Dorset County Pension Fund

Central Clearing and other regulatory changes

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A BNY MELLON COMPANY℠

Insight INVESTMENT

Background on EMIR

In response to the financial crisis, in 2009 the finance ministers of the G20 countries committed to reform derivatives that are traded bilaterally or over-the-counter (OTC). The European Union implemented the G20 commitments by creating the European Market Infrastructure Regulation (EMIR). For users of derivatives, EMIR has three main impacts:

- OTC and exchange-traded derivatives must be reported to trade repositories
- certain OTC derivatives will be subject to mandatory central clearing
- non-centrally cleared OTC derivatives are subject to risk mitigation standards

EMIR came into force on 16 August 2012 but its implementation is still being phased in. The phase-in schedule is described later in this paper.

Insight[1] has prepared extensively for the introduction of the EMIR. We have been a leading voice representing European pension investors in seeking to protect pension interests. Insight has been proactive throughout the legislative process, identifying the issues and potential solutions and then lobbying to represent clients' interests. We continue to engage with market participants and pan-European policy-makers to influence and highlight any unintended consequences that may arise for our clients.

We set out below some thoughts on EMIR and its implications.

Please note that this paper is not intended to be legal advice or investment advice.

Summary and action points

This paper summarises the key aspects of EMIR and central clearing as it relates to your investments with Insight and also potential implications for your currency hedging mandate which is not managed by Insight.

In short the obligations under EMIR are those of the Qualifying Investor Alternative Investment Fund (QIAIF), the bespoke pooled fund in which you are invested. Dorset County Pension Fund (the Fund) does not have any direct obligations under EMIR as a result of its investment with Insight.

The QIAIF benefits from the pension scheme exemption and therefore does not need to clear at this stage. We are encouraging our segregated mandate clients to put in place the documentation for Insight's clearing platform in order to give them the option of cleared trading as and when appropriate; as a result, we have put in place clearing documentation for the QIAIF.

When the margin rules for non-centrally cleared derivatives come into force, Insight will ensure that the QIAIF complies with those requirements.

There are several actions for the Fund to consider as part of the regulatory changes:

- to discuss with Insight any collateral implications as developments evolve and in particular in the event that Insight choose to clear positions
- consider any additional investment restrictions associated with clearing should be included in the investment guidelines for the QIAIF.

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[1]Insight is the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Pareto Investment Management Limited (PIML), Cutwater Asset Management Corp. (CAMC), Cutwater Investor Services Corp. (CISC) and Insight North America LLC (INA), each of which provides asset management services.

- to the extent that you wish to, you/ or someone on your behalf may view the underlying clearing documentation.

Regulatory timetables

EMIR is being implemented in three phases as follows:

Phase I: 2013 to 2014	Phase II: 2015 to 2018	Phase III: 2016 to 2020
Reporting and operational standards	**Mandatory clearing**	**New collateral requirements for non-cleared trades**
• Report all derivative contracts to Trade Repositories • Minimum operational standards • ***Insight has implemented on behalf of our clients***	• Requirement to clear certain derivative transactions • IRS mandated from 2016 and CDS mandated from 2017 and phased-in for different counterparty types • ***Temporary exemption applies for pension schemes until August 2017***	• Bilateral collateralisation requirements • Initial margin (IM) requirement likely to apply to the largest users of derivatives only • ***Only very large pension schemes (those with over €8bn of non-cleared swaps) likely to be caught for IM and only from 2020***
	Earliest timing: • For wider market: 2016 to 2018 • For pension schemes: expected earliest to be August 2017*	**Likely earliest timing:** • Variation margin: from March 2017 • Initial margin: phased-in from 2016 to 2020

*This may be delayed to August 2018 as the European Commission is consulting on extending the pensions exemption

Phase 1, which includes trade reporting and certain risk mitigation requirements, has been implemented by Insight in order to assist our clients to comply with their EMIR obligations. For example, in order to assist segregated mandate clients to meet their trade reporting obligations, Insight undertook an extensive project to enable us to report directly both trade data and collateral and valuation data to the UnaVista trade repository on behalf of our clients (rather than, for example, delegating reporting to a third party). With UnaVista, we were able to comply fully with EMIR's prescribed requirements and timetable. Further detail about our actions in relation to Phase 1 requirements are set out in our EMIR Implementation Update (available online).

Phase 2 relates to the mandatory clearing of certain OTC derivatives. We set out below the relevant timetables. However, pension schemes are able to use an exemption from mandatory clearing until at least August 2017 (and potentially up to August 2018 or beyond), which we describe below under the sub-heading "Pension Scheme Exemption".

European mandatory clearing timetable: interest rate swaps (IRS)

	Timing	Which trades are captured?
Entry into force:	21 December 2015	
Category 1: Clearing members	6 month phase-in: 21 June 2016	Trades executed from 21 February 2016 (frontloading)
Category 2[2]: Financial counterparties (>=€8bn)	12 month phase-in: 21 December 2016	Trades executed from 21 May 2016 (frontloading)
Category 3: Financial counterparties (<€8bn)	18 month phase-in: 21 June 2017 or 21 June 2019[3]	New trades only
Category 4: Non-financial counterparties	3 year phase-in: 21 December 2018	New trades only

- Pensions exemption overrides the above timetable
- Pension schemes will not be required to clear before August 2017 (and possibly not until August 2018 as the European Commission is considering extending the exemption further), and only for new trades executed from this point

There is also a similar timetable for clearing credit default swaps (CDS). Your mandate with Insight does not invest in CDS.

Phase 3 of the EMIR implementation relates to rules that will require the mandatory collateralisation of OTC derivatives from 1 March 2017. We explain these rules later.

[2]A counterparty shall be category 2 if it belongs to a group whose aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives for the three months January, February and March 2016 is equal to or above €8bn. However, this test is not relevant for those benefiting from the pensions exemption.
[3]Category 3 clearing obligation for IRS is currently expected to start on 21 June 2017, although the European policy-makers are considering delaying this until 21 June 2019.

The pension scheme exemption

The pension scheme exemption is automatically available to EU pension schemes that are 'institutions for occupational retirement provision' (IORPs) and investment vehicles acting solely and exclusively in their interests (e.g. a single investor QIAIF). The pension scheme exemption means that:

- eligible pension schemes will not need to clear OTC derivatives centrally until at least August 2017 (there is currently a consultation underway to extend it until August 2018 and EU legislators may agree to amend EMIR to extend it further); and
- counterparty banks may be able to offer favourable pricing for non-centrally cleared OTC derivatives

Insight currently believes that there is value in pension schemes preserving the optionality to clear swaps at a later date when clearing may become more economically advantageous or made mandatory by regulators. However, we are encouraging all clients to put in place the clearing infrastructure to ensure that they can easily make the switch to clearing if that becomes advantageous or mandatory. As a result, we are ensuring that all Insight QIAIFs have the infrastructure to clear.

The pension scheme exemption exists because current clearing models require the mark-to-market of cleared derivatives to be daily collateralised in the form of cash variation margin (VM). European policy-makers recognised that requiring pension schemes provide VM in the form of cash was likely to result in an investment drag, as pension schemes would need to divest physical assets in order to create cash to meet margin calls. Indeed, a recent study commissioned by the European Commission[4] estimated that the costs to pension schemes of mandatory clearing would range from €2.3bn to €4.7bn annually and the expected impact could be up to 3.66% over 20 to 40 years on retirement incomes across the EU[5]. This is a disproportionate impact which potentially outweighs the benefits of mandatory clearing.

The pension scheme exemption is intended to exempt pension schemes from mandatory clearing whilst the industry develops alternatives to cash VM. We are therefore of the view that the pension scheme exemption should continue to be in place until a viable and appropriate VM solution is developed.

Further information on the pension scheme exemption and our lobbying efforts can be found in our paper: http://www.insightinvestment.com/global/documents/iisf/EMIR_pension_fund_exemption.PDF

4Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements: a report for the European Commission prepared by Europe Economics and Bourse Consult (referred to as the Europe Economics and Bourse Consult report in the following footnotes). http://ec.europa.eu/finance/financial-markets/docs/derivatives/150203-external-study_en.pdf
5Page 68, Europe Economics and Bourse Consult report.

How central clearing works

Until recently, most OTC derivatives were traded bilaterally, i.e. directly between two counterparties. An investment manager, acting on behalf of a pension scheme, will typically source prices for a potential transaction from a range of banks. The trade is executed directly with the bank that offers the best terms, and the bank and the pension scheme become the legal counterparties to the trade. The pension scheme is exposed to the risk that the bank counterparty might default on its payments agreed under the derivative contract.

Central clearing requires a central counterparty (CCP) to be the legal counterparty to the transactions. The rationale of regulators for mandating clearing is that CCPs are well-capitalised entities and provide continuity to a transaction even if a bank counterparty defaults. However, central clearing does not eliminate counterparty risk and does not eliminate the role of dealer banks for the investor community, including pension schemes

The trade flow for centrally cleared transactions is illustrated below at Figure 1. An investment manager, acting on behalf of a pension fund, will source prices for a potential transaction from a range of banks, in a similar way to how OTC derivatives are traded today. The trade is executed with the bank counterparty, called the ‘executing broker’, providing the best terms. This transaction is then ’cleared’ by the CCP via a pension fund’s designated clearing member bank. This is because only clearing member banks who are members of CCPs can enter into transactions directly with CCPs and therefore a pension fund will need a relationship with a clearing member bank to facilitate clearing. The end legal transaction is therefore between the pension fund and its designated clearing member bank, with corresponding transactions through the clearing chain to the executing broker. The CCP intermediates between the pension fund’s designated clearing member bank and the executing broker acting in its capacity as a clearing member. This is a similar arrangement to that typically used for exchange-traded derivatives.

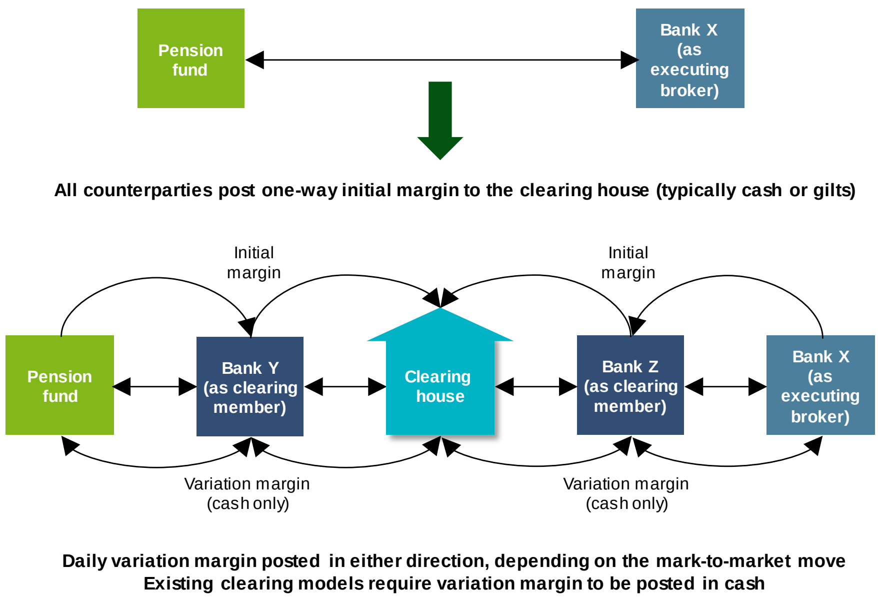
Figure 1.

Pricing is sourced from a wide panel of executing brokers

- Executing brokers can be any dealer bank

Transaction is centrally cleared

- Client accesses clearing house (also known as central counterparty or CCP) indirectly through its clearing member
- Client has counterparty risk to clearing member
- Key considerations include: (1) choice of clearing member; (2) ability to ‘port’ positions to an alternative clearing member; and (3) protection of margin and account structure



Cleared transactions require the posting of two types of margin:

- Initial margin (IM): This must be posted to the CCP at inception of the trade and is typically in the form of government bonds or cash. The CCP sets the rate of IM and can adjust its level through the life of the trade. A pension scheme posting IM as government bonds will still continue to receive the return on its bond. Typically, pension schemes do not post IM when trading OTC derivatives today.
- VM: This covers the daily change in the value of the derivative contract and must be posted in cash format only. Today, OTC derivative trades are collateralised in a similar way but collateral can typically be posted in government bonds or cash, and most pension schemes typically post government bonds. The move to cash-only VM would be a change for most pension funds.

Unlike bilateral OTC derivatives, cleared trades have only one pricing source: the CCP itself. This allows the exposure calculations and the settlement of VM to take place sooner. VM is typically settled on the morning of the next business day for valuations from the close of business the day before, and with zero minimum transfer amounts.

Because a pension fund will have counterparty exposure to its clearing member, some key considerations could include appointing a panel of clearing members, the ability to move positions and assets between clearing members (known as ’porting’), and the level of segregation of positions and assets at clearing member level and CCP level.

Insight's clearing platform

Insight has created an innovative, robust clearing solution to enable clients to maximise efficiencies, select clearing members and to manage position risk and collateral implications. Insight has appointed a panel of clearing members to provide clearing services for OTC derivatives to our clients and funds. We expect that our panel of clearing members will support mandatorily cleared products and other cleared products (e.g. inflation swaps) and will provide access to all major clearing houses authorised under EMIR (LCH, Eurex and others). The Insight clearing platform is operationally ready and available for clients to use and we have well-established processes to manage margin calls, including calculating and monitoring collateral buffers in order to maximise efficiencies for clients.

The legal framework for Insight's clearing platform is based around a uniform Master Client Clearing Agreement (MCCA) with each of our panel clearing members. The MCCA is an Insight standard agreement that embeds certain core terms that are essential to clearing and the protection of clients (e.g. type of account, treatment of margin and porting), and provides visibility of these terms to clients, whilst providing the flexibility for Insight to evolve the underlying client clearing documents over time as clearing members and clearing houses develop their offerings. Importantly, the MCCA structure also gives each Insight client access to the beneficial commercial terms that Insight has been able to negotiate with clearing members on behalf of all our clients, and all Insight clients are able to onboard with our panel of clearing members on substantially similar terms. Using our framework, clients can delegate decisions around whether to clear individual trades to Insight, in the knowledge that we will do so whilst upholding our commitments under our Order Execution Policy.

Further detail on our approach to central clearing, including an innovative educational guide, is set out on our central clearing website: http://www.insightinvestment.com/centralclearing/

Margin rules for non-centrally cleared derivatives

This section has relevance for your mandate with Insight and, in addition, given the implications in terms of the treatment of forward foreign exchange (FFX) positions may impact your currency hedging mandate which is managed elsewhere.

In March 2015, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (BCBS-IOSCO) issued an international framework for margining of non-centrally cleared derivatives, together with a timetable for implementation[6].

The BCBS-IOSCO framework has two basic requirements:

- VM: to collateralise on a daily basis the mark-to-market exposure of all non-centrally cleared OTC derivatives entered into on and from a specified compliance date (see below); and
- IM: a phased-in obligation to post and collect collateral in order to collateralise possible forward-looking losses for all non-centrally cleared OTC derivatives[7].

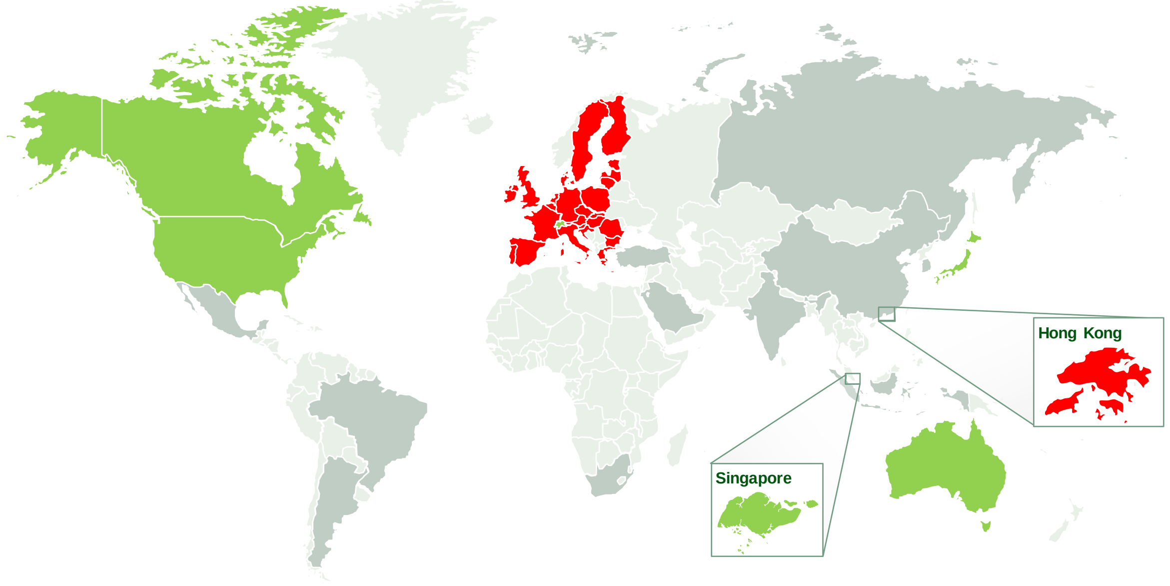
These changes are being implemented in the EU as part of EMIR, as part of the Dodd-Frank reforms in the United States and their equivalents in other jurisdictions. Broadly speaking, the VM rules come into effect on 1 March 2017, although there are slight variances in implementation timetable by product and from jurisdiction to jurisdiction. The IM rules are phased in until 2020 based on an entity's gross notional; we do not expect the Fund to be in scope for the IM until 2020 at the earliest.

Insight has commenced a comprehensive implementation programme to ensure that we can comply with the relevant rules on behalf of the QIAIF and to assist our clients in complying with their EMIR obligations. This includes changes to our trading documentation and operational processes. If you would like further details about the rules and the steps that we are taking, this can be found in our Implementation Update: margin for non-centrally cleared derivatives.

One significant variance in the global implementation of the rules is the approach to VM on physically-settled FFXs and swaps, as shown in the diagram below:

[6]See http://www.bis.org/bcbs/publ/d317.htm
[7]The scope of an OTC derivative can vary slightly from jurisdiction to jurisdiction.

VM on physically settled FX in selected jurisdictions



VM on physically delivered FX in scope

VM on physically delivered FX out of scope

The European Union differs from most jurisdictions in that EMIR will require VM on physically-settled FFX and swaps, although the timeline is expected to be:

- physically-settled FX swaps: 1 March 2017
- physically-settled FFX: 3 January 2018 (to be confirmed)

This will mean that entities established within the EU, including pension schemes and QIAIFs, must collect or post VM on physically-settled FFX and FX swaps by the relevant compliance dates. In turn, this will require the EU entity (or its investment manager) to have appropriate documentation and operational processes in place to collateralise the physically-settled FFX and FX swaps. Insight's policy is to collateralise both FFX and swaps from 1 March 2017. Whilst the European regulations state VM for FFX does not need to be exchanged until January 2018, the feedback Insight has received from a majority of counterparty banks is that they will expect their clients to exchange VM on both swaps and forwards from 1 March 2017.

Many liability hedging clients have been enquiring about using Insight to conduct their FX hedging in order to benefit from a shared collateral pool and provide more flexibility in meeting settlement amounts.

Any other issues

Insight has been a leader in actively representing the interests of our pension fund clients to regulators and the industry. Insight, and specifically Andrew Giles, Chief Investment Officer (CIO) - Solutions, has led the European pensions and investment industry's lobbying in respect of the move towards centralised clearing for swap contracts resulting from the EMIR. Insight played an instrumental role in securing the pension fund exemption for our pension scheme clients.

We continue to be very engaged in discussions with regulators, industry groups and other interested parties to influence the direction of future regulation to ameliorate the impact on our pension fund clients. For example, we have recently liaised extensively with industry groups and regulators about proposed rules under EMIR for margin on uncleared derivatives and the proposed rules for pre-trade transparency under MiFID II in order to highlight a number of issues that would negatively impact our pension fund clients.

A core element of our approach is to understand the structural impacts of regulatory change and to innovate to provide solutions for our clients in order to protect their broad economic interests. For example, mandatory clearing will create significant cash liquidity requirements for our pension fund clients. As a result, we have worked and are working closely with clearing houses and industry to find solutions to address the liquidity and transformation risks that would otherwise face our pension fund clients. This approach underlines Insight's proactive, solutions-focussed service for its clients.

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