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ISDA/AFME position paper on the scope of EMIR – May 2011

Introduction

ISDA and AFME believe that in general the obligations set out in the proposed regulation on OTC derivatives, central counterparties and trade repositories (hereafter: EMIR) should cover not only OTC derivatives, but also derivatives contracts and cash securities that are traded on exchanges and other trading platforms.

We believe that such a broadening of the scope of EMIR would deliver two significant benefits:

(1) It would enhance competition between different trading venues, and should ESMA allow in future, between central counterparties providing clearing services for derivative products. This reflects the fact that the extension of Article 8 (Access to a CCP, previously Article 5) to exchange-traded derivatives would prohibit the anti-competitive bundling of execution and clearing services – 'vertical silos' – by operators of those markets. We also believe that cash securities should be included in the text of Article 8a (Access to venue of execution, previously Article 5a). We are of the opinion that, as far as listed derivatives are concerned, any venue should be allowed to admit derivatives to trading when they are cleared by a CCP. Greater competition will deliver benefits to the users of cash securities and exchange-traded and OTC derivatives in terms of reduced costs and greater choice. As explained below, this is a long-standing problem that European policymakers have for a number of years sought to address.

(2) It would ensure that EMIR is future-proof. Currently, Multilateral Trading Facilities (MTFs) don't necessarily mandate central clearing of derivative contracts (this is the case, for example, with FXall, Tradeweb, 360T, Bloomberg and MarkitAxess). EMIR as drafted covers such platforms, but does not cover Regulated Markets. Given that the Markets in Financial Instruments Directive does not include detailed rules on the central clearing of derivatives traded on Regulated Markets, confining the application of EMIR to OTC derivatives, including those traded on MTFs, would lead to differential clearing practices across different execution venues.

The problem of vertical silos

Under current European law, it is possible for providers of market infrastructure to integrate execution and post-trade services, limiting the ability of market users to determine separately the most appropriate execution and post-trade facilities according to their needs.

This has long been recognised as a significant barrier to European integration. In 2001, the Giovannini Group's report on Cross-Border Clearing and Settlement Arrangements in the European Union explained that "inefficiencies in clearing and settlement represent the most primitive and thus most important barrier to integrated financial markets in Europe."

This is a problem that the European Commission was keen to resolve. In 2002, the Commission called for "generalised access (i.e. by all markets, infrastructure providers and market participants) to all necessary systems." It suggested that the review of the Investment Services Directive (that would ultimately lead to the adoption of MiFID) should provide "for the possibility of choice of systems for post-trade activity". Again in 2004, the Commission emphasised that "in an integrated barrier-free environment, infrastructure providers and users of the relevant services should have access to and choice of their preferred, properly authorised and supervised clearing and settlement system."

Despite this commitment, progress has been slow, and European law continues to tolerate the distortion of competition in financial markets through the vertical integration of trade execution and post-trade services.

We believe that EMIR provides the opportunity to resolve this problem for the long-term benefit of users of European financial markets.

We would also note that in order to provide clearing services, CCPs are reliant on data feeds and software licence agreements provided by execution platforms, so the issue of competition between exchanges should also be tackled in the context of the review of the Markets in Financial Instruments Directive.

Interoperability

A CCP acts as a third party to a trade, stepping in as the counterparty to each of the original counterparties of the trade, thereby providing assurance to both sides of a trade that it will settle at the agreed price in the event of a default of one of the original counterparties. Under an interoperability arrangement, CCPs establish links with one another so that a user of one CCP can execute a trade with a counterparty that has chosen to use another CCP. This fosters competition for clearing, which will ultimately create a better service for market participants.

For interoperability to work, a CCP has to assume a credit exposure to another CCP, creating diverse risks and legal considerations which need to be addressed. Whilst interoperability for clearing of derivatives trades may become a reality following the proposed review by ESMA, we do not believe that mandating it is appropriate at this particular time.

It is important to understand that expanding the scope of EMIR to include exchange-traded derivatives contracts **does not** amount to introducing full interoperability for derivatives at this time. The Presidency compromise text of 29 April 2011 includes text (Article 8a, moved from Article 5a) that would require an exchange to provide trade feeds on a non-discriminatory and transparent basis to any CCP that has been authorised to clear the products that trade on that venue. This will ensure that two members of a given exchange could choose to use a CCP of which they are both members to clear a trade, rather than being forced to use the venue's preferred CCP. This is not the same as interoperability, which would enable the parties to the trade to use **different** CCPs.

Over the medium-term, this text also provides a legislative basis that will support the goal of interoperability for derivatives trading. It does not, however, mandate it at this time.

Detailed policy considerations

In considering the extension of EMIR to exchange-traded derivatives, we believe that European policymakers should also recognise that the broad scope approach should not automatically apply to all of the provisions of the Regulation. In particular:

- It might not be appropriate to apply the reporting requirements set out in Article 6 to exchange-traded futures contracts.
- EMIR rules on segregation and portability should not apply to exchange-traded derivatives, given the very large number of clients of futures brokers.
- Amendments addressing omnibus clearing may need to be made for exchange-traded derivatives and cash securities, if many market participants use chains of brokers.
- Collateral requirements set out in Article 43 should be sensitive to the availability of collateral, noting the increase in collateral that would be required under the broad scope approach.

It is also important to note that the extension of EMIR clearing requirements to exchanges and other platforms must not be such as to impose a clearing obligation on non-financial end-users who trade on those platforms and whose trading activity falls below the clearing threshold.

We believe that such issues could readily be resolved through careful consideration of how to extend the scope of EMIR. We therefore encourage policymakers to commit to a broad scope EMIR, with a view to ensuring that Europe does not miss out on the benefits that greater competition would bring.