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

Putting EU27 financial stability & competitiveness at risk

9th October 2020, Brussels

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 the EU27 financial stability and competitiveness** by undermining the ability of market infrastructures to ensure orderly trading, liquidity and clearing. Therefore, FESE strongly welcomes ESMA's no action letter and the prolongation of the national temporary exemptions by one year until 4th July 2021 as part of the finalisation of the CCP Recovery and Resolution dossier.

- However, as this temporary relief will soon be elapsing, we call on the co-legislators to permanently fix the "Non-discriminatory" Access provisions as this **policy would result in fragmentation, decreased innovation and competitiveness, while in parallel creating significant financial stability risks.**

- These aspects are even more important within the context of a sustainable economic recovery from the Covid-19 pandemic for which the EU27 will need deep and liquid ETD markets. Last but not least, Brexit is approaching quickly whereby the UK, an important provider of financial infrastructure in Europe, will become a third country under the EU rules as of January 2021.

2. Weakening innovation and hampering EU27 global competitiveness

- 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 risk undermining the innovation and competitiveness of EU ETD markets.**

- **The EU is one of the most competitive regions in the world** – The EU has come a long way in increasing competition and transparency across market infrastructures, notably

[1] MiFIR Articles 35-37 and 38 on access for third country CCPs and trading venues.

via MiFID I and MiFID II/R. As of today – with 137 RMs, 244 MTFs and 74 OTFs (for equity and non-equity instruments), and 13 CCPs (compared to 5 in the US) – the EU is the most competitive market in the world. Competition across ETDs has and continues to thrive: where a non-vertically integrated TV has a new commercially viable product, which it would like a vertically integrated CCP to clear, the CCP will either agree to clear it (given that it is in their commercial interests to do so) or it will provide for a new product on its affiliated TV and clear it. For example in the past, DTB (former Eurex) successfully competed with LIFFE on the Bund-Future thanks to innovation (electronic execution), and new products are regularly developed to cater for new market needs, to support futurisation or pick up in Environmental Social Governance (ESG) standards.

- **Harm competition and innovation** – Concentrating all clearing activities into one CCP would effectively diminish competition in the EU (the very thing the "Non-discriminatory" Access provisions are supposed to foster) and bring down innovation due to increased latency in approving new products and services (which would need to be approved by one CCP). For example, both LIFFE (former ICE Futures Europe) and LME opted to split from LCH. Clearnet, their common clearing house, due to inhibitions to competition and innovation. The current linkage between the TV and the CCP is overwhelmingly the most efficient model for ETD markets in most developed jurisdictions because the integrated service is more efficient for product development, leading to a highly responsive industry with faster introduction of new products.

- **Increase in costs and concentration** – The more links across TVs and CCPs will multiply, the more only a minority of structurally large banks will be able to afford the costs linked to maintaining the connectivity links and checks. This risk may increase the concentration of clearing members and create barriers to grow the next generation of EU credit institutions that can handle the complexity of interlinkages between TVs/CCPs. As firms would lose some of the netting efficiencies of the current system, the overall cost of holding positions across different TVs and CCPs in terms of capital and margin requirements would increase. Clearing Members would also have to actively manage the exposure of their clients across CCPs (even more than they do today) when it comes to breaching limits and caps in positions. We expect only a limited set of Clearing Members to be capable of handling the capital costs of holding such links across TVs and CCPs to be able to attract clients. Clients/investment firms which could not withstand the increase in costs would be prevented from entering new positions, thereby diminishing the overall activity and liquidity of these markets.

- **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 and strengthening its economic sovereignty by increasing the role of the Euro, 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 Art. 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 Art. 38(3)[2] of MiFIR, 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 Art. 38(3) of MiFIR to ensure a comparable trading environment in the 3rd country**, 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.

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[3], ESRB[4]), 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[5]. In fact, the European Commission exclusively based its report on a qualitative assessment (of a now obsolete arrangement) and argued that any stability risks would be negligible.[6]

- 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[7]. The effect of the transitional provisions was to defer the application of the "Non-Discriminatory" Access provisions to ETDs until 3rd July 2020 and needed to be prolonged by one year under the impact of the unprecedented uncertainty of the Covid-19 pandemic and the ongoing EU27-UK negotiations on their future relationship.

- **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 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**.

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[2] 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
[3] See here: https://www.esma.europa.eu/file/17395/download?token=h_3JyqTq
[4] See here: https://www.esrb.europa.eu/pub/pdf/other/160210_ESRB_response.pdf?b34727f97ef6c1ef3a9fd58f3d67035e
[5] 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).
[6] https://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-468-F1-EN-MAIN-PART-1.PDF
[7] 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.

- **CCP "Non-discriminatory" Access to trading venues would inevitably fragment liquidity and weaken the resilience of ETD markets -** 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, as explained above. 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**. In an example where a TV has access arrangements with three CCPs, it would be forced to create three separate order books for any given product (as counterparties can only trade with those who wish to clear at the same CCP). This would result in an inefficient and costly system which would provide a misleading impression of choice while, in reality, fragment liquidity. 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. Fail to ensure a comparable and consistently monitored trading environment

- **In respect of access to licenses to EU-based benchmarks** based on Art. 37 of MiFIR, 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 Art. 28(4) of MiFIR 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*[8]. 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 Art. 37 of MiFIR 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 Articles 35 to 38 of MiFIR to **ensure a comparable and consistently monitored trading environment**.

[8] EMIR Recital 36

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.**[9]

- **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 **force artificial competition via regulatory intervention,** neglecting the fact that the integrated system of trading and clearing ETDs has fostered intra-EU competition and product innovation. While EU TVs and CCPs need to ensure their competitiveness on a global level, it should be noted that **no other major 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 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.

[9] 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).

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