmanageable for the CIS. It will also result in the CIS being unable to engage in uncleared derivatives as it might exceed the Thresholds on a consolidated basis and not in a position to provide the required initial margin.

From a legal point of view, the CIS is an entity completely distinct from the client who invests in it.
Assets of the client may not be claimed to reimburse debts incurred by the CIS and conversely assets of the CIS may not be claimed directly to cover the client's debts.
Risks incurred by the CIS also remain at the CIS' level and do not affect directly the client.

2 – UCITS with compartments
NAM manages CIS, including UCITS which are divided in several compartments which are clearly separated from each other with their own assets, different investment policies etc…. Each compartment is treated as a distinct CIS/UCITS.

We are concerned that the CIS or UCITS might be viewed as a "group" and that the Thresholds are calculated at the level of the CIS or UCITS which may result in each compartment being prevented from entering into uncleared derivatives.

We believe that Thresholds must be exclusively calculated at the compartment level.

This view is supported by UCITS regulations under French and Luxembourg law which stipulate that each compartment's rights and liabilities are segregated from the other compartments and constitute a separate UCITS.

- UCITS' Compartments under French law:
Unless otherwise specified in the regulations or statutes, each compartment is segregated financially. The compartments are solely responsible of the matters related to their debts, liabilities and obligations (Article L. 214-5, I of the Monetary and Financial Code).When a UCITS is comprised of one or more investment compartments, each compartment is considered as a distinct UCITS (Article R.214 -2 of the Monetary and Financial Code).

- UCITS' Compartments under Luxembourg law:
When a UCITS has several compartments, each of them is considered as a separate UCITS (Article 40, Law of 17 December, 2010).
A UCITS may include multiple compartments, each corresponding to a distinct part of the assets of the UCITS (article 181 (1) Law of 17 December 2010).
The assets of a compartment are exclusively dedicated to the rights or claims of the investors and the creditors that have arisen on or after the date of the incorporation and before the dissolution of the compartment, unless otherwise provided in the management agreements or the constitutional documents.
Each compartment of a UCITS may be liquidated without affecting the rights of other compartments. (s. 181 (6) Law of 17 December 2010).

<u>On the exchange of variation margin by regulated structured funds :</u>

Regulated structured funds present different specificities that justify an exemption of two-way variation margin.

First, as regulated funds, they pose very little systemic risk. Regulated funds tend to use derivatives for hedging rather than for taking positions. And more mechanisms already exist to frame the counterparty risk.
Requiring that they post large amounts of variation margin would have a direct effect on their performance as assets used for collateral cannot be invested elsewhere. It is important to remember that many of these funds are ultimately held by retail investors. Is the best use of the assets of the fund to be posting collateral for defaults which rarely occur, and which have very little impact on the financial sector, or to improve performance for investors?

Secondly, most of these funds benefit from a 100% capital guarantee. This guarantee is explicit as they are guaranteed by a credit institution and also implicit.
The OTC instruments in which they invest benefit from this implicit guarantee making the risk highly asymmetric between those funds and their counterparties. The valuation of those instruments is on average and most of the time positive, often with no cap and to the benefit of the fund. In the very few cases where the valuation is negative, the downside is limited.
As a result, these funds present a very low risk for counterparties, making two way variation margin irrelevant.

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ELEMENT 1: SCOPE OF COVERAGE – INSTRUMENTS SUBJECT TO THE REQUIREMENTS

Q1: Treatment of foreign exchange forwards and swaps

We agree that a distinction should be made between initial margin and variation margin given that these types of transactions are not likely to be a source of systemic risk as they are physically settled, with fixed payment obligations and usually short-term.

- variation margin: it should apply to foreign exchange swaps and forwards with a maturity of more than three months. These transactions do not present significant counterparty risk to market participants. The current market practice is to pay variation margin on transactions of a maturity exceeding three months, and we do not believe it is advisable to change this practice. In this context, the "Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions" published in February 2013[3] ("Supervisory Guidance for FX") advises that variation margin is exchanged with sufficient frequency and does not require variation margin for transactions entered with certain counterparties (sovereigns, central banks, etc…).

- initial margin: foreign exchange swaps and forwards should be exempt from initial margin requirements regardless of maturity.

  Settlement risk can be mitigated thanks to the use of appropriate platforms. For instance, CLS[4] allows real-time settlement between counterparties for each pair of matched instructions by matching the corresponding debit and credit entries across Settlement Members.
  It is also to be noted that the Supervisory Guidance for FX does not require the exchange of initial margin.

ELEMENT 2: SCOPE OF COVERAGE – SCOPE OF APPLICABILITY

As mentioned in our general comments, transactions entered into by structured regulated funds should be exempt from posting variation margin.

Regulated funds tend to use derivatives for hedging rather than for taking positions and more mechanisms already exist to frame the counterparty risk.
The exemption would allow these funds to continue to engage in this activity without incurring excessive cost and would limit the negative impact of initial margin requirements on their liquidity.
Also, requiring that they post large amounts of variation margin would have a direct effect on their performance as assets used for collateral cannot be invested elsewhere. It is important to remember that many of these funds are ultimately held by retail investors. Is the best use of the assets of the fund to be posting collateral for defaults

[3] Basel Committee on Banking Supervision's "Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions" published by the Bank for International Settlements
[4] Continuous Linked SettlementCLS is a leading global settlement system for FX trading.

which rarely occur, and which have very little impact on the financial sector, or to improve performance for investors?
Secondly, most of these funds benefit from a 100% capital guarantee. This guarantee is explicit as they are guaranteed by a credit institution and also implicit.
The OTC instruments in which they invest benefit from this implicit guarantee making the risk highly asymmetric between those funds and their counterparties. The valuation of those instruments is on average and most of the time positive, often with no cap and to the benefit of the fund. In the very few cases where the valuation is negative, the downside is limited.
As a result, these funds present a very low risk for counterparties, making two way variation margin, irrelevant.

We would also like to stress again the fact that **the definition of "consolidated group" relating to thresholds should not apply to CIS** for the legal, operational and risk management reasons set out above in our general comments.
Each CIS (including "dedicated CIS" and compartments of CIS) should calculate thresholds at its own individual level.

Comments on Point 2(h) of the Background discussion :

We understand that under the initial margin threshold, there is no obligation to collect initial margin however the collecting party has the option to collect and may choose to do so.
Our concern is that the collecting party who has the option, imposes its choice to collect to its counterparty which might not be set-up for exchanging collateral under the threshold.
In this case, we believe that this optional collecting of initial margins should be agreed between the parties.

We would like IOSCO to specify that this optional exchange of initial margin is not only at the hand of the collecting party but subject to both parties' agreement.
We also believe that the choice should not be made transaction by transaction but at the outset of the relationship between the parties.

Thus, we would like IOSCO to clarify that the parties' agreement on a global and bilateral basis which should be documented in the collateral annex signed between the parties.

ELEMENT 3: BASELINE MINIMUM AMOUNTS AND METHODOLOGIES FOR INITIAL AND VARIATION MARGIN

Comments on Requirement 3 :

As asset managers, we believe that a standardized margin schedule should be the preferred approach as UCITS' regulations require that they set their own valuation process, which must be independent and not rely on its counterparty's valuation in accordance with the UCITS' Directive[5].

A standardized margin schedule used by both parties would also lessen the risk of disputes as compared to quantitative portfolio models developed by counterparties.

[5] Directive 2009/65/EC, article 51 (4) b.

However, the option to use a quantitative portfolio model must remain available as it may be more appropriate in certain situations.

In our view, it would be advisable to promote an industry initiative involving markets participants globally in order to propose and sign-off methodology on a set of standard models for various types of non-cleared OTC products.

ELEMENT 4: ELIGIBLE COLLATERAL FOR MARGIN

Comments on Requirement 4:

- On the list of eligible collateral:

We understand that the list is to be determined by the competent national authority, which raises the issue of maintaining a level-playing field across different jurisdictions.
It also appears unrealistic to let national authorities decide the levels of haircuts applicable to eligible collateral as such haircuts must be flexible in order to reflect with as little delay as possible the latest market developments and capture risk appropriately. A process requiring national authorities' decisions to modify haircuts is too rigid.

In our opinion, this issue could be resolved by leaving the determination of eligible collateral and applicable haircuts to the parties which is the current market practice. This should result from the parties' negotiation taking into account their respective risk mitigation policies and documented in a collateral annex (ISDA Credit Support Annex or FBF Annexe Remises en Garantie) as it is already the case today.

At the very least, we think that IOSCO's recommendation should also include shares/units of short term Money-market UCITS and that such shares/units should be should be treated as cash as they are very liquid assets.

Lastly, if national authorities decide to include assets which are not highly liquid and which valuation might generate frequent disputes between the parties, it would be advisable that national authorities also provide a model of valuation for these assets. This would help decrease the risk of disputes.

- On disputes relating to collateral:

Both parties should be able to initiate disputes and not just the collecting party.

ELEMENT 5: TREATMENT OF PROVIDED INITIAL MARGIN

Q2: Re-hypothecation and re-use of initial margin

We agree that collateral must be sufficiently protected in case of default of either the collecting or posting party which is why we favour transfer of title of exchanged collateral over the creation of security interests.

However, banning re-hypothecation and re-use is contrary to the current market practice and would also generate considerable costs and constraints for CIS and in particular UCITS.

The market current practice for OTC derivatives is to sign collateral contracts (ISDA's English Law Credit Support Annex and FBF Annexe Remise en Garantie) which provide for transfer of title of the exchanged collateral and payment of interest on cash collateral, in

favour of the transferor (the posting party). The reinvestment of collateral received enables the transferee (the collecting party) to pay the interest due to the transferor.

In addition, prohibition of re-hypothecation and re-use of initial margin would have a negative impact on the economy as liquidity would dry up and assets who could be used to finance the economy would instead be lying dormant in collateral accounts.
Figures in the Quantitative Impact Study (QIS)[6] attached to this consultative document shows that with a 50 M threshold, around 558,232 M€ are expected to be exchanged as initial margin which is a tremendous amount. If initial margin may not be reinvested, it deprives the economy of enormous sums and would have an adverse effect on the objectives pursued by central banks' current monetary policies.
Sourcing collateral will also be an issue for CIS, who will obliged to use their assets in order to post collateral, instead of investing these assets, This will have a detrimental impact on the performance of the CIS and as a consequence is contrary to the investors' interests.
Another negative effect of this prohibition is that it would deprive the collecting party of a way to generate interests that must be paid to the posting party. How will the collecting party be able to pay interest on collateral that it may not reinvest?
Receiving collateral would prove to be a costly operation.

Finally, such ban would also require that the current legal framework, in particular the Collateral Directive[7], is revised in order to make it compatible with the existing rules or create new types of securities. One possibility would be to create a form of "trust" or "fiducie" specifically designed for this purpose and which would manage the collateral exclusively to the benefit of the parties and ensure that in case of default of one of the parties, the other party may claim the transferred collateral.
Specific legislation may also be necessary to provide expressly that this type of security remains valid and is enforceable in case of bankruptcy.

In our view and based on the existing legal framework, appropriate balance between collateral protection and an unduly drain of liquidity may be achieved by restricting re-use to "safe" investment techniques such as:
- deposits with credit institutions having their registered office in a UE member state or in a state with equivalent prudential rules.;
- investment in high-quality government bonds;
- reverse repo transactions with credit institutions subject to prudential supervision;
- investment in short-term money market funds
- collateral posted to clearing houses (central counterparties) when entering into cleared derivatives

ELEMENT 6: TREATMENT OF TRANSACTIONS WITH AFFILIATES

Given that UCITS and AIF structures are not concerned by consolidated supervision, we are not in a position to respond to the proposed requirement to adapt margin requirements for derivatives between affiliates.
However, perhaps the proposal for affiliates could be extended to apply to transactions between a fund and its custodian. In such a case, the exchange of initial margin would not be appropriate as the custodian would hold both the assets of the funds and the initial margin. We believe that in such circumstances, either no initial margin should be posted or that it should be posted to a third party.

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[6] Appendix B, p . 32 Table 5
[7] Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements

ELEMENT 8: PHASE-IN OF REQUIREMENTS

Q 3: Phase-in

We agree that phasing-in the initial and variation margin requirements is necessary and that it should be gradually implemented after a reasonable period of time (at least a year) following the EMIR clearing obligations.

Indeed, the operational, contractual and financial impacts of EMIR's implementation are considerable for the industry and phasing-in of the new collateral requirements for non-centrally cleared derivatives should not start before 2016 at the earliest.

Lastly, on the aspect of thresholds, we would like to stress again the fact that **the definition of "consolidated group" should not apply to CIS** for the legal, operational and risk management reasons set out above in our general comments.
Each CIS (including "dedicated CIS" and compartments of CIS) should calculate thresholds at its own individual level.

APPENDIX C QUANTITATIVE IMPACT STUDY (QIS) ON MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED OTC DERIVATIVES

Q 4 :Accuracy & applicability of the QIS results

The statistics collected by IOSCO are interesting in many aspects, however from a general point of view we feel that some of the data are not representative for asset managers such as ourselves.

Our specific remarks are the following:

<u>On point 5 "Initial margining requirements for non-centrally cleared derivatives"</u>

We have noted that the current average practice of the QIS respondents is less conservative than the approach suggested by the IOSCO in that it takes shorter risk-horizon (8 in versus of 10 days) and lower confidence level (96% against 99%).
This shows that IOSCO's approach would significantly change current market practice.

<u>On point 7."Bilateral initial margin and centrally cleared margin requirements[8]"</u>

The reported amount of initial margin is not relevant from our perspective of asset managers since it mainly stands for the margin collected by 19 derivatives dealers (at 48%).
For the regulated structured funds we manage, the impact would represent roughly 3 bps on their performance, should they be subject to initial margin requirements.

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[8] P. 35 of the QIS