Aligning the Derivatives Clearing Obligation (CO) and Derivatives Trading Obligation (DTO) through an amendment to UK MiFIR

1. Background

We are currently sharing this paper (albeit tweaked slightly to refer only to EU regulations and institutions) with the EU authorities. As most of the references referred to below are inherited pieces of legislation made prior to onshoring, they refer to EU regulation and authorities. However, looking ahead, we propose changes to UK MiFIR so that UK MiFIR and UK EMIR are future proofed should the CO and DTO be aligned.

Prior to the adoption of the 2019 EU EMIR Refit legislation[1], the CO (under EU EMIR) and the DTO (under EU MiFIR) applied to 'Financial Counterparties' (FCs) as defined under Article 2(8) EU EMIR. The wording of EU EMIR, EU MiFIR and related technical standards, as well as ESMA statements, provide strong support for the belief that it was the intention of legislators and regulators that the DTO should only apply to FCs that are also subject to the CO.[2]

EU EMIR Refit has introduced a new 'Small Financial Counterparty' (SFC) category which has been made exempt from the CO. The exemption from the CO for this category of counterparties has not resulted in an equivalent exemption from the DTO under EU MiFIR for the same category of counterparties, however. Furthermore, the original Article 28 EU MiFIR reference to in-scope Non-Financial Counterparties exceeding the clearing threshold(s) (NFCs+) no longer made sense after the adoption of EU EMIR Refit, with Article 10(1)(b) EU EMIR having been replaced by a new clause allowing NFCs exceeding the threshold(s) 4 months to start clearing their positions and only in the asset class where they exceeded the clearing threshold.

Therefore, despite being exempted from the clearing obligation, SFCs and NFCs below the clearing thresholds for some asset classes (in which derivatives classes are subject to the CO and DTO) appear to remain subject to the DTO for such asset classes, under EU MiFIR Level 1.

ESMA has confirmed (in its statement of July 2019[3]) that it expects NCAs not to prioritise supervisory actions to enforce the DTO when SFCs and NFCs below the clearing threshold(s) (for

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[1] Regulation (EU) 2019/834 of 20 May, 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories

[2] For example:

- Article 28 EU MiFIR states that the DTO applies to 3rd country entities that would be subject to the CO if established in the EU;
- The CO and DTO phase-in dates are fully linked in the relevant RTS.

[3] https://www.esma.europa.eu/sites/default/files/library/esma70-156-1436_public_statement_mifir_dto.pdf

some asset classes (in which derivatives classes are subject to the CO and DTO)) execute contracts in-scope of the DTO. We understand that ESMA statements prior to IP completion date such as this one remain relevant in the UK. ESMA technically has no powers to disapply or delay the application of a directly applicable legal text, however. In accordance with the mandate in Article 85 EU EMIR Refit for both ESMA and the European Commission (EC) to opine on whether the scope of the CO and the DTO should be aligned – in particular in terms of in scope entities – ESMA supported the alignment of the CO and DTO in its final report of February 2020[4].

2. **Should SFCs and NFCs- (for some asset classes (in which derivatives classes are subject to the CO and DTO)) be required to comply with the DTO?**

ISDA believes it would not be proportionate to expect SFCs and NFCs- (for some asset classes (in which derivatives classes are subject to the CO and DTO)) to comply with the DTO.

- *There would be no risk-based justification for such a requirement*

The derivatives activity of SFCs and NFCs- (for some asset classes (in which derivatives classes are subject to the CO and DTO)) falls below thresholds set by the onshoring of ESMA requirements to indicate whether or not there is a risk-based justification for a clearing requirement. As such, there is equally no risk-based justification for these entities to be required to trade products in scope for the DTO on-venue.

- *Requiring SFCs and NFCs- (for some asset classes (in which derivatives classes are subject to the CO and DTO))) to comply with the DTO could either force them back into clearing (negating one of the main achievements of EU EMIR Refit) or incentivize them to stop trading products subject to the DTO.*

Although certain trading venues facilitate trading in uncleared OTC derivatives, the benefits of trading on-venue in terms of price discovery, minimization of trading documentation requirements and straight-through operational processing of trades are most effectively realized in cleared OTC derivatives. In particular, standardized collateral arrangements at each CCP are a key component of pricing, allowing dealers to price cleared OTC derivatives accurately for all clients. By contrast, collateral arrangements are detailed in bilateral credit support agreement terms between dealer and client, making it more complex for dealers to offer pricing on-venue and making it more difficult for clients to compare quotes between their dealers.

As such, a requirement for SFCs and NFCs- (for some asset classes (in which derivatives classes are subject to the CO and DTO)) to comply with the DTO could necessitate that they clear these contracts, despite the fact that one of the main achievements credited to EMIR Refit is to relieve these counterparties from the CO.

Furthermore, noting that the venue onboarding requirements will be the same for all participants, irrespective of their characterisation for EU EMIR purposes (FC+, SFC, NFC+, NFC-), SFCs and NFCs-

[4] https://www.esma.europa.eu/sites/default/files/library/esma70-156-2076_emir_final_report_on_alignment_clearing_and_trading_obligations.pdf

(for some asset classes (in which derivatives classes are subject to the CO and DTO)) may face disproportionate administrative burdens associated with on-venue trading of DTO products if forced to do so, noting that their activity in the DTO products is likely to be smaller than a comparable firm which is an FC or NFC+.

While it is possible that in some cases, depending on their business model, and depending on the product, some clients may feel that they benefit from on-venue trading and clearing on a voluntary basis – for reasons related to, for example, STP, electronic workflow or pricing – the option remains open for such clients to trade on-venue if they wish.

For all of the reasons cited above, we do not believe that imposing the DTO on SFCs and NFCs- (for some asset classes (in which derivatives classes are subject to the CO and DTO)) would be appropriate.

3. **The CO and DTO should be aligned in transaction terms (as well as in counterparty terms)**

We believe that UK MiFIR should also align the CO and DTO in *transaction* terms, in order to 'future-proof' UK EMIR and UK MiFIR in this regard, removing or preventing legal uncertainties (as explained in the following paragraphs).

ISDA believes that the set of transactions subject to the DTO should be a subset of transactions subject to the CO, i.e., no transactions that are exempt from the CO (whether because entities and/or products are exempt from the CO) should be subject to the DTO. Applying the DTO to these entities and products effectively scopes them back into the CO for the reasons already described.
This dynamic alignment approach would prevent you from having to amend UK MiFIR every time there is a (permanent or temporary) amendment to the product or counterparty scope of the UK EMIR CO. It would also prevent the unnecessary and unwanted uncertainty associated with requesting forbearance of the FCA whenever such uncertainty arises.
There are several examples of where such uncertainty exists, including:

- Article 1 EU EMIR specifically exempts a range of public and other entities from the scope of EU EMIR, some of which might otherwise be treated as FCs or NFC+s subject to the CO and other obligations under EU EMIR. For example, some central banks and debt management offices are completely exempt from EU EMIR obligations (including the CO) while some multilateral development banks and other public sector entities are exempt from the CO and other obligations (but not the reporting obligation). Article 28 EU MiFIR does not specifically exclude transactions which benefit from the exemptions under Article 1 EU EMIR even though it does specifically exclude intragroup transactions covered by Article 3 EU EMIR and transactions with pension funds benefiting from the transitional exemption from the CO under Article 89 EU EMIR. It should be made clear that the DTO does not apply to transactions with entities that have explicit exemptions from the CO under UK EMIR.

- Contracts in products in asset classes which are now subject to the CO and DTO but which were entered into by counterparties prior to the effective dates of the CO, currently benefit from relief from the clearing obligation where counterparties have had to incorporate fallbacks or new Risk Free Rates through amendments to EU EMIR adopted in the recent revisions to the Benchmarks Regulation. Some of these counterparties – especially those with low levels of derivatives activity – may be uncertain and concerned as to whether inclusion of a fallback (as required under Article 28(2) EU Benchmarks Regulation) would trigger the DTO to apply to a trade which would be in scope for the DTO. Our proposed amendment would prevent and eliminate any such uncertainty. We emphasise here that we are referring to relief for 'legacy' contracts (i.e. contracts entered into prior to the EU EMIR CO and MiFIR DTO effective dates) and therefore not for contracts dating from after the EU EMIR CO and MiFIR DTO effective dates.

In the annex, please find suggested wording for an amendment to EU MiFIR which would align the CO and DTO on a transaction basis which we have sent to the EU authorities. We ask that these amendments be applied to UK MiFIR.

Please contact Roger Cogan (rcogan@isda.org) if you wish to discuss further.

Annex: Clearing obligation (CO)/derivatives trading obligation (DTO) alignment

We have set out below draft amendments to Article 28 MiFIR (Regulation (EU) No 600/2014) aimed at clarifying that the DTO in Article 28 MiFIR should be aligned in counterparty and transaction scope with the CO in EMIR and that, as a result, any changes made to the scope of the CO in EMIR (e.g., to exempt certain counterparty types or transaction types from the clearing obligation) should automatically be reflected in the scope of the DTO in MiFIR.

Option 1	**Option 1**
Article 28 **Obligation to trade on regulated markets, MTFs or OTFs** 1. Financial counterparties **and non-financial counterparties** as defined in **~~Article 2(8) of~~** Regulation (EU) No 648/2012 **~~and non-financial counterparties that meet the conditions referred to in Article 10(1)(b) thereof~~** shall conclude transactions **~~which are neither intragroup transactions as defined in Article 3 of that Regulation nor transactions covered by the transitional provisions in Article 89 of that Regulation~~** with other such financial counterparties or other such non-financial counterparties **~~that meet the conditions referred to in Article 10(1)(b) of Regulation (EU) No 648/2012~~** in derivatives pertaining to a class of derivatives that has been declared subject to the trading obligation in accordance with the procedure set out in Article 32 and listed in the register referred to in Article 34 only on: (a) regulated markets; (b) MTFs; (c) OTFs; or	**Comments:** We have amended paragraph 1 so that it no longer references specific provisions of EMIR which may change in future (e.g., Article 10(1)(b) EMIR is no longer the correct provision to reference in relation to NFC+s – we could amend this to correct the cross-reference, but if further changes are made to EMIR it would be necessary to amend this again.) The fact that small FCs and NFC-s should not be subject to the trading obligation is now addressed by new paragraph 2a. New paragraph 2a aims to align Art 28 with Art 4 EMIR. The wording in Art 28(1) carving out intragroup transactions as defined in Art 3 EMIR and transactions covered by the transitional provisions in Art 89 EMIR is deleted, as this now duplicates para 2a in part. New paragraph 2a is based on the intragroup exemption in Art 4(2) EMIR, which provides that "OTC derivative contracts that are intragroup transactions […] shall not be subject to the clearing obligation." New paragraph 2a refers to "derivative transactions" rather than "OTC derivative

(d) third-country trading venues, provided that the Commission has adopted a decision in accordance with paragraph 4 and provided that the third country provides for an effective equivalent system for the recognition of trading venues authorised under Directive 2014/65/EU to admit to trading or trade derivatives declared subject to a trading obligation in that third country on a non-exclusive basis. 2. The trading obligation shall also apply to counterparties referred to in paragraph 1 which enter into derivatives transactions pertaining to a class of derivatives that has been declared subject to the trading obligation with third-country financial institutions or other third-country entities that would be subject to the clearing obligation if they were established in the Union. The trading obligation shall also apply to third-country entities that would be subject to the clearing obligation if they were established in the Union, which enter into derivatives transactions pertaining to a class of derivatives that has been declared subject to the trading obligation, provided that the contract has a direct, substantial and foreseeable effect within the Union or where such obligation is necessary or appropriate to prevent the evasion of any provision of this Regulation. ESMA shall regularly monitor the activity in derivatives which have not been declared subject to the trading obligation as described in paragraph 1 in order to identify cases where a particular class of contracts may pose systemic risk and to prevent regulatory arbitrage between derivative transactions subject to the trading obligation and	contracts", as this tracks the wording used in Art 28 MiFIR. New paragraph 2a carves out transactions which are "exempt from or otherwise not subject to the clearing obligation", in order to cover both transactions where a specific exemption exists (e.g., the intragroup exemption) and also transactions where one counterparty might be excluded from the clearing obligation or which may be out of scope for other reasons (e.g., as a result of the small FC regime or the transitional provisions in Art 89 EMIR).

derivative transactions which are not subject to the trading obligation. **2a. Derivative transactions that are exempt from or otherwise not subject to the clearing obligation under Article 4 of Regulation (EU) No 648/2012 shall not be subject to the trading obligation.** 3. Derivatives declared subject to the trading obligation pursuant to paragraph 1 shall be eligible to be admitted to trading on a regulated market or to trade on any trading venue as referred to in paragraph 1 on a non-exclusive and non-discriminatory basis.	