A review of the cumulative effect of European derivatives law reform

JUNE 2015

Introduction

FIA Europe and its members concur with the public statements of EU Commissioner Jonathan Hill, CFTC Chairman Timothy Massad and others that now is the time for consideration of the cumulative effect of derivatives regulation.

This paper has been prepared with a view to assisting, among others, (i) the Basel Committee, as it considers the impact of the leverage ratio and the other capital rules relating to the clearing of derivatives; (ii) the European Commission as it reviews EU derivatives legislation through the lens of promoting jobs and growth in the European Union; and (iii) the Financial Stability Board (FSB) pursuant to its G20 mandate to "assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse".[1]

It briefly summarises the material issues and potential solutions, with a view to generating further debate and discussion with, and within, the legislative and regulatory communities.

Section 13 of the G20 Communique of Pittsburgh 2009 (the "**Communique**") set out certain G20 commitments (the "**G20 Commitments**") in five short paragraphs that, in Europe, eventually led to the creation of EMIR, MiFID II/MiFIR, CRD IV/CRR, REMIT and an overhauled market abuse regime. Various other initiatives, not least the European Commission's proposals on clearing house recovery and resolution, will follow in coming months.

Numerous positive outcomes have been, and will be, achieved as a result of the implementation of the G20 Commitments.

Nonetheless, the phrase "the devil is in the detail" has rarely been more apt: as a result of a lack of detail in the Communique as to precisely *how* the G20 Commitments should be implemented, it has been left to local and regional legislators to fill in the blanks. The Communique was much clearer on *by when* the G20 Commitments should be implemented, but those dates have proven too ambitious for most G20 countries.

Materially different approaches have been taken by the US and Europe with respect to reporting, margining, trading, regulatory capital requirements and other critical facets of our industry, leading to a host of overlaps and conflicts. Europe has implemented the G20 Commitments more expansively than the US, at times going far beyond the scope of the G20 Commitments themselves.

Of all the recommendations contained in this paper, the most critical one is that the leverage ratio under Basel III should be amended to recognise the exposure-reducing effect of segregated margin. Without that important change, the viability of clearing under EMIR is significantly at risk.

About FIA Europe

FIA Europe represents some 170 firms involved in the exchange-traded and centrally-cleared derivatives markets – including banks, brokers, commodity firms, exchanges, CCPs, vendors, law firms and consultants. FIA Europe works with its members to maintain constructive dialogue with government and regulatory authorities and deliver high standards of industry practice.

[1] G20 Communique, Pittsburgh 2009

EXECUTIVE SUMMARY

In summary, our members recommend that:

– **Leverage ratio:** the leverage ratio under Basel III be amended to recognise the exposure-reducing effect of segregated margin and to adopt SA-CCR as a replacement for CEM in the leverage calculation, so as to facilitate and promote central clearing under EMIR;

– **Indirect clearing:** indirect clients be permitted to opt out of the "leapfrog" payment regime and the legal roadblocks to the successful implementation of indirect clearing under EMIR and MiFIR be remediated;

– **Pre-execution and straight-through processing checks:** exchange-traded derivatives (ETD) be exempted from the pre-execution and straight-through processing checks contained in MiFIR: certainty of clearing is already ensured for ETD via the rulebooks of the exchanges and CCPs;

– **Creating harmonious cross-border regulation:** the European Commission continues to liaise with key global stakeholders from the legislative and regulatory community to further discuss and develop a process of creating regulation that is mutually reinforcing of their respective agreed agendas, is globally consistent and is harmonious. A roadmap for agreeing such process should be agreed in the short term. Equivalence determination processes should be clear, transparent and standardised. Outstanding equivalence assessments under Articles 13 and 25 of EMIR, and Article 19(6) of MiFID; must be expedited. Discussions with third country regulators should always commence as early as possible in the legislative process. The European Commission could increase its efficiency in pro-actively identifying and addressing conflicts of European laws with those of third countries and national Members States by establishing a dedicated team for this purpose;

– **Reporting:** the EMIR reporting obligation with respect to exchange-traded derivatives be removed; the dual-sided EMIR reporting regime be changed to a single-sided regime; and all of the existing derivatives reporting obligations be consolidated into a single EU reporting regulation;

– **Thresholds:** the European Commission carefully consider the critical role that specific trading strategies of different market participants play in terms of liquidity provision, when the European Commission sets the thresholds for pre- and post-trade transparency and the "ancillary activities" exemption under MiFIR; and

– **Industry feedback:** more time be provided for cost/benefit analysis and consultation responses – the European Commission's new "Better Regulation" agenda is a welcome step in the right direction. The more transparent that regulators can be, the better.

Inconsistencies in regulatory implementation

Summary

EMIR vs CRD IV

Scope creep from the G20 Commitments

EU legislation vs third-country legislation vs national Member State legislation:
- Inconsistent global timetables
- Differing regional application of G20 Commitments
- Lack of a common approach to equivalence determinations
- Equivalence decisions should be granted in a timely manner to avoid creating market uncertainty
- Insufficient consideration of the impact of third country legislation
- Insufficient consideration of the impact of national Member State legislation

As the European Commission considers the current state of derivatives regulation, we encourage it to work with its peers at the Basel Committee, the FSB, the European Parliament and key third-country regulators such as the Commodity Futures Trading Commission (CFTC), among others, to address the following inconsistencies in the European regulatory framework:

EMIR vs CRD IV

Summary: EMIR and CRD IV do not mutually re-enforce the G20 objective of increasing the extent to which derivatives are cleared via CCPs. Whilst EMIR seeks to promote central clearing, the CRD IV-mandated regulatory capital costs and leverage ratio requirements applicable to central clearing have directly resulted in clearing brokers leaving the industry, thereby reducing access to central clearing. The feedback from our members is that this trend will continue.

OUR SUGGESTION: *Our members recommend that the leverage ratio be amended so as to recognise the exposure-reducing effect of segregated margin and that SA-CCR be adopted as a replacement for CEM in the leverage calculation, in order to address the shortcomings of the CEM model (as outlined in BCBS279). This is essential, to ensure that: there is sufficient balance-sheet capacity among clearing brokers to clear the derivatives that are declared subject to mandatory clearing under EMIR; there is sufficient end-user choice in the range of clearing members through which it can clear; and to mitigate the risk of further significant reduction in the availability of clearing.*

Whereas the European Markets Infrastructure Regulation (EMIR) aims to promote and mandate central clearing, the CRR requirements on exposures to CCPs result in relatively high risk weighted assets and leverage ratio constraints for clearers with exposure to CCPs.

This affects the business model and economics of clearing brokers - it remains challenging for clearing brokers to maintain a viable return on equity with respect to their business. This is impacting end-users, in the form of higher prices and entry barriers.

If these trends continue and clearing brokers' businesses are loss making, then it is inevitable that shareholders will demand that the institutions' capital be used in other parts of the business that generate a positive return.

Consequently, we have seen a number of clearers of client business exiting the market. [2]

2 Most recently, Nomura (OTC clearing), Royal Bank of Scotland, BNY Mellon and State Street

Considering the capital and resources required, it is now highly unlikely that new players will enter the market.

The leverage ratio under CRD IV imposes restrictions in the capacity of clearing brokers to clear for their clients – it is unclear whether there is sufficient balance sheet capacity amongst the European clearing brokers to clear all of the derivatives transactions that are anticipated to become subject to mandatory clearing under EMIR. To our knowledge, no detailed data analysis of such capacity has been conducted by regulators or legislators.

The leverage ratio also heightens the risk that clients of a defaulted clearing member will be unsuccessful in their attempts to transfer their positions and assets to 'back-up' clearing brokers upon the default of one of their existing clearing brokers. This risk will materialise if those non-defaulted clearing brokers determine that they do not have sufficient balance sheet capacity to clear the positions of the clients of the defaulted clearing member.

Without a sufficiently diverse pool of clearing brokers via which end-users can clear their derivatives and to whom they can successfully port their positions in the event of a default of one of their clearing brokers, many of the key goals of EMIR are unlikely to be achieved.

The Basel Committee on Banking Supervision (BCBS) proposals for the greater standardisation of market risk model requirements are another development that may well affect the economics of the clearing broker business model.[3] Many clearing brokers have sophisticated, proprietary and tailored risk models in place approved by national competent authorities for the purposes of capital calculations. Greater standardisation may have an impact on the workings of such models and subsequently affect the business models of clearing brokers.

Scope creep from the G20 Commitments

OUR SUGGESTION*: Exchange-traded derivatives should be exempt from EMIR reporting.*

The scope of the recent European derivatives regulation exceeds the G20 commitments in several areas.

By way of illustration, the G20 Commitments called for *OTC derivative contracts* to be reported to trade repositories – there was no expectation or requirement in the G20 Commitments for exchange-traded derivatives to be reported to trade repositories. This is discussed in more detail under "reporting" below.

EU legislation vs third-country legislation vs national Member State legislation

Summary: Given that derivatives markets are global, it is critical that the regulatory framework applicable to them is globally consistent, whilst also leaving room to address more regional market issues. The G20 Commitments have been implemented locally in an inconsistent manner, at different paces. Inconsistent methodologies have been applied by Europe when determining whether or not to recognise third-country regulation as being "equivalent" to European regulation. The equivalence process itself is opaque, with little objective guidance provided to help third-country regulators determine whether, and how, their regulations will be deemed sufficient for equivalence to be granted.

OUR SUGGESTIONS*: The easiest way to mitigate the risks of regulatory arbitrage and to ensure internationally coherent regulation is to:*

- *agree sufficiently granular global standards;*
- *move forward on the same timetable as our immediate peers;*
- *implement regulation in a consistent manner globally; and*
- *have the means to pro-actively identify regulatory conflicts and overlaps.*

3 http://www.bis.org/bcbs/publ/d298.pdf

Early and active communication with peer regulators is key to ensuring consistent and harmonious regulation. Equivalence decisions should be granted in a timely manner to avoid creating market uncertainty.

The European Commission should continue to engage with key global stakeholders to further discuss and develop a process of creating regulation that is mutually reinforcing of their respective agreed agendas, is globally consistent and is harmonious.

A roadmap for agreeing such process should be agreed in the short term, even if it takes somewhat longer to agree how to create and implement global derivatives legislation.

Our members also encourage the European Commission to:

- *establish a standardised "toolkit" of recognition methodologies that it can use in a consistent manner going forward when determining the equivalence of third-country regimes; and*
- *allocate to one or more of its staff members within DG FISMA the responsibility to pro-actively identify and consider the impact of legislation proposed by the European Commission in light of existing / proposed European laws and laws of third countries and EU member states.*

The extension of US and European regulation extra-territorially has created a panoply of overlaps and conflicts in the fabric of global financial services regulation:

Inconsistent global timetables

Whilst the opportunity for a coordinated roll out of the G20 Commitments has now passed, there is still plenty of time and scope for a closer alignment of the European and US regimes. The EMIR review on which the European Commission has just commenced is the perfect opportunity for the EU and the US to align their standards, to promote international regulatory consistency and a level playing field, thereby mitigating the risks of arbitrage or business migration between the two regimes and promoting a fair competitive regime for all.

The key Asian jurisdictions must also be closely involved in such dialogue, as European business could as readily move east over time as west. Such loss of business would harm the creation of jobs and growth in Europe.

Differing regional application of G20 Commitments

In order to better promote and facilitate the key regulatory tools of recognition and equivalence, more consistency in global regulation would be desirable.

To the extent possible and appropriate, our members we encourage harmonisation of product scope, types of entities to whom the regulation is subject and other key aspects of proposed regulation.

Lack of a common approach to equivalence determinations

In discussions with the European Commission, we have been informed that equivalence determination methodologies are up for negotiation during the trilogue process, as much as any other provision. Respectfully, we do not consider that a helpful long-term approach.

Taking a different approach to third-country recognition in EMIR, MiFIR and the proposed EU Benchmarks regulation has led to a variety of approaches to recognition and equivalence – there is limited ability to leverage experience of recognition under one piece of legislation when considering the next. The detailed rules and processes of recognition are, in practice, incredibly opaque – one need look no further than the EMIR Article 25 recognition provisions and process for evidence.

For reasons we understand, albeit disagree with, the European Commission has largely been reluctant to use IOSCO principles as the basis for third-country equivalence assessments. We note that the stance of the

European Parliament appears to be developing in that regard with respect to recent dossiers such as the proposed EU Benchmarks regulation – this is a positive and welcome development in the step towards more global consistency and harmonisation.

Equivalence decisions should be granted in a timely manner to avoid creating market uncertainty

Article 13 EMIR: No equivalence decisions have been forthcoming under this Article, despite the expectation that mandatory clearing will take effect from April 2016. It is therefore not currently possible for firms to meet their EMIR obligations relating to clearing, risk mitigation techniques or reporting by complying with similar third country legislation.

Article 25 EMIR: The first set of equivalence decisions for the regulatory regimes of CCPs in Australia, Hong Kong, Japan and Singapore were granted last year and the Capital Requirements Regulation transitional period is in the process of being extended by a further six months to 15 December 2015. If equivalence determinations for the outstanding jurisdictions are not forthcoming, EU firms may not be able to clear derivatives on CCPs located in such jurisdictions (even indirectly) and, in any event, will incur onerous capital requirements if they continue to access third-country CCPs that have not been recognised – this would likely lead to such firms ceasing to access those third-country CCPs, resulting in a fragmentation in liquidity.

Article 19(6) MiFID: Under EMIR, unless the European Commission has determined a regulated market based in a third country as equivalent under Article 19(6) of MiFID I derivatives traded on that regulated market by EU counterparties will be considered OTC derivatives, rather than exchange-traded derivatives. The European Commission has yet to deem equivalent any third-country regulated markets under that Article. This is particularly problematic for Non-Financial Counterparties that trade on third-country regulated markets, as those exchange-traded derivatives will count towards the clearing threshold under EMIR and could force such counterparties above the threshold, thereby unintentionally subjecting them to the EMIR clearing and margin obligations.

Looking forward, it is critical that the equivalence assessments with respect to third-country firms under Title VIII of MiFIR be conducted as early and as promptly as possible, so as to minimise any disruption to the global financial markets and to maximum opportunities to further develop jobs and growth within the European Union off the back of third-country investment.

Insufficient consideration of the impact of third-country legislation

Various parts of this decade's European financial services regulation apply extra-territorially.

There have been a number of instances in which EMIR and MiFID II/R conflict with third-country legislation when the applicable provisions are applied extra-territorially.[4]

This leads to a number of provisions that require disapplication outside of the European Union – the laws of Europe cannot override the laws of third countries and we do not believe it to be the political intention of legislators for industry participants to cease trading with, or providing services to, counterparties located outside of the European Union.

Insufficient consideration of the impact of national Member State legislation

Not only does EU law need to sit harmoniously with the laws of third countries – it also needs to dovetail appropriately with existing Member State legislation.

The areas of most consistent conflict between EU and Member State legislation are insolvency and tax laws.

4 E.g. the requirement that U.S. FCMs offer Individually Segregated Accounts (ISAs) to their clients when clearing on EU CCPs: this requirement is fundamentally incompatible with the U.S. bankruptcy code to which many such FCMs are subject.

We note that the insolvency law challenge has been identified in the European Commission's proposals for a Capital Markets Union and encourage the European Commission to pro-actively ascertain and consider where European legislation potential conflicts with Member State insolvency law. Indirect clearing is the most pressing area of conflict for our members in this regard.

Aspects of European regulation that merit further consideration

In the interests of brevity, we summarise below the primary issues that we have identified with respect to EMIR and MiFID II/MiFIR implementation, to the extent not already addressed above:

Summary

- Indirect clearing
- Pre-execution and straight-through processing checks under MiFIR
- Reporting
- Acknowledge the importance of the multiple trading strategies and diverse characteristics of participants in the derivatives market
- Suspension of the clearing mandate in extreme circumstances
- The importance of cost/benefit analysis and accurate, up-to-date, data cannot be understated: 8 to 10 weeks is too short for a meaningful consultation period
- Regulators also benefit from being transparent

Indirect clearing

OUR SUGGESTIONS*: Access to clearing for as many undertakings as possible is a key, systemically important goal.*

We ask the European Commission to mitigate the legal barriers to indirect clearing, by (i) permitting indirect clients to <u>opt out</u> of the "leapfrog" model, (ii) expressly stating that, where an indirect client <u>does</u> opt for the leapfrog model, the leapfrog provisions in EMIR and MiFIR mandatorily override any national Member State insolvency laws and (iii) clarifying the jurisdictional scope of the provisions.

The leverage ratio should also be amended to recognise the exposure-reducing effect of segregated margin. That will free up the capacity of clearing members to clear for indirect clients, as well as direct clients.

Indirect clearing under EMIR has not been successful for a number of reasons - the primary legal challenges relate to:

- uncertainty over the jurisdictional scope of the provisions; and
- a conflict between the EMIR/MiFIR provisions and insolvency law.

We understand that the European Commission considers that they do not have the mandate in level 2 legislation under EMIR or MiFIR to clarify the jurisdictional scope of the indirect clearing provisions, i.e. to clarify in which jurisdiction must the CCP, clearing member, direct client and indirect client be located in order for these provisions are to apply – must they all be inside the EU or can some/all of them be located outside the EU?

This is a critical question that is already hampering the offering of indirect clearing under EMIR and threatens to do so under MiFIR.

One of the key features of indirect clearing is that upon the default of the direct client, any excess collateral held by the CCP and/or clearing member with respect to the positions of the indirect client may be paid by the clearing member ***straight*** to the indirect client. This is known as the "**leapfrog model**". The aim of the leapfrog model is to ensure that such excess collateral does not become part of the insolvency estate of the direct client – it purports to achieve this by permitting the clearing member to pay excess margin straight to the indirect client, rather than requiring the clearing member to pay such excess margin to the direct client and then for the indirect client to wait in line for onward payment of such excess as a creditor of the direct client.

There is a significant risk that any such *direct* payment of excess collateral by the clearing member to the indirect client could be successfully challenged by the insolvency official of the direct client as being unenforceable under the insolvency laws applicable to the direct client.

This would result in the payment from the clearing member to the indirect client being invalid, on the grounds that (i) the excess collateral was owed by the clearing member to the *direct* client and (ii) payment of such excess collateral by the clearing member straight to the indirect client *did not* satisfy the claim of the direct client to such excess collateral.

Were the payment of excess collateral by the clearing member straight to the indirect client ruled unenforceable, this puts the clearing member in an invidious position –it potentially has to pay out an amount equal to such excess collateral *twice*: having made payment straight to the indirect client, it will have to try to claim such payment back from the indirect client (on the basis that such payment was not legally unenforceable). The clearing member would also then have to make payment to the direct client, regardless of whether the clearing member was successful in claiming the first payment back from the indirect client.

Whether such a leapfrog payment is legally enforceable is a question governed by the insolvency laws applicable to the direct client. If that direct client is located in an EU Member State, the European Commission and ESMA consider that the primacy of EU law principle means that the bankruptcy official of the direct client cannot challenge such leapfrog payment. However, as there is no express reference in EMIR nor MiFIR to the indirect clearing provisions overriding national Member State insolvency law, various law firms in London to whom we have spoken consider that such leapfrog payments *could* potentially be subject to successful challenge under English insolvency law. **Clearing members are not prepared to offer indirect clearing if by doing so they risk having to attempt to claw back payments made straight to indirect clients pursuant to these provisions, whilst also still owing the same amount of money to their direct clients.**

Even if the European Commission and ESMA are correct in their analysis that EMIR and MiFIR, as regulations, automatically mandatorily override national Member State insolvency law, that analysis will not support indirect clearing in the event that the direct client is located *outside of the EU* – European regulations cannot and do not override the insolvency laws of third countries, e.g. the US Bankruptcy Code.

Our solution to this issue is to recommend that EMIR be amended so as to put indirect clients in the same position as direct clients, by giving indirect clients a *choice* as to the degree of credit protection they receive when clearing derivatives:

– under the existing EMIR regime, *direct* clients can opt for a higher degree of protection by opting for an Individually Segregated Account. For such clients, Article 48(7) of EMIR provides that upon a default of the clearing member and the closing out of the direct client's positions, the CCP may make payment of any remaining excess collateral *straight* to the direct client (i.e. the CCP can make a "leapfrog" payment straight to the direct client, thereby avoiding the insolvency estate of the clearing member). Crucially, however, under the existing EMIR regime, direct clients can, instead, elect to *opt out* of the higher level of credit protection provided by Article 48(7). To do this, they simply need to select an Omnibus Segregated Account level of segregation, rather than opt for an Individually Segregated Account. In practice, almost all direct clients in the market have opted for an Omnibus Segregated Account to-date;

- **we suggest that in order to ensure indirect clients have the same choice as direct clients regarding the levels of credit protection to which they are entitled, indirect clients should also be able to *opt out* of a leapfrog payment if they do not require that additional level of client protection;**
- **in order to promote and facilitate greater access to indirect clearing, it must be permitted for direct clients to offer the *opted out* model, even if they are unable or unwilling to offer the leapfrog model.**

Permitting indirect clients to *opt out* of the leapfrog payment model would result in four available means of clearing derivatives:

- As a clearing member;
- As a direct client;
- As an indirect client that is entitled to receive excess collateral directly from the clearing member upon the default of the direct client (i.e. a leapfrog payment); and
- As an indirect client, with NO entitlement to receive a leapfrog payment from a clearing member upon the default of the direct client.

The exchange-traded derivatives market has successfully provided indirect clearing access around the globe for decades without "leapfrog" style credit protection arrangements being considered necessary. Buy-side participants were comfortable with taking the credit risk of the direct client under such arrangements, as an acknowledged cost of obtaining access to trading opportunities and clearing services around the world.

Pre-execution and straight-through processing checks under MiFIR

OUR SUGGESTION*: Exempt exchange-traded derivatives from the MiFIR pre-execution and straight-through processing check regime.*

Pre-execution and straight-through processing checks should not be required for exchange-traded derivatives as, in contrast to the client-clearing market for OTC derivatives, certainty of clearing of exchange-traded derivatives is ensured via the binding contractual arrangements of the trading venue and CCP rulebooks. If the client's clearing broker declines to clear the trade, it will nonetheless still be cleared by the executing broker's clearing broker. The only way that the executing broker can close out that position is by entering into an equal but opposite (offsetting) cleared transaction.

The futures market has strong track record – there are very few occasions on which a CCP's default fund has been used for futures[5]. The futures market also remained largely unaffected by the crisis in 2008. It would therefore be of more utility from a systemic risk perspective for regulators to focus on mandating that the exchanges that clear on those CCPs implement pre-trade functionality at gateway level to ensure a level playing field amongst different market participants.

Introduction of mandatory pre-execution limit checks and/or straight-through processing checks at clearing member level would cause significant disruption to ETD markets by delaying the speed of execution and by requiring a very complex web of connectivity between the client, all its executing brokers (which could be dozens in number), all the venues on which it trades, all its clearing brokers and all the CCPs on which it clears. This is unnecessary, given the certainty of clearing that exists for exchange-traded derivatives.

5 These examples are limited to the failure of the Hong Kong Futures Exchange in the wake of the global stock market crash in 1987 and the default of HanMag Securities in Korea prompting default fund use of the KRX CCP in 2013.

Reporting

OUR SUGGESTIONS*: remove the reporting obligation with respect to exchange-traded derivatives; change the dual-sided EMIR reporting regime to a single-sided regime; and consolidate all the existing derivatives reporting obligations into a single EU Regulation.*

ETD reporting: The G20 Commitments only require reporting of *OTC derivative transactions* to trade repositories. They make no reference to the reporting of exchange-traded derivatives. All the information that regulators should require for exchange-traded derivatives is already held by central hubs: exchanges and clearing houses. Rather than requiring reporting of ETD to trade repositories, our members consider that regulators would receive more meaningful, timely and accurate data directly from such exchanges and clearing houses.

ESMA's most recent figures[6] show that 16 billion trade reports have been submitted to trade repositories since February 2014. Only 31% of the 200 million+ reports submitted to trade repositories in April 2015 related to OTC derivatives.

Over 1 billion trade reports for exchange-traded derivatives remain unmatched between trade repositories. The matching rate for inter-trade repository reconciliation of ETD trade reports is 1%.

Single-sided reporting: The EMIR reporting requirements are designed to provide transparency, protect against market abuse, improve data quality and mitigate systemic risk. However, recent experience has shown that the dual-sided reporting requirement has failed to meet these objectives.

Instead, as a result of substantial operational difficulties, significant trade data gaps exist today. In particular, under a dual-sided reporting regime, trades need to be linked/matched.
This increases the number of trade records, which amplifies the challenges on aggregation, consistency and implementation costs for the industry.

The matching process across counterparties and repositories, especially when a large number of transactions are executed on the same day, is extremely laborious and have proved extremely challenging and open to interpretation.

The need for a consolidated reporting regulation: With hindsight, one can see that reporting of derivatives transactions merited an EU regulation of its own, rather than reporting obligations being set out across half a dozen or more different regulations for which reporting is merely a small component. The reporting obligations under EMIR, MiFIR (both transaction and commodity position limit reporting), REMIT and AIFMD all operate in very different ways and the applicable data is reportable to a variety of different sources but, in sum, they all boil down to two key questions: tell me about the trade you have entered into and tell me about the net open position that you have once you have entered into such trade.

Acknowledge the importance of the multiple trading strategies and diverse characteristics of participants in the derivatives market

OUR SUGGESTION*: We ask the European Commission to carefully consider the critical role that multiple trading strategies and diverse characteristics of participants in the derivatives market play.*

There is an increasingly common undertone in recent EU and national Member State consultations that non-hedging related trading strategies are the scourge of financial markets, which leads to excessive volatility. Whilst this may be true *in extremis,* a degree of speculation in markets is necessary for them to function.

Different trading strategies of market participants promote price discovery, maintain accurately priced markets and can reduce market uncertainty and volatility. At the simplest level, market makers each provide a key service

6 29 May 2015: https://www.esma.europa.eu/news/ESMA-fosters-derivatives-market-transparency?t=326&o=home

in ensuring the liquidity of financial markets, by matching buyers with seller. Pension funds rely on a degree of speculation in order to generate a reasonable rate of return for their members. If Europe is to experience an increase in jobs and growth, then speculation in derivatives markets has an important, necessary and healthy role to play, for wholesale industry markets and the real economy alike.

Such strategies play a key role in the chain of relationships between different market participants and to the end-user of all asset classes.

Despite their key role in the infrastructure, market makers and other liquidity providers have indicated their intention to leave certain markets, citing the imminent regulation (e.g. MiFID II / MiFIR) and associated increased cost of capital. This would lead to further unintended consequences of decreasing liquidity and concentration of systemic risk.

In general, MiFIR and CRD IV each envisage their future application to a wider range of firms than is the case today. In particular, MiFIR will reduce the availability of the "ancillary activities" exemption for users of commodities derivatives and CRD IV will apply to all non-bank entities engaged in commodity derivatives that are authorised as an investment firm under MiFID II once the current exemption for commodities dealers from Articles 493 and 498 of CRD IV expires at the end of 2017.

The primary focus of energy companies and commodity trading firms that may be required to register as an investment firm under MiFID II is not "how will we ensure we become compliant with MiFID II" but rather "how will my company deal with the fact that as a result of becoming an investment firm under MiFID II, the regulatory capital requirements under CRD IV will apply to me?".

The additional capital costs that derive from application of CRD IV to such firms will result in significant increases in energy costs for end users and in the costs of raw materials for producers. This risks actively hampering the drive of the European Commission to promote jobs and growth within the European Union.

Suspension of the clearing mandate in extreme circumstances

OUR SUGGESTION*: Regulators should have the power to suspend the clearing obligation promptly in extreme circumstances.*

Under EMIR, the clearing obligation cannot be terminated or suspended as a matter of urgency in extreme circumstances. This means that CCPs may find themselves clearing more risk in a contract or product than there would be market capacity to manage upon a member default. A CCP may therefore have no option but to encourage participants to reduce these clearing provisions by increasing margin requirements to levels at which it is uneconomic to hold the positions and thus force the risk to be closed out.

The importance of cost/benefit analysis cannot be understated – eight to ten weeks is too short for a meaningful consultation period

OUR SUGGESTIONS*: We ask that European legislators and regulators provide more time to respond to their industry consultations, so that more meaningful responses and data can be provided. We note and welcome the European Commission's recent commitment to 12-week consultation periods as part of its new "Better Regulation" agenda. The data that regulators need is largely available to regulators already, either via trade repositories, trading venues or clearing houses – what regulators urgently need is a means to make sense of all this "big data".*

We are (rightly) repeatedly reminded by the European Commission, ESMA and others that our members' opinions are most useful and persuasive when supported with data.

Unfortunately one of the trends of recent years is that the timeframes permitted for responses to national and European regulatory consultations have become shorter and shorter. The opportunity to provide meaningful, reviewed, approved and appropriate data is, therefore, extremely limited.

The European Commission, European Parliament, ESMA and National Competent Authorities alike all acknowledged to us that calibrations made under MiFID II/MiFIR with respect to the pre- and post-trade transparency obligations and the "ancillary activities" exemption were made in a poor data environment. There is a material risk that the thresholds will ultimately be set at a level that is incorrect and leads to unintended consequences.

Regulators also benefit from being transparent

OUR SUGGESTIONS*: We acknowledge that equivalence assessments are confidential, sensitive, discussions between regulators. We ask that the process by which equivalence is granted is much more transparent and standardised. At a minimum, regulators should publicly state which jurisdictions have applied for equivalence/recognition and the date(s) by which the key decisions must be made with respect to such jurisdictions. If the actual dates are uncertain (due to the uncertain time it takes to reach a negotiated agreement with third-country regulators), we encourage regulators to, nonetheless, provide their "best guess" estimates, to the extent possible, so that industry participants can plan appropriately.*

One of the key aims of MiFID II is to bring transparency to the derivatives and other financial markets. This approach is welcomed by our members.

Transparency is a key tool to enable regulators and industry participants alike to better understand the markets and to plan for the future.

To that end, it is critical that certain key processes applied by legislators and regulators alike be more transparent – given that derivatives markets are global, this is most important in the area of third-country recognition and equivalence, but is equally important with respect to the authorisation process of European CCPs under EMIR: further transparency as to when a CCP's application is deemed complete would have helped the industry.

The cost and complexity of compliance with global regulation is extremely material and requires significant advance planning by industry participants to ensure that they have appropriate financial, IT and human resources in place to procure their timely implementation and compliance.