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ESRB
European Systemic Risk Board
European System of Financial Supervision

ESRB response to ESMA on the temporary exclusion of exchange-traded derivatives from Articles 35 and 36 of MiFIR

1. Introduction

Pursuant to Article 52(12) of the Markets in Financial Instruments Regulation (MiFIR)[1], the European Commission is required to submit a report to the European Parliament and the Council of the European Union by 3 July 2016 assessing the need to temporarily exclude exchange-traded derivatives (ETDs) that require open and non-discriminatory access to central counterparties (CCPs) and trading venues from the scope of Articles 35 and 36 of MiFIR. This report must be based on a risk assessment carried out by the European Securities and Markets Authority (ESMA) in consultation with the European Systemic Risk Board (ESRB). The report must take account of any risks that such open access provisions pose to the overall stability and orderly functioning of financial markets across the European Union. Depending on the conclusions of the report, the Commission may adopt a delegated legal act to exempt ETDs from the scope of Articles 35 and 36 for up to 30 months following MiFIR's entry into force.

The Commission has asked that the risk assessment should

- focus on the identification and likelihood of potential risk factors, and the magnitude of any negative effects if these risks were to materialise;
- focus on risks which can be deemed specific to the access arrangements pursuant to MiFIR, as opposed to broader risk factors that could be assessed in relation to derivatives markets under other EU legislation, particularly the European Market Infrastructure Regulation (EMIR)[2]; and
- be supported by quantitative and qualitative analysis.

The ESRB's opinion has been prepared in line with the mandate for the ESMA risk assessment, particularly as regards the narrow scope of the assessment, i.e. the temporary exclusion of ETDs from the open access provisions in MiFIR and the potential consequences. For the ESRB's views on related legislation, see the ESRB's input into the review of EMIR[3] and the ESRB report on systemic risks associated with interoperability arrangements.[4]

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[1] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

[2] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

[3] See "ESRB report on the efficiency of margining requirements to limit pro-cyclicality and the need to define additional intervention capacity in this area" and "ESRB report on issues to be considered in the EMIR revision other than the efficiency of margining requirements", both of which are dated 29 July 2015 and available on the ESRB's website.

[4] The ESRB has been asked by the Commission to provide its assessment of any possible systemic risk implications of interoperability arrangements by 31 January 2016, as is also required by Article 85(4) of EMIR.

2. Regulatory framework

Title VI of MiFIR ("Non-discriminatory clearing access for financial instruments") aims at removing various commercial barriers that can be used to prevent competition in the clearing of financial instruments. In this sense, "open access" means that "*To avoid any discriminatory practices, CCPs should accept to clear transactions executed in different trading venues, to the extent that those venues comply with the operational and technical requirements established by the CCP, including the risk management requirements*" (recital 38 of MiFIR).

Article 35 of MiFIR stipulates that a CCP shall accept to clear financial instruments on a non-discriminatory and transparent basis, regardless of the trading venue on which a transaction is executed, to ensure that a trading venue has the right to non-discriminatory treatment of contracts traded on that trading venue. A CCP may require that a trading venue comply with the operational and technical requirements established by the CCP, including the risk management requirements.

In parallel, Article 36 of MiFIR stipulates that a trading venue must, upon request, provide trade feeds on a non-discriminatory and transparent basis to any CCP authorised or recognised under EMIR that wishes to clear transactions in financial instruments that are concluded on that trading venue.

In terms of substance, Articles 35 and 36 of MiFIR mirror the provisions of Articles 7 and 8 of EMIR on open access to CCPs and trading venues for over-the-counter (OTC) derivatives. Similar to MiFIR, Article 8 of EMIR states that "*access of the CCP to the trading venue shall be granted only where such access would not require interoperability or threaten the smooth and orderly functioning of markets in particular due to liquidity fragmentation and the trading venue has put in place adequate mechanisms to prevent such fragmentation*".

It should be noted that the temporary exclusion provisions mentioned in Section 1 are limited to ETDs. EMIR does not include temporary exclusion provisions for OTC derivatives, such as those provided by MiFIR for ETDs, and MiFIR does not include temporary exclusion provisions for financial instruments other than ETDs.

A trading venue's request to access a CCP must be formally submitted to the CCP and to the relevant competent authorities of both the CCP and the trading venue; similarly, a CCP's request to access a trading venue must be formally submitted to the trading venue and to the relevant competent authorities of the both the trading venue and the CCP. Upon receipt of such a request, the competent authority of the CCP or that of the trading venue must, under Article 35(4) of MiFIR, grant access only where such access would not require an interoperability arrangement, threaten the smooth and orderly functioning of markets, in particular due to liquidity fragmentation, or adversely affect systemic risk. If the request requires interoperability, and the trading venue and the CCPs that are subject to the interoperability arrangement have consented to the arrangement, the MiFIR provision does not prevent access being granted as long as the risks to which the incumbent CCP is exposed, which arise from inter-CCP positions, are collateralised at a third party. Pursuant to the EMIR legal framework and as in any other CCP interoperability arrangements, the arrangement must be assessed and approved by the relevant national competent authorities (NCAs) and be subject to the opinion of the relevant colleges of supervisors.

The draft regulatory technical standards (RTS) on access for CCPs and trading venues[5] specify the conditions under which access may be denied or must be granted by CCPs and trading venues or their NCAs. Denial of access may be based on the anticipated volume of transactions (only for access by CCPs), operational risk and complexity, and other factors creating significant undue risk. The draft RTS also specify the conditions under which competent authorities must deny access once the RTS have been published and enter into force.

If the Commission's assessment concludes that there is no need to exclude ETDs from the scope of Articles 35 and 36 in accordance with Article 52(12), a CCP or trading venue may, before MiFIR's entry into force, apply to its competent authority for permission to avail itself of transitional arrangements. The competent authority may decide that Article 35 or 36 should not apply to the relevant CCP or trading venue in relation to ETDs for a transitional period lasting until 3 July 2019, taking into account the risks that applying the access rights to ETDs under Article 35 or 36 would pose to the orderly functioning of the relevant CCP or trading venue.

3. Systemic risk implications of open and non-discriminatory access

The open and non-discriminatory access provisions are intended to increase competition in the clearing and trading of financial instruments. Article 35 of MiFIR aims to foster competition between trading venues, as they are given the right to have their trades cleared by the CCP of their choice. Article 36 gives CCPs the right to trade feeds from trading venues on a non-discriminatory basis, with the aim of fostering competition in clearing services.

Open and non-discriminatory access to CCPs (Article 35 of MiFIR) allows trading venues to clear contracts with the CCP of their choice. In principle, this could lead to a more concentrated clearing market in the EU. Market participants with non-directional positions may benefit from widened multilateral netting and the resulting decrease in collateral requirements by clearing all correlated contracts with the same CCP. This could lead to a concentration of market participants at a particular CCP for a specific financial instrument (or for related financial instruments, as positions resulting from transactions in these instruments can be "risk netted" for margining determination purposes through portfolio margining). For market participants with directional positions, which by nature have limited (if not no) scope for netting, convergence on one or more CCPs may also be observed if some CCPs offer more favourable conditions.

Concentration in clearing activities for specific instruments can already be observed in the EU, where some instruments are exclusively or predominantly cleared by a single CCP.

From a systemic risk perspective, the conditions favourable for concentration may increase the already existing "single point of failure" risks if a financial instrument is cleared in a systemically significant order of magnitude by only one CCP. In such a scenario, the disruption to financial markets and the real economy may be more severe if that CCP becomes distressed, as a larger share of the market will be affected. It may also be more difficult for clearing members and clients to move positions to another CCP, considering that a fully fledged recovery and resolution regime

[5] See "RTS 15: Draft regulatory technical standards on access in respect of central counterparties and trading venues" of the ESMA report on MiFID II/MiFIR, "Regulatory technical and implementing standards – Annex I", published on 28 September 2015.

for CCPs is not yet in place. Furthermore, trading is more likely to be disrupted if trading venues are served by only one CCP.

The ESRB is aware that open access provisions are not the only potential drivers of the concentration of the clearing of specific financial instruments at a CCP. A reinforcement of the current concentration could also occur in the future as a result of the “natural” commercial growth of a CCP’s business when its services successfully meet the preferences of market participants.

The current concentration in clearing activities may also be attributable to the lack of open access to trading venues, which prevents CCPs from clearing instruments traded at particular trading venues. Open and non-discriminatory access to trading venues (Article 36 of MiFIR) aims to counter the risk of concentration in the clearing market by allowing multiple CCPs to compete for trades from a particular venue. From a financial stability perspective, it should be noted that if multiple CCPs clear financial instruments traded at the same venue and one of them becomes distressed, it is more likely that another CCP will be able to continue clearing trades executed at that venue, and the trading venue will not have to halt trading. However, given the netting inefficiencies and the increased collateral needed to clear trades at multiple CCPs, the scope for multiple CCPs to continue clearing trades from the same trading venue in the long run without interoperability arrangements seems limited. Instead, CCPs might enter into interoperability arrangements,[6] provided that the relevant EMIR provisions are fulfilled, or clearing members might converge around one or a few CCPs.

MiFIR and the draft RTS (after their publication and entry into force) provide for various instruments to prevent risks arising from access agreements. While such agreements allow a trading venue to request that a CCP clear a financial instrument regardless of whether the CCP is already authorised to clear the instrument traded at that venue, the CCP may deny access where it would not be able, with reasonable effort, to launch a clearing service for a new instrument that complies with the requirements of EMIR. A CCP may also deny access where the volume of expected transactions resulting from the access agreement would exceed the scalable design of the CCP or its planned capacity, including with regard to potential additional capital needs.

Clearing a wider range of instruments, or a larger volume of a specific instrument, may increase the complexity of a CCP’s risk management framework and create additional operational risk. However, CCPs may deny access on the grounds of such operational risk or of legal risk, or a threat to its economic viability or ability to meet minimum capital requirements.

For ETDs, it should be noted that Article 28 of MiFIR introduces a trading obligation for derivatives which fulfil certain conditions. The effect of this trading obligation is expected to be an increase in trading of OTC derivatives at trading venues (with some of these becoming ETDs if traded on a regulated market), which thus fall within the scope of the MiFIR access provisions. ETDs are different from transferable securities and money market instruments in several respects, namely the nature of the underlying product, the related fungibility, and settlement arrangements. Markets for transferable securities such as equities and bonds operate on a T+2 basis, with limited collateralisation against market risk owing to the short settlement lag and the use of delivery-

[6] See “ESRB report to the European Commission on the systemic risk implications of CCP interoperability arrangements”.

versus-payment mechanisms, which prevent exposure at the moment of settlement. Derivatives are generally longer-term products, with contracts potentially maturing a number of years after they have been entered into, and are used mainly by professional investors.

In the opinion of the ESRB, the main risks associated with ETDs in terms of open and non-discriminatory access are related to interoperability arrangements. The open access provisions in MiFIR may in fact provide an incentive for the establishment of new interoperability arrangements for ETDs to allow participants at CCPs to benefit from the cost reductions and netting benefits associated with only being a member of one or a few CCPs while clearing contracts with members of other, linked CCPs.

Title V of EMIR ("Interoperability arrangements") applies only to transferable securities and money market instruments; the ESMA Guidelines and Recommendations on CCP interoperability arrangements have been prepared for interoperability arrangements established under Title V of EMIR. ESMA recommends that NCAs apply ESMA's Guidelines and Recommendations to interoperability arrangements for products other than transferable securities or money market instruments, and expects that CCPs will have regard to the provisions in Title V of EMIR when structuring such interoperability arrangements. However, the ESRB believes that, given the potential for a significant expansion of such arrangements, further analysis of the specificities and the complexities related to potential new derivatives links is needed. Such analysis should provide the basis for an assessment of the extent to which the existing Level 1 text of EMIR and the ESMA Guidelines and Recommendations cover the risks that are specific to derivatives links, and identify where adjustments may be necessary. It is against this background that the incentives provided by MiFIR for establishing new interoperability arrangements for ETDs must be considered, if ETDs are not temporarily excluded from Articles 35 and 36. Furthermore, it should be taken into account that the EU regulatory framework for CCPs is not yet completed as a common recovery and resolution framework for CCPs that would ensure efficient processes for handling the distress of a single CCP, as well as more complex structures such as CCPs with interoperability arrangements currently is not in place.

Regarding the MiFIR provisions for interoperability arrangements, the ESRB notes that a competent authority is required to grant access only where such access would not require an interoperability arrangement, or if all the parties involved agree to the interoperability arrangement. However, it is the understanding of the ESRB that such an interoperability arrangement would still have to be assessed and approved by the NCAs and be subject to the opinion of the relevant colleges of supervisors.

Section 2 stated that EMIR does not include temporary exclusion provisions for OTC derivatives, and that MiFIR does not include temporary exclusion provisions for transferable securities and money market instruments. A temporary exclusion of ETDs would therefore result in ETDs temporarily not being subject to open access provisions, while OTC derivatives, transferable securities and money market instruments would remain subject to these provisions. This may reduce the netting benefits and increase the total level of exposure in the system if ETDs are cleared by CCPs that do not clear transferable securities and/or correlated non-ETD contracts that could otherwise have benefitted from portfolio margining (provided that the relevant conditions are met).

4. Conclusions

The open and non-discriminatory access provisions are intended to increase competition in the clearing and trading of financial instruments by ensuring a level playing field among CCPs and trading venues. In terms of the market structure of CCP clearing services, different outcomes can be reasonably expected: these provisions could lead to further concentration in the EU market for clearing services, as a larger number of financial instruments may be cleared by one or a few CCPs. The open access provisions may also provide an incentive for the establishment of new interoperability arrangements to allow participants at CCPs to benefit from the cost reduction and netting benefits associated with only being a member of one or a few CCPs while clearing with members of other, linked CCPs.

As explained above, different risks and benefits in terms of financial stability can be attributed to such market structures, and the ESRB notes that EMIR and MiFIR provide safeguards against these risks.

With regard to interoperability arrangements, the ESRB notes that a competent authority is only required to grant access where such access would not require an interoperability arrangement. The ESRB also notes that such arrangements must always be assessed and approved by NCAs and be subject to the opinion of the relevant colleges of supervisors. From a financial stability perspective, however, the ESRB notes that, given the potential for a significant expansion of such arrangements, there is a need for further analysis of the extent to which the current regulatory framework for interoperability arrangements sufficiently covers the risks that are specific to ETDs, as well as analysis of where adjustments may be necessary.

Furthermore, the ESRB acknowledges the current scarcity of relevant data on the trading and clearing of ETDs and notes that it is not currently possible to perform a quantitative analysis of the potential impact, e.g. in terms of the scope of the netting of the open access provisions under consideration.

Against this background, the ESRB is of the opinion that the balance between the different financial stability implications, in the light of the relevant risk containment measures, does not lead to the identification of significant macroprudential risks or benefits that would clearly argue either in favour of or against a temporary exclusion of ETDs from Articles 35 and 36 of MiFIR. This conclusion follows from the qualitative analysis, as relevant data for a reliable quantitative analysis are not available. The ESRB proposes that ESMA takes into account the macroprudential considerations put forward in this note when preparing the report to the Commission.