MiFIR "Non-discriminatory" Access to derivatives clearing & trading

Putting EU27 financial stability & competitiveness at risk

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1. Executive summary

- The EU27's current political reflections on key initiatives, such as the future of the Capital Markets Union or the international role of the Euro, are a symbol of the **need to have fully operational, stable and independent market infrastructures to support the financing of their economies** through their capital-raising and risk-management functions.

- However, the **"Non-discriminatory" Access provisions under MiFID II/R for Exchange-Traded Derivatives (ETDs) constitute a key risk to EU27 financial stability and competitiveness** by undermining the ability of market infrastructures to ensure orderly trading, liquidity and clearing.

- Though the "Non-discriminatory" Access provisions intended to bring greater competition to European markets, it is critical to realise that such a **policy would result in fragmentation, unfairly and artificially forced via regulation while in parallel resulting in significant financial stability risks.**

- These aspects are all the more important within the context of Brexit whereby the UK, an important provider of financial infrastructure in Europe, will become a third country under the EU rules.

2. Introduction

- MiFIR requires CCPs to provide access to trading venues (TVs), and TVs to provide access to CCPs in respect of transferable securities, money market instruments and ETDs. It also provides a regime for CCPs and trading venues to request "Non-discriminatory" Access to licence benchmarks[1].

- While applying "Non-discriminatory" Access ("Open Access") under MiFIR to transferable securities and money market instruments poses little systemic risk, **applying it to ETDs would undermine the stability and liquidity of the European derivative markets[2]**. In this context, and taking an example in which a RM operating a market in ETDs had access arrangements with three CCPs, any order placed into the anonymous order book could only match with other orders which were intended to be cleared by the same CCP. This is because, by design, the CCP is the counterparty to each side of the trade and therefore must stand between two equal and opposite positions in order to maintain its own flat position. Given that fact, the RM would be forced to create separate order books for any given product (i.e. there would need to be one order book for each CCP connected to the RM through MiFIR access arrangements). Users that intend to hold positions at different CCPs could not be matched in a single order book. As a result, liquidity would

[1] MiFIR Articles 35-27 and 38 on access for third country CCPs and trading venues.
[2] These risks are explained in further detail in the accompanying Technical Analysis.

be fragmented. The alternative - i.e. a "single order book" in which multiple CCPs may be used for clearing - would almost certainly create a misleading impression of liquidity and market depth.

- For precisely this reason, the **Level 1 institutions provided for a special treatment of ETDs in the context of the MiFIR "Non-discriminatory" Access provisions**. First, by mandating a financial stability impact assessment. Secondly, by not allowing access where it would require an interoperability arrangement. And thirdly, by making the introduction of the provisions for ETDs conditional on them not threatening the smooth and orderly functioning of markets (in particular due to liquidity fragmentation) or would not adversely affect systemic risk.[3]

- **Such safeguards by the Level 1 institutions were included for legitimate reasons, given that ETDs are fundamentally different** to cash products. Derivative contracts can have a long duration (typically months or years), are far more complex, and require much more stringent requirements and controls from CCPs as neutral and independent risk managers.

- Against the background of the financial crisis, and notably considering the significant costs incurred for society, **it is of utmost importance to ensure that financial stability is not being compromised at any point.**

3. Financial Stability Risks Remain Unaddressed

- **Lack of a quantitative impact assessment on financial stability risks** – To date, the European Commission, under consideration of the reports provided by the European Supervisory Authorities (ESMA[4], ESRB[5]), has been unable to conduct a quantitative impact assessment regarding the potential financial stability risks resulting from extending the "Non-discriminatory" Access provisions to ETDs – as was originally mandated[6]. In fact, the European Commission exclusively based its report on a qualitative assessment (of a now obsolete arrangement[7]) and argued that any stability risks would be negligible.[8] By contrast, **all relevant National Competent Authorities (NCAs) have decided to follow the principle of precaution and have granted temporary transitional provisions** to all of the CCPs and TVs which requested it in respect of the "Non-Discriminatory" Access requirements for ETDs[9]. The effect of the transitional provisions is to defer the application of the "Non-Discriminatory" Access provisions to ETDs until 3rd July 2020.

- **Trading venue "Non-discriminatory" Access to CCPs would weaken the role of CCPs as corner stones of the G20 reforms:** It would introduce risks to **financial stability** (not to mention the risk of legal challenge) arising from the pooling of open interest from economically equivalent – but not identical – ETD contracts in the same CCP as a result of multiple trading venues gaining access to it. It would require such contracts to be treated as fungible, despite the fact that the contracts' legal basis (in terms of governing law and jurisdiction), governing authorities (in terms of the trading venue creating the contract and its regulator) and the arrangements for taking emergency action (e.g. in

[3] See Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012; Title VI, Article 35, 4 (a) and 4 (b).
[4] See here: https://www.esma.europa.eu/file/17395/download?token=h_3JyqTq
[5] See here: https://www.esrb.europa.eu/pub/pdf/other/160210_ESRB_response.pdf?b34727f97ef6c1ef3a9fd58f3d67035e
[6] See Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012; Title X, Article 52 (12).
[7] See for example here: https://www.thetradenews.com/oslo-bors-lsedm-end-linked-derivatives-order-book-partnership/
[8] https://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-468-F1-EN-MAIN-PART-1.PDF
[9] From the larger derivatives CCPs, only LCH ltd has not requested to be exempted: https://www.esma.europa.eu/sites/default/files/library/esma70-155-4809_list_of_access_exemptions_art.54.pdf.

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relation to force majeure and other market events) would differ. These factors may seem esoteric, particularly in a "business as usual" context, but they are **vital to market confidence when a trading venue has to take action in order to deal with unforeseen events or circumstances in order to protect contract integrity or maintain an orderly market**.

- **CCP "Non-discriminatory" Access to trading venues would inevitably fragment liquidity and weaken the resilience of ETD markets as a result of multiple CCPs clearing a single trading venue's ETDs -** A transparent and resilient price discovery system for ETDs is crucial for financial markets as a whole, given that ETD markets serve as a benchmark (reference price) for a broad range of underlying and related assets (e.g. bonds, shares and commodities), including the relevant OTC derivatives (non-exchange negotiated derivatives) associated with those assets. For example, Interest Rate Derivatives are key indicators as to how markets expect rates set by central banks to evolve. However, **breaking the links between the TV and its CCP would disrupt liquidity and the price discovery process of ETDs across different exchanges**. The erosion of the price discovery process and the resultant weakening of an accurate reference price can ultimately lead to serious financial stability risks, such as the creation of asset bubbles or the inability of financial supervisors to set accurate capital requirements for market participants such as credit institutions.

4. Artificially Forced Intra-EU Competition vs. Global EU Competitiveness

- **Hypothetical marginal gains** – The EU has come a long way in increasing competition and transparency across market infrastructures, notably via MiFID I and MiFID II/R. As of today – with 126 RMs, 191 MTFs and 76 OTFs (for equity and non-equity instruments), and 16 CCPs (compared to 5 in the US) – the EU is the most competitive market in the world. The putative marginal gains from further increasing competition in the EU is highly questionable in a global context where other jurisdictions do not pursue the same objectives, but rather focus on size and scalability.

- **Global competition and EU competitiveness** – The EU is the only jurisdiction to have imposed "Non-discriminatory" Access provisions on ETDs, while all other major open market economies, such as the US and Japan, have decided against them. If the EU is serious about building a strong Capital Markets Union, it would need to consider strong derivatives exchanges as a cornerstone of price formation, alongside its financial stability and investor protection objectives.

- **Competitive Level Playing Field -** "Non-discriminatory" Access requests by third country CCPs and trading venues – While Article 38 of MiFIR includes reciprocal arrangements, it is unclear how a competitive level playing field would be ensured in the event third country infrastructure gains access to EU CCPs and trading venues. In particular, there are no provisions in the legislative framework to ensure that competing ETD contracts offered by third country trading venues following successful access requests to EU CCPs would be traded on equivalent terms to ETDs in Europe.

- **In respect of ETDs**, with an equivalence determination limited to MiFIR Article 38(3)[10], 3rd country trading venues are merely required to be "*subject to authorisation and to effective supervision and enforcement on an ongoing basis*". There are no provisions in MiFIR Article 38(3) to ensure a comparable trading environment in the 3rd country,

[10] As recently clarified by ESMA in its Q&A on equivalence frameworks for third country trading venues accessing CCPs: page 61-62 https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_markets_structures_issues.pdf

meaning the application of equivalent transparency and market structure requirements. This is a critical issue: currently, trading in ETDs in the EU is predicated on the basis that transparent trading on lit order books is the prerequisite for the most liquid ETDs which serve as a benchmark (reference price) both for a broad range of underlying assets (e.g. bonds, shares and commodities) and a large number of related products (including the relevant ETD and OTC derivatives). As such, the most liquid ETDs which provide such reference prices are central to the wider price formation process in cash, physical, ETD and OTC markets.

- **In respect of access to licenses to EU-based benchmarks** based on MIFIR Article 37, while the equivalence procedure contains a reciprocity provision where it concerns access to benchmark licenses, no safeguards have been made for a comparable trading environment, which could lead to third country trading venues being able to offer trading of products based on EU benchmarks on the basis of different regulatory and supervisory standards than those applied in the EU (e.g. lit trading may not be a pre-requisite for the most liquid ETDs, thus undermining the provision of reference prices to the wider market). In contrast, the equivalent trading environment for derivatives subject to the DTO (i.e. not ETDs) has been safeguarded by the additional requirements of MiFIR Art. 28(4) that seeks equivalence at the level of admission of the products, the information requirements and market transparency and integrity. These safeguards do not apply to ETDs as, by definition, they cannot fall under the DTO because they are not OTC derivatives.

- Moreover, in assessing the benchmark licence provisions in MiFIR it is important to compare them with the **EMIR framework.** While EMIR establishes similar requirements for licences to be made available on proportionate, fair, reasonable and non-discriminatory terms, the scope is limited to instances where such *property rights relate to products or services which have become, or impact upon, industry standards*[11]. MiFIR, in contrast, omits any reference to industry standards, thus broadening the scope.

- While its proponents justified this approach as a means of delivering open access, we believe it fails to properly acknowledge the intellectual property rights of existing benchmarks, which could for example disincentive innovation in Europe. This could be resolved by amendment to MiFIR Article 37 to align the regime with that included in EMIR.

- Taking into consideration the aforementioned proposals, we suggest streamlining the resulting proposed amendments to reflect the changes in the MiFIR Articles 35 to 38 to **ensure a comparable and consistently monitored trading environment**.

5. Conclusion

- The "Non-discriminatory" Access provisions pursuant to MiFID II/R were intended to provide a **virtuous balance between ensuring safe and stable trading and clearing infrastructures whilst maintaining a competitive environment in the EU.**

- Although the provisions are applicable to transferable securities, money market instruments and ETDs, the **Level 1 institutions recognised the financial stability risks in relation to applying the "Non-discriminatory" Access provisions to ETDs.**[12]

[11] EMIR Recital 36
[12] See Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012; Title VI, Article 35, 4 (a) and 4 (b); and Title X, Article 52 (12).

- However, **a quantitative financial stability impact assessment has never been carried out - while the basis for the qualitative impact assessment has ceased to exist.**

- It is critical to realise that the "Non-discriminatory" Access provisions would not result in fair competition – but in **unfairly forced, artificial competition via regulatory intervention**. In this context it should be noted that **no other jurisdiction has decided to implement such provisions** for ETDs except the EU.

- Against the background of serious financial stability risks, orderly market and contract integrity concerns, unfair competition, a lack of global reciprocity – and important political priorities in the financial services sphere – **a permanent exclusion of ETDs from the "Non-discriminatory" Access provisions under MiFID II/R is necessary to support the EU27's financial stability agenda and to ensure its competitiveness at global level.**

- In ensuring competitiveness at a global level, a key focus should be ensuring that trading venues in third countries are not allowed to use the "Non-discriminatory" Access provisions, e.g. via access to benchmarks under Article 37, to underpin competing ETD contracts based on unlevel playing field conditions, such as regulatory requirements relating to trade transparency, position limits and reporting, notably relating to central regulatory and supervisory provisions governing transparency.

- Moreover, **the scope of MIFIR Article 37 should be revised to align it with that included in EMIR regarding the requirement for licences to be made available.**

- In the Technical Analysis, we include detailed scenarios to illustrate the issues raised by "Non-discriminatory" Access in respect of specific and concrete market examples.