Mr. Patrick Pierson
European Commission
Rue de la Loi 200
B-1049 Brussels
Belgium

30 December 2013

Subject: Equivalence decision and LSOC segregation model

Dear Mr. Pierson,

The Committee on Investment of Employee Benefit Assets ("**CIEBA**"), Pensions Europe ("**PE**"), the European Association of Paritarian Institutions ("**AEIP**") and the Pension Investment Association of Canada ("**PIAC**") (together, the "**Global Pension Coalition**") hereby would like to provide comments regarding the recognition of non-European Union based central counterparties ("**CCPs**") for operation in the European Union. The Global Pension Coalition represents a very significant portion of the largest private defined benefit and defined contribution pension plans in the United States, Canada and Europe. The pension plans represented by the Global Pension Coalition provide retirement benefits for over a hundred million individuals in more than a dozen countries.

From our perspective as end users in the derivatives markets and fiduciaries for our pension beneficiaries, it is essential that the initial margin that we post is sufficiently protected under the European Markets Infrastructure Regulation ("**EMIR**"). This issue is of great importance for us, particularly due to our large one-sided OTC derivative positions. Below we describe why non-EU ("**Third-Country**") CCPs that solely offer segregation based on the "Legally Segregated, Operationally Commingled ("**LSOC**") model , such as CCPs based in the United States, do not meet the requirements laid down in Article 39 of EMIR and should therefore not be recognized under EMIR.

Equivalence test of segregation model under EMIR

Under EMIR eligible OTC derivatives must be cleared via a CCP that has either been authorised or recognised in accordance with Article 17 or Article 25 of EMIR. The recognition of a Third-Country CCP requires the European Commission to adopt an implementing act under Article 5 of Regulation (EU) No 182/2011. This should determine, amongst others, that the legal and supervisory arrangements of its home country ensure that CCPs authorized by the relevant regulatory authority in its jurisdiction comply with legally binding requirements which are equivalent to the requirements laid down in Title IV of EMIR.

Title IV of EMIR also covers the segregation requirements, including the requirement regarding full individual segregation. Article 39 of EMIR mandates that CCPs and clearing members offer clients at least the choice between omnibus client segregation and individual segregation. As some of our members have made clear to regulators in other jurisdictions, less protective models such as LSOC do not provide the structural protections afforded by individually segregated accounts against, amongst others, abuse or negligent recording of collateral by clearing members (Annex 1).[1]

Some CCPs and clearing members have asserted that LSOC qualifies as satisfying the requirement to offer 'individual client segregation' as defined under Article 39(3) of EMIR. We disagree with this assertion. LSOC, which, in fact involves commingling of accounts, does not offer equivalent protection to a physically segregated account. In its Q&A ESMA supported this view and stated the following[2]:

> *'In the case of a default of a clearing member, Article 48(6) of EMIR requires that a CCP's model of individual segregation provides for the transfer of the assets and positions held for the account of an individually segregated client to another clearing member or provides for the CCP to actively manage the risks in relation to those positions, including liquidating the assets and positions,. Where the transfer of the assets and positions held for the account of an individually segregate client to another clearing member does not take place, then pursuant to Article 39(9) of EMIR, the CCP's model of individual segregation should ensure that the assets recorded in the individually segregated account are not exposed to losses connected to positions recorded in another account. Accordingly it is not sufficient that the account of the CCP identifies only the value due to the account of the client. It must identify the specific assets (e.g. the particular or equivalent securities) due to the account of the client.*
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> *Alternative approaches to segregation that identify only the value due to the accounts of the clients (while recording the assets provided for the account overall) may be offered in addition, provided they meet the relevant requirements of Article 39 of EMIR, but they do not meet the requirement to offer individual client segregation.'*

Given the above we do not agree with ESMA's determination that the segregation requirements established by the United States regulatory authorities are broadly equivalent to EMIR.[3] Although we concur with the factual analysis of ESMA, for the following reasons the application of those facts to the law requires a different conclusion:

1. *No Choice*. Whereas EMIR stipulates that CCP's and clearing members must offer both individual client segregation and omnibus client segregation, LSOC is currently the sole segregation scheme available under US regulation.

2. *No Identification of Collateral to a Customer*. For an account to be EMIR-compliant for the purposes of individual client segregation, the CCP must be able to identify the specific positions and collateral held on the account as belonging to a specified client. In the current LSOC model the CCP cannot identify exactly which assets belong to whom *('asset*

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[1] See for example the CIEBA Letters of 8 August 2011 and 22 December 2011.

[2] Questions and Answers, Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR), 11 November 2013, ESMA/1633, CCP Answer 8(d), p. 33.

[3] ESMA, Final Report, Technical Advice on third country equivalence under EMIR-US, 1 September 2013, ESMA 2013/1157, p. 108-11.

segregation'). In fact, the LSOC model only identifies the value of the collateral held in an omnibus account with respect to each client of a clearing member ('*value segregation'*). Under EMIR, an equivalent account structure would qualify for omnibus" segregation but is not permitted for individual client segregation.

In an LSOC model the CCP does not know which collateral has been posted by a client or on behalf of a client. The CCP may be aware of the value of the collateral, but not of the actual assets which were posted by a particular client. Article 39(9)(a) of EMIR however prescribes that segregation is only achieved when the assets and positions are recorded in separate accounts which is not the case in the LSOC model.[4] As a result, LSOC models do not qualify as individual segregation. Within the LSOC model, the CCP may only allocate positions by liquidating securities collateral (i.e. converting all securities into cash and all cash into one currency) in the event of a clearing member's default. For clients, this may lead to a situation in which potentially huge amounts of collateral will be liquidated in a stressed market ('*firesale prices'*). Furthermore even when porting takes place the clients face a replacement risk with respect to their securities collateral. Given the fact that the main goal of portability is to avoid having a replacement risk this is not a good outcome.

3. <u>No mandatory protection for excess collateral</u>. The current LSOC models in the United States do not contain a mandatory provision, in accordance with Article 39(6) of EMIR, that ensures that when a client opts for individual client segregation, any margin in excess of the client's requirement shall also be posted to the CCP and distinguished from the margins of other clients or clearing members.[5] This means that in the current LSOC model excess margins can still be held by the clearing members and are exposed to bankruptcy risk.

Conclusion and request

Given the above it is clear that the current LSOC models do not qualify as individual client segregation.

We invite the European Commission to clarify that an LSOC model does not qualify as individual segregation under EMIR and therefore jurisdictions which effectively just allow LSOC models cannot be deemed equivalent. As regards to foreign CCPs that would like to provide their services in the European Union and/or European clients while offering the LSOC model , this analysis should ultimately lead to the conclusion that these CCPs do not comply with Article 39 EMIR. Consequently they should not be allowed to provide their services in the European Union, because the 'equivalence test' under EMIR does not allow them to do so.

We would welcome the opportunity to discuss this in more detail in a face-to-face meeting.

With kind regards,

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[4] The fact that the definition of assets in Article 39(10) EMIR includes '*the proceeds of the realization of collateral'* does not change that. Furthermore if a client posts securities A and another client posts securities B than it is possible that the proceeds of liquidating securities A may be relatively high and the proceeds of liquidating securities B might be relatively low. If the CCP does not know which client posted securities A or B, the client that posted securities A suffers a loss in this example.

[5] An LSOC model combined with the obligation to post excess margins at CCP level ('*LSOC with excess'*) would be an improvement but does not mitigate the primary risk mentioned under 2.

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We appreciate your consideration of our views.

Committee on Investment of Employee Benefit Assets

Pensions Europe

The European Association of Paritarian Institutions

The Pension Investment Association of Canada