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Review of the clearing thresholds under EMIR

1. Introduction

The International Swaps and Derivatives Association (**ISDA**) and the Futures Industry Association (**FIA**), together the "**Associations**", welcome the opportunity to respond to ESMA's Discussion Paper on the review of the clearing thresholds under EMIR.

In particular, we would like to flag the following key issues:

- The **absence of equivalence decisions under EMIR Article 2a** has led to the imposition of additional burdens on EU firms which trade on non-EU exchanges or which have non-EU affiliates who trade on non-EU exchanges. This is likely to result in negative impacts for EU clients, as EU firms may seek to avoid dealing on non-EU exchanges, and can face practical difficulties in providing risk management or investment solutions to their EU and non-EU clients, which also results in a negative impact on the competitiveness of EU firms compared with their non-EU competitors.
- The **approach to calculation of the clearing threshold under EMIR** (and in particular the inclusion of centrally cleared OTC derivatives as well as physically settled exchange traded derivatives in the threshold calculation) results in more onerous outcomes for EU NFCs than under OTC derivatives regimes in other jurisdictions.
- The Associations support the call by EFET for a **substantial increase in the EMIR clearing threshold for commodities** to a level comparable with thresholds in non-EU jurisdictions.
- The Associations would also welcome **clarification of the treatment of emission allowances** under EU financial services regulation, and in particular confirmation that emission allowances are not commodities and that derivatives on emission allowances are not commodity derivatives for the purposes of EMIR or for any other purposes.

2. Responses

Question 1: Please explain if you see a need for further clarification on how to identify OTC contracts for the purpose of the calculation of the positions to be compared to the clearing thresholds.

Article 2a EMIR – treatment of derivatives traded on non-equivalent third-country trading venues

We discuss this further in our response to question 4, but one key point that requires further review is the treatment of derivatives traded on non-equivalent third-country markets. In the absence of equivalence under EMIR Article 2a, exchange traded derivatives traded on non-EU markets are considered to be OTC derivatives for the purposes of determining (i) whether small financial counterparties have breached the clearing threshold to become FC+s or (ii) whether non-financial counterparties have breached the clearing threshold to become NFC+s.

Changes resulting from EMIR Refit

The Associations welcome the changes made as a result of EMIR Refit, and in particular the creation of the new category of FC-, exempting small FCs with low volumes of trading activity in OTC derivatives from the clearing obligation. We also welcome the change to the clearing threshold approach for NFCs so that an NFC will only become subject to the clearing obligation in relation to an asset class for which the clearing threshold is exceeded. However, we note that an NFC would still be treated as an NFC+ for all other purposes under EMIR even if it only exceeds the clearing threshold in relation to one asset class. In particular that NFC would be subject to stricter risk mitigation techniques and margin requirements. This requirement imposes a substantial burden on the central treasury functions of corporate groups, which would, in the event that one of their affiliates breaches the clearing threshold in one asset class, be forced to margin transactions in all other asset classes.

Question 2: Please explain if you see a need for further clarification to identify OTC contracts that can be considered as reducing risks directly relating to commercial activity or treasury financing activity. And please mention any additional aspects to be further considered with regards to the hedging exemption.

The current definition of hedging is too narrow to cover all transactions which a corporate group might enter into in order to mitigate its commercial risk. One reason for this is the narrow understanding of what constitutes or relates to a "commercial activity" which can then be hedged through an OTC derivatives transaction. In addition, there are some key differences in the approach to EMIR compliance in different Member States. For example, in Germany there is a formal legal requirement for an official external audit of EMIR implementation by NFCs, with regulations and guidance that implement this requirement. This can give rise to a stricter

interpretation of what constitutes "hedging" in Germany than in other Member States. We understand that in other Member States there is either a broader understanding of what constitutes "hedging" or else some competent authorities may provide relief to their local NFCs, giving rise to an unlevel playing field.

We would welcome the introduction of a hedging exemption for financial counterparties as well as for non-financial counterparties. The ability to use derivatives for hedging is an important part of risk mitigation for financial counterparties as well as non-financial counterparties. The hedging exemption was introduced for non-financial counterparties to ensure that the clearing thresholds did not restrict non-financial counterparties in their ability to hedge their commercial risks. A similar argument applies in the context of financial counterparties – they should also not be restricted in their ability to hedge the risks to which they are exposed in conducting their business (i.e., their commercial risks). The European Commission indicated that one of the objective of EMIR Refit was to ensure that the requirements of EMIR were proportionate to the systemic risk of counterparties, and we consider that the absence of a hedging exemption for financial counterparties remains an area where the requirements of EMIR are disproportionate to the systemic risk faced by financial counterparties.

The need to ensure that financial counterparties do not face impediments in their ability to appropriately mitigate their commercial risks has been recognised in other EU financial regulation (for example with the introduction of a hedging exemption for financial counterparties under the position limits regime in MiFID), and we would welcome a similar approach under EMIR.

We would also support ESMA's suggestion in its June 2019 letter[1] to the European Commission that financial counterparties should be able to take into account the hedging exemption available to non-financial counterparties when calculating the positions of the entities in the group to which the financial counterparty belongs. At the moment, a financial counterparty is required to take into account the positions of all entities in its group, whether FCs or NFCs, whether these are hedging or non-hedging positions. However, the NFCs in that group would calculate their position based on the non-hedging positions of the NFCs in the group. This requires a group containing FCs and NFCs to carry out at least two different sets of calculations for the same group entities. We agree with ESMA that, if it is appropriate to assess the positions of an NFC based only on non-hedging positions, it should also be appropriate for an FC in the same group to assess the positions of NFCs in its group on the same basis.

Question 3: Please provide information and examples on how counterparties count fungible ETDs and OTC derivatives for the purpose of the calculation of the clearing thresholds.

[1] https://www.esma.europa.eu/sites/default/files/library/esma70-151-2392_letter_to_ec_-_emir_refit_-_hedging_exemption_in_the_calculation_of_the_clearing_thresholds.pdf

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Question 4: Please provide data and arguments to illustrate the potential impact of the lack of an equivalence decision under Article 2a of EMIR and what could be done to alleviate your concerns (besides an equivalence decision)? Please specify the kind of transactions and activities that would be affected and the purpose of those, and whether there are alternatives.

We would welcome amendment of Article 2a of EMIR to remove the need for an equivalence decision. We do not consider that it is proportionate or appropriate to have an equivalence regime purely for the purpose of establishing whether a derivative contract should be considered OTC or not under EMIR, and we are concerned that the current lack of equivalence decisions is leading to unintended consequences for EU firms.

We understand that Article 2a of EMIR was introduced because the original definition of "OTC derivative" cross-referred to Article 19(6) of MiFID I, which provided for the Commission to publish a list of third country markets considered to be equivalent to an EU regulated market, although no such list has been published and MiFID I has subsequently been repealed. As a result, a new equivalence regime was created under Article 2a of EMIR. However, defining "OTC derivatives" in a way that means that (in the absence of a Commission equivalence decision) instruments traded on non-EU venues would be considered to be "OTC" derivatives leads to inconsistent results and negative impacts for EU FCs and NFCs.

The issues that arise as a result of the application of Article 2a and the lack of equivalence decisions arise particularly in the context of calculating the clearing thresholds for EU FCs and NFCs with non-EU affiliates. For example, an EU NFC would be required to calculate its clearing thresholds on the basis of all EU NFCs and non-EU entities that would have been NFCs if established in the EU. It is highly likely that if the non-EU entities in the group enter into derivatives on exchanges, those exchanges would be non-EU exchanges. In the absence of an equivalence decision for the relevant exchange, those derivatives would have to be counted towards the clearing threshold as OTC derivatives, with the result that an EU NFC that is part of a large global group is more likely to exceed the clearing threshold than an EU NFC that is part of a purely EU group even though there may be no difference in the systemic risk faced by the counterparties. Even if the Commission does make further equivalence decisions under Article 2a, it is unlikely that they will cover all relevant jurisdictions or all relevant exchanges, so this situation will continue so long as the definition of "OTC derivative" is linked to an equivalence decision.

In addition, the impact for EU FCs and NFCs or this situation will continue to escalate for as long as there are no equivalence decisions in existence for key jurisdictions, as notional volume increases over time.

This situation is clearly disproportionate where the relevant trades cleared on a non-EU CCP are entered into by non-EU affiliates of an EU entity, as these transactions would never be

subject to obligations applicable to OTC derivatives under EMIR. The only impact of categorising these transactions as OTC derivatives is to impose additional burdens on EU firms with non-EU affiliates.

However, we also consider that this situation is disproportionate where the relevant trades are entered into by EU entities. In particular, categorising exchange traded derivatives as OTC derivatives is likely to result in negative impacts for EU clients, as EU firms may consequently seek to avoid dealing on non-EU exchanges. There are contracts on non-EU exchanges for which there are no alternatives on EU trading venues. Restricting the ability of EU firms to trade on non-EU exchanges gives rise to practical difficulties for EU firms in providing risk management or investment solutions sought by their EU and non-EU clients, resulting in a negative impact on their competitiveness against non-EU competitors as well as negative impacts for EU clients who will have reduced ability to access non-EU markets.[2].

We would also note that, in contrast, the UK has recognised a number of EU exchanges including Eurex, giving rise to an unlevel playing field resulting in a competitive disadvantage for EU dealers compared to UK dealers.

Question 5: Please describe the scenarios when transactions do not qualify as hedging transactions.

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Question 6: Please describe your views on how the EMIR framework works (also compared to other regimes) for the purpose of the clearing thresholds and the requirements triggered by those? Please provide examples and supporting data.

In the context of commodity derivatives we note that the European Federation of Energy Traders (EFET) has commissioned an independent assessment of international approaches to the regulation of OTC energy and commodity derivatives markets (the "Benchmark Study"). This Benchmark Study compared the EU EMIR rules with international standards for the clearing and margin obligations of non-financial firms (NFCs). The aim was to identify the regulatory objectives of OTC-derivatives regulation, to outline the different legal approaches taken to achieve these and to determine the regulatory burden associated with these approaches. The Benchmark Study considered the USA, Australia and Singapore as relevant competing jurisdictions because they have all implemented the goals of the 2009 G20 summit in Pittsburgh regarding OTC derivatives trading and are comparable markets regarding either the size of the underlying market and/or the number and variety of international market participants.

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[2] ISDA and other trade associations have commented previously in more detail on the impacts for EU firms of the absence of an equivalence decision under Article 2a. We have included a link to our previous letter on this subject: https://www.isda.org/a/C7YTE/Equivalence-of-UK-Derivatives-Regulated-Markets-Under-EMIR-Article-2a.pdf

As a result of this comparison between international standards of OTC derivatives markets regulation, the Benchmark Study concluded that the approach to application of clearing and margin obligations to NFCs used by the EU under EMIR is the most restrictive of all approaches.

The headline conclusion of the Benchmark Study is that the EU EMIR regime includes the lowest clearing threshold applicable to the largest set of entities, products and activities:

- Only the EU applies its regime to all trading activities around the globe without restriction, i.e. all world-wide energy and commodity derivatives activities count against the EMIR clearing threshold, even if no EU-product, EU-venue or EU-entity is involved;
- Only the EU includes any centrally cleared OTC derivatives as well as some physically settled exchange traded derivatives into the threshold calculation;
- Several jurisdictions, including Australia and Singapore, limit the application of OTC-clearing regulations solely to financial institutions and, consequently, non-financial market participants are not limited in their trading in OTC markets as they are not subject to any clearing threshold test (hence, there is no hedging exemption for non-financial firms); and
- Those jurisdictions which include non-financial market participants, including the U.S. and the EU, offer privileges for hedging transactions which are not considered for the clearing threshold. However, the definition of eligible commercial risks for hedging under EU EMIR is rather restrictive and the privilege correspondingly narrow.

This is discussed in more detail in the EFET response to this consultation.

Question 7: Considering the current coverage provided by the clearing thresholds in relation to credit derivatives and the different type of counterparties (FCs and NFCs), is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

Members of the Associations do not consider that there are any particular aspects or issues that ESMA should look into or pay attention to.

Question 8: Considering the current coverage provided by the clearing thresholds in relation to interest rate derivatives and the different type of counterparties (FCs and NFCs), is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

Members of the Associations do not consider that there are any particular aspects or issues that ESMA should look into or pay attention to.

Question 9: Considering the current coverage provided by the clearing thresholds in relation to commodity derivatives and the different type of counterparties (FCs and NFCs), is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

The associations support the response to this question provided by EFET, and would welcome a substantial increase of the EMIR clearing threshold for commodities to a level comparable with thresholds in non-EU jurisdictions.

In particular, the Associations agree with EFET that ESMA should not focus on the EU perspective when performing its data analysis, but instead take a global approach for the following reasons:

- The EMIR Commodity Clearing Threshold ("EMIR CCT") calculation has a global scope. This is because under EMIR all world-wide energy and commodity derivatives activities count towards the EMIR CCT, even if no EU product, EU venue or EU entity is involved.
- Energy and commodity markets are global markets. Limiting the analysis to EU27 energy and commodity markets underestimates the size of these markets which are actually global in nature and therefore overestimates the relative importance of EU27 NFCs in these global markets.
- A focus that is too narrow ultimately overestimates the systemic relevance of commodity trading by EU NFCs and leads to too strict (low) clearing thresholds.

We note that ESMA might not have access to the same data with regard to trades conducted outside the EEA. However, a possible work-around could be a comparison of the EU trading data with derivative trading statistics from other jurisdictions (e.g. the US), to gauge the relative size of respective geographic market segments and thereby the size of the overall global market.

In addition, we are concerned by the fact that emission allowances are included as "commodities" for these purposes and we would welcome further work by ESMA on whether or not this remains an appropriate approach.

In particular:

- **Consistent treatment of emission allowances in EU regulation**: we understand that emission allowances are only included within the class of "commodity derivatives" for the purposes of EMIR because EMIR takes the approach of categorising all derivatives into five broad classes, and the commodity derivative category was deemed to be the most appropriate for emission allowances (even though derivatives on EU emission allowances at least would be categorised as falling under section C(4) of Annex I to

MiFID, rather than under any of the classes of commodity derivatives under Annex I to MiFID). We understand that this does not have any bearing on the categorisation of emission allowances for other purposes (e.g., they are very clearly not "commodities" for the purposes of MiFID). However, we would welcome a review of this approach as part of a more general review of the treatment of emission allowances under EU financial services regulation as we are concerned that it is not always clear that emission allowances are not commodities and that they should not be regulated in the same way as commodities.

- **Need for a clear definition of what constitutes an emission allowance for these purposes**: as part of a more general review of the treatment of emission allowances under EU financial services regulation we would also welcome a clear definition of what constitutes an "emission allowance" for the purposes of the various references in EU regulation to emission allowances. This term is typically used without being defined, meaning that it is unclear whether references to emission allowances mean only instruments that qualify as "emission allowances" under section C(11) of Annex I to MiFID (i.e., emission allowances that qualify for recognition under the ETS) or whether some or all references to emission allowances would also capture a broader range of assets.

- **Potential need for another category of "derivatives" under EMIR**: we would also welcome further review of whether it may be appropriate either to create additional categories of derivatives under EMIR to accommodate new or developing classes of derivatives or else to clarify that classes of derivatives that do not fall into the existing five categories should not count towards the clearing thresholds for those categories.

  It is unlikely that any new types of derivatives would fall under the heading of credit derivatives, equity derivatives, interest rate derivatives or currency derivatives. However, the category of commodity derivatives should not be used as a catch-all class without further investigation as to whether or not this is an appropriate treatment. We have discussed emission allowance derivatives above, but similar issues also arise in relation to derivatives on cryptoassets, for example. It may be appropriate to create an "other derivatives" category for classes of derivatives that do not fall into any of the other categories of derivatives.

  If the category of commodity derivatives is intended to capture any derivatives that do not clearly fall into one of the other asset classes under EMIR, then the clearing threshold should be reviewed periodically to take into account not just volumes of commodity derivatives but also volumes of other derivatives, and adjusted accordingly.

Question 10: Considering the current coverage provided by the clearing thresholds in relation to equity derivatives and the different type of counterparties (FCs and NFCs), is there any aspect or issue you consider ESMA should look into or pay attention to?

Please, in your answer, provide as granular details and any relevant data to illustrate your response.

Members of the Associations do not consider that there are any particular aspects or issues that ESMA should look into or pay attention to.

Question 11: Considering the current coverage provided by the clearing thresholds in relation to currency derivatives and the different type of counterparties (FCs and NFCs), is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

Given the interconnectedness of the clearing thresholds for each of the asset classes in the Discussion Paper and the current calibration for FX, based on the data available the clearing threshold appears to be appropriate and there are no issues that members consider should be brought to the attention of ESMA.

Question 12: Beyond the different treatments between FCs and NFCs in the calculation, are there differences between the different types of counterparties that might justify a different calibration of the actual clearing thresholds?

In addition, please consider if a different calibration of the current clearing thresholds by type of counterparty should apply in the same manner to all asset classes. Please provide any supporting data that might help illustrate your response.

Members of the Associations do not consider that there are differences between the different types of counterparties that would justify a different calibration of the clearing thresholds. We consider that the differences between FCs and NFCs are most appropriately captured by differences in the approach to calculation of the clearing threshold. If there are different methods of calculating the clearing threshold for FCs and NFCs, as well as different clearing thresholds, this is likely to lead to significant increased complexity for EU groups that need to carry out both the FC and NFC clearing threshold calculation, as well as for EU entities that need to ask non-EU counterparties to carry out this calculation in order to assess which obligations under EMIR apply to transactions with those counterparties. It is already challenging for EU firms to obtain this information from their non-EU counterparties, and this will become more challenging the more complex the calculation becomes.

Any changes to calibration of clearing thresholds should take into account the global nature of OTC derivatives markets, as well as the extraterritorial nature of the margin rules in most jurisdictions.

Question 13: Looking at the simulations presented in the paper and at the impact they would have, do you have any views on the sensitivities of the thresholds?

We note that the simulation shows that increasing the current clearing thresholds by EUR 1 billion would not have a significant impact on the population and notional captured (except potentially in the case of credit derivatives). ESMA concludes from this that the clearing thresholds are not too sensitive to slight changes, or that there are not many counterparties that manage their activity to remain close to the thresholds.

However, we consider that there is another possible interpretation of the simulation. The lack of significant impact of raising the clearing thresholds by EUR 1 billion may also indicate that the current thresholds are set too low and should be raised by significantly more than EUR 1 billion. The clearing thresholds are meant to distinguish between entities that are important for systemic risk and those that are not. The majority of entities are not important for systemic risk, and so if the clearing thresholds capture the majority of the market then this would appear to indicate that the clearing thresholds are set too low, placing inappropriate burdens on small and non-systemically important entities.

We thank you for taking the time to consider our views on this issue. If you have questions on any of the issues addressed in this letter, we are happy to discuss them with you at your convenience.

Yours sincerely,

International Swaps and Derivatives Association
Futures Industry Association

Annex

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 960 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter @ISDA.

About the FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. FIA's mission is to: support open, transparent and competitive markets; protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets.