The EU legal framework EMIR, MIFID II/MiFIR and ISDA

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EMIR and the regulation of derivative markets

- G 20 Pittsburg declaration (2009):

"All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Noncentrally cleared contracts should be subject to higher capital requirements."

EMIR and the regulation of derivative markets

- Other important international standards
  - CPMI/IOSCO: Principles on Financial Market Infrastructures („FMI“): cover i.a. Central Counterparties and Trade Repositories
  - IOSCO: - Report on Trading of OTC Derivatives (2011)
    - International Standards for Derivatives Market Intermediaries (2012)
    - Margin Requirements for Non-Centrally Cleared Derivatives (2015)
    - Risk Mitigation Standards for Non-Centrally Cleared OTC Derivatives (2015)
  - IOSCO Principles and Methodology: Principles for Intermediaries and Secondary Markets covering also OTC and other derivatives.

EMIR and the regulation of derivative markets

- International Status of implementation
  - US most advanced, followed by EU
  - Implementation in the US through Dodd-Frank Act; in the EU through EMIR and MIFID II/MiFIR
  - Implementation still lagging for example in some Asian countries
  - Implementation is monitored by the FSB in annual progress reports on OTC derivatives market reforms
  - Extraterritoriality of US regulation has been an issue, but has been settled through guidance and mutual understanding

EMIR and the regulation of derivative markets

- Main goals of EMIR:
  - Reduce systemic risks of derivatives trading
  - Make risks transparent in an aggregated format
  - Give Supervisors detailed information on potentially risky positions
  - Central clearing obligation for suitable contracts
  - Requirement of risk-mitigation techniques for non-centrally cleard OTC derivatives
  - Reporting of derivatives transactions to Trade Repositories
  - Common harmonised supervisory standards for CCPs and TRs

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- EMIR – Regulation of CCPs:
  - EMIR entails supervisory standards for CCPs, i. authorisation requirement, organisational and prudential requirements, regular review and evaluation
  - Further details are specified in ESMA Regulatory Technical Standards
  - Pan-European cooperation is an important aspect of CCP supervision:
    - Establishment of colleges
    - Cooperation between national authorities and additionally with European agencies, e.g. ESMA

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- EMIR – Trade Repositories:
  - A TR is a legal entity operating a database on derivatives transactions
  - Supervisory competence lies soley with ESMA
  - National authorities may contribute to the supervision of TRs through ESMA processes, e.g. in working groups or through the Board of Supervisors
  - ESMA publishes list of registered TRs in the EU

EMIR and the regulation of derivative markets

- EMIR – Reporting:
  - All counterparties and CCPs have to report details to TRs in the following events:
    - Conclusion of a derivative contract
    - Modification of a derivative contract
    - Termination of a derivative contract (before maturity)
  - Further technical details are specified in ESMA Level 2 RTS

EMIR and the regulation of derivative markets

- EMIR – Non-financial counterparties:
  - Non-financials become subject to the clearing obligation, if the reach certain thresholds
  - Calculation of threshold entails all derivatives contracts within the group which are not objectively measurable as reducing systemic risks directly related to the commercial activity
  - Further technical details are specified in ESMA Level 2 RTS
  - Issue was highly contentious and achieved compromise suffers some ambiguity regarding which transactions directly serve hedging purposes

EMIR and the regulation of derivative markets

- EMIR – Third country treatment:
  - EU Commission can declare legal, supervisory and enforcement arrangements in third countries equivalent
    » Acceptance of US standards
  - ESMA may recognize third-country CCPs
  - ESMA may recognize third-country TRs

MiFID II/MiFIR: Thematic Highlights

- Markets issues:
  - Complementing the clearing obligation: the trading obligation
  - Open access regarding trading and clearing
  - Position reporting and position limits
  - Trade transparency in the non-equities space
  - Consolidation and dissemination of market data
- Excursus: Intermediaries/investor protection issues
  - Inducements
  - Product governance
  - Product intervention

Complementing the clearing obligation: the trading obligation

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- Principle: When a class of derivatives is declared subject to the clearing obligation, it shall be traded at least on an organised trading facility (OTF)
- Other conditions for trading obligation:
  - Admission to trading or being traded on at least one venue
  - Sufficient liquidity
- Further details specified in ESMA Level 2 RTS

Open access regarding trading and clearing

- Art. 35 MiFIR: Non-discriminatory access to a CCP
- Art. 36 MiFIR: Non-discriminatory access to a trading venue
- Goal is to foster competition especially between CCPs
- While interoperability is already common in the equities space, concerns remain regarding possible systemic risks of derivatives clearing

Position reporting and position limits

- Position Reporting and Position Limits Regime especially for commodity derivatives, in order to discourage excessive speculation
- Primary responsibility for Position Limits rests with market operator, but Supervisory Authority to be informed
- Rationale for Position Limits: Support liquidity, prevent market abuse, support orderly pricing and settlement conditions
- Position Reporting:
  - By category of traders
  - Weekly Publication of aggregate numbers
  - CA receives complete breakdown

Trade transparency in the non-equities space

- Trade transparency entails pre-trade transparency (on orders) and post-trade transparency (on executed transactions)
- Transparency obligations extended from shares to bonds, strucured products and derivatives
- Calibration of a transparency-regime difficult and complex:
  - Too much transparency could harm market liquidity, too little could run short of political transparency goal
  - Non-equities space comprises a big number of often heterogenous instruments

Consolidation and dissemination of market data

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- Producers of market data to be regulated as Approved Publication Arrangements (APAs), similar to Trade Repositories

  » Organisational responsibilities and quality control

- European Consolidated Tape to be created through competing Consolidated Tape Providers (CTPs)

  » Important political goal to close the gap to the US and foster fair and effective price formation

- Success of concept remains to be assessed

Regulation of High Frequency Trading (HFT)

- Definition of HFT:
  - German example based on absolute value of messages regarding the criterion of a high intra-day messaging rate, i.e. 75.000 Messages per trading day or two messages per second
- Other supporting measures:
  - Obligation to have market making schemes in order to ensure sufficient liquidity
  - Quoting obligation for algo-traders who pursue a market-making strategy
  - Technological safeguards such as volatility interruptions and pre-trade controls

Inducements

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- Inducements for non-independent advice only permissible, if they are quality-enhancing
- Quality-enhancement:
  - Originally defined in a negative way, i.e. it is not given, if inducements only serve the purpose of financing business operations
  - In the debate the BaFin argued in favour of recoginzing the criterion of local availability of advice
  - Now defined in a positive manner, but requirements still fairly demanding

Product Governance

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- Obligations for Manufacturer and Distributor in relation to the product design and continued appropriateness of public marketing
- Manufacturer has to define target market
  » Rationale: Product should be designed for and be marketed to suitable investors only <u>in order to avoid mis-selling</u>
- Continuous monitoring obligation, whether risk profile of instrument has (negatively) changed with time
- In Germany early implementation through „Kleinanlegerschutzgesetz“

Product intervention

- ESMA has intervention powers, e.g. can suspend public distribution of a product under the following conditions:
  - Significant concerns about investor protection or threat for the orderly functioning or stability of markets
  - Concern or threat is not already addressed by regulation or measures of National Competent Authorities
- ESMA developed a non-exhaustive list with criteria to consider when assessing the requirements above, e.g. complexity/transparency of product, potential detriment, problematic selling practices, relation to fraud/crime
- Product intervention powers particularly relevant in case of complex, possibly derivative products

Key to clearing & trading obligation: Sufficient standardisation » ISDA

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- ISDA = International Swaps and Derivatives Association
- While ISDA as a trade association is legally not a standard setter, its master agreement is the de facto template and reference point for most derivatives products
- Use of the ISDA mater agreement allows for greater standardisation and netting of contracts
- Greater standardisation of contracts is conducive to central clearing and organised trading

Many thanks for your attention!

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