SwissFinanceCouncil
Fostering International Dialogue

13 August 2015

Swiss Finance Council's Response to European Commission's public consultation on Regulation (EU) No 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR Review)

Please note that the Swiss Finance Council (SFC) focuses its response to questions 2.1, 2.6 and 2.10 of the public consultation.

Part II - General questions

Question 2.1: Definitions and Scope

Are there any provisions or definitions contained within Article 1 and 2 of EMIR that have created unintended consequences in terms of the scope of contracts or entities that are covered by the requirements?

Yes.

If your answer is yes, please provide evidence or specific examples. How could these be addressed?

A concrete example where EMIR has created unintended consequences is shown by the absence of equivalence decisions to date in the context of MiFID I. The lack of equivalence determination of third-country markets under Article 19(6) of MiFID I means that each time a non-financial counterparty (NFC) enters into an exchange traded derivative contract on a third-country market, it is erroneously treated as an OTC derivative under the definition of Article 2(7) of EMIR.

This has an unintended consequence for the purposes of Article 10(1)(b) and 10(3) of EMIR, insofar as these cleared trades are treated as OTC trades and therefore count towards the clearing threshold applicable to non-financial counterparties under Article 10(1)(b) of EMIR. This may lead an NFC to be above the clearing threshold due to the computation of those "false OTC derivatives" executed on third-country exchanges and, as result, subject to EMIR stricter requirements with respect to clearing obligations, risk mitigation and implementation timelines. We believe this to be contrary to the Commission's intentions reflected in its Green Paper on Building a Capital Markets Union (CMU), as we understand that one of the cornerstones of the CMU is precisely to make markets work more effectively and efficiently.

We understand that, in the context of the recently agreed proposal for a Regulation on reporting and transparency of Securities Financing Transactions (SFTR), the legal view emerged that the Commission cannot adopt a decision on the equivalence of third-country markets in relation to derivatives under Article 19(6) of MiFID I as this provision only refers to an equivalent third-country market with respect to shares admitted to trading on such a market, and not derivatives.

To address this legal issue, SFTR Article 27b amends the definition of OTC derivatives in EMIR and introduces a specific equivalence procedure under EMIR (with a new EMIR Art. 2a) enabling the Commission to determine the equivalence of third-country markets with respect to derivatives executed on those markets. We welcome those provisions in SFTR and strongly encourage the Commission to prioritise the equivalence assessments of third-country markets given that they have been outstanding for a long time, i.e. since MiFID I came into force.

More generally, there is a need to ensure that definitions that are dependent upon determinations to be made in other legislations, e.g. equivalence, are clearly identified, tracked and assessed to minimise the impact of inconsistent application upon those subject to the legislation. Not only should defined terms in EMIR be aligned with terms used in other related EU legislation, but they would also ideally be aligned with the terms used by BIS and CPMI-IOSCO.

Question 2.6: Cross-Border Activity in the OTC derivatives markets

(a) With respect to activities involving counterparties established in third country jurisdictions; are there any provisions or definitions within EMIR that pose challenges for EU entities when transacting on a cross-border basis?

Yes.

If your answer is yes, please provide evidence or specific examples. How could these be addressed?

Re. Article 13 on the equivalence mechanism to avoid duplicative or conflicting rules:

The process of equivalence determination as foreseen under Article 13 of EMIR is still incomplete and lacks legal certainty and predictability for EU firms engaging in cross-border transactions in a market which the Commission rightly qualifies as being 'global' in nature. The absence of positive equivalence decisions deters investment between the EU and third-countries, and therefore acts as an incentive to focus activity in local markets, to avoid being subject to duplicative or conflicting rules. This trend will only intensify when EMIR clearing obligation and margin requirements for uncleared OTC derivatives come into effect next year, and lead to a regionalisation of one of the most global financial markets. This regionalisation, in turn, results in liquidity fragmentation, increased trading costs and market inefficiencies at a time where the CMU offers a significant opportunity to introduce reforms that get capital flowing to the real economy, not only from within the EU but also from all over the world.

Several concrete measures could be taken to address these challenges:

- First, all efforts must be taken to swiftly carry out the equivalence determination process under Article 13 of EMIR for all major third-country jurisdictions. This is essential to avoid market participants facing potentially duplicative or conflicting requirements, which is the stated intention of Article 13 of EMIR. Without this equivalence mechanism being in place, market participants will be faced with completely unjustifiable additional costs to comply with overlapping regimes simultaneously, or otherwise will be unable to trade in a manner that is fully compliant with all rules applicable to a transaction. The absence of equivalence decisions already creates significant legal and compliance risk and dis-incentives the use of derivatives for hedging purposes. As noted, this was not the objective of the co-legislators when the EMIR legislation was adopted.

- Second, the Commission should clarify that Article 13(3) of EMIR applies on a 'per obligation basis', i.e. the Commission adopts separate equivalence decisions regarding the obligations contained in Articles 4, 9, 10 and 11 respectively of EMIR, instead of a single all-encompassing equivalence decision, meaning the choice given to EU counterparties to apply the relevant equivalent third-country rules would apply on a per requirement basis. In this way, EU market participants could for instance benefit from the adoption by the Commission of a positive equivalence decision on the clearing obligation in force in a given third-country without having to wait for the completion and outcome of the equivalence assessment of the margining requirements in that third-country.

- Third, it should be confirmed that when an EU counterparty trades with a counterparty established in an EMIR Article 13(2) equivalent jurisdiction, the EU counterparty can freely agree with the other counterparty which set of equivalent rules would apply to a particular trade between them. Moreover it should be clarified that the application of this "free choice principle" also allows EU counterparties to apply the equivalent third-country rules to which their counterparty is subject (vs only the equivalent rules of the third-country where the counterparty is established). This clarification would address situations where EU firms enter into transactions with counterparties that are obliged to comply with another set of rules determined as equivalent by the Commission. For instance, where an EU counterparty trades with a Cayman or an EU fund which qualifies as a US person under Dodd-Frank, this EU counterparty would need the ability to choose to apply equivalent US rules.

- Fourth, future or revised legislation should provide for transitional arrangements to be in place while equivalence is being assessed in order to address delays in the equivalence determination process and provide market participants with legal clarity and certainty. Similarly, EMIR Article 13 raises major legal uncertainty as it does not provide any guidance with regards to the process or timeline for the delivery of equivalence decisions.

- Lastly, any assessment of equivalence for the purpose of EMIR (but not only) should follow a policy objectives and outcomes-based approach, which considers whether the regulatory outcome is equivalent, rather than whether the particular rule is the same. Future and revised legislation could specify more precisely what these outcomes should be, making the equivalence determination process quicker and more predictable.

<u>Re. Article 25 on the recognition of third-country CCP</u>:

Equivalence decisions under Article 25 of EMIR remain outstanding for a significant number of third- country jurisdictions, including Switzerland and the US. Without a positive equivalence decision, CCPs incorporated in the concerned third-countries will be unable to obtain recognition under EMIR.

This absence of third-country CCP recognition raises major concerns from both a clearing and capital requirement perspective:

- Clearing concern: the absence of equivalence decisions under Article 25 of EMIR also prevents EU counterparties from clearing OTC derivative contracts subject to an EMIR clearing obligation through non-EU CCPs that have not been recognised under EMIR, even if those contracts are cleared via a local clearing member. The reason being that a clearing obligation under EMIR can be satisfied only via an EU authorised CCP or a non-EU recognised CCP.

- Capital concern: at the expiry of the transitional provisions (on 15 December 2015) related to own-funds requirements for exposures to CCPs in the Capital Requirements Regulation (CRR), third-country CCPs that are not recognised by ESMA will no longer be considered as qualifying CCP (QCCP) under CRR. This will directly affect EU firms acting on a cross-border basis as EU-based banks and investment firms will no longer be able to apply the preferential capital treatment applicable to exposures to CCPs benefiting from the QCCP status. As a result, contracts that EU firms will still be able to clear on non-recognised third-country CCPs (i.e. contracts not subject to EMIR clearing obligation) will face significantly higher capital requirements than if they were cleared in a CCP with QCCP status under CRR. These non-QCCP capital requirements are likely to be so high as to make clearing on a non-QCCP uneconomic. This will impact not only EU firms clearing on third-country CCPs that have applied for recognition under EMIR, but EU firms clearing on CCPs established in third-country jurisdictions which are not subject to EMIR Article 25 equivalence assessment.

Re. Article 39 segregation requirements:

Another concrete example which poses challenges is the conflict of laws which has arisen from the extra-territorial application of Article 39 of EMIR on segregation and portability. For instance, US Futures Commission Merchants (FCMs) are required by Article 39(5) of EMIR to offer individually segregated accounts to their clients when providing clearing services on EU CCPs. Such a requirement is incompatible with the US Bankruptcy Code so that US clearing members are unable to comply with Article 39 of EMIR.

We propose that the Commission addresses this issue by amending EMIR to disapply the Article 39 requirement to offer clients both an individual segregation and omnibus segregation option in respect of clearing members located in any third-country where conflicts of laws arise, for example by leveraging the third-country equivalence decisions issued under EMIR Article 25. Non-EU clearing members should still be required to comply with the disclosure requirements of EMIR Article 38 and Article 39(7) in accordance with the relevant guidance in the ESMA Q&A.

(b) Are there any provisions within EMIR that create a disadvantage for EU counterparties over non-EU entities?

Yes.

If your answer is yes, please provide evidence or specific examples. How could these be addressed?

Intra-group trades:

We note that the recently published Commission's Delegated Regulation on the clearing obligation for certain G-4 currency denominated interest rate swaps (IRS) includes a transitional period for intragroup transactions between an EU and non-EU group counterparty. This is to address the situation where an Article 13 equivalence decision has not been made in respect of the relevant third-country. We fully support this transitional period.

However, the second joint European Supervisory Authority (ESA) consultation on margin requirements for non-cleared derivatives did not include a similar provision. In the absence of such a transitional period in the non-cleared margin rules, there is a disadvantage for groups containing both EU and non-EU counterparties, as without a positive equivalence determination for the relevant third-country, such groups may not rely on the intra-group exemption from the non-cleared margin requirements with respect to cross-border transactions between EU and non-EU group counterparties. Wholly EU groups of companies and pure non-EU groups of companies do not face these restrictions. Therefore, the forthcoming technical standards on non-cleared margin requirements should contain a transitional period, similar to the G-4 IRS transitional period, to address this.

Scope of reporting:

The scope of the reporting obligations under Article 9 of EMIR creates a disadvantage for EU counterparties as these obligations apply to both OTC derivatives and exchange traded derivatives (ETD) whereas the reporting obligation in other jurisdictions is limited to OTC derivatives. We note that the commitments of G20 leaders at their 2009 Pittsburgh Summit did not cover ETD reporting, therefore the reporting requirements under EMIR go beyond the global commitment. Similarly, the reporting requirements under EMIR were primarily designed for OTC derivatives, hence the difficulty to apply such requirements to ETDs. The amount of ESMA Q&As which have been necessary for ETD reporting highlights the lack of clarity and suitability of the rules. And whilst the Q&As are helpful, many ETD reporting issues remain outstanding.

We therefore believe ETDs should be removed from the reporting obligation under EMIR so as to align the Regulation with the G20 commitment and create a global level-playing field.

Some of the challenges highlighted in our response to Q 2.6 could be addressed in new Q&As to be published by the European Commission and ESMA. However, these Q&As are not legally binding and cannot thus provide the necessary legal certainty and clarity required by market participants. Legislative changes from the European Commission or ESMA would therefore be welcome.

Question 2.10: Additional Stakeholder Feedback

Are there any significant ongoing impediments or unintended consequences with respect to any requirements or provisions under EMIR and not referenced in the preceding questions that have arisen during implementation?

Yes.

If your answer is yes, please provide evidence or specific examples. How could these be addressed?

The Swiss Finance Council wishes to raise with the Commission the impact that the increasingly fragmented regulatory framework for derivatives trading is having on the global market place. We support the goals of the G20 and EU derivatives reforms to mitigate systemic risk by migrating a maximum of suitable OTC derivatives to central clearing, standardization and on venue trading where appropriate; and enhanced transaction reporting and transparency. However, whereas derivatives trading was once a truly global market, divergent approaches to implementing the G20 derivatives reforms regulation across jurisdictions are fragmenting and regionalizing derivatives trading. This comes at a time when market and trading risks, and volatility, are rising around the world. Clients and trading counterparties' needs to utilize derivatives for hedging, risk management and mitigation are particularly strong and, if anything, growing. The problem is most acute for cross-border transactions in light of the complexities resulting from cumulative, and sometimes conflicting, rules of multiple jurisdictions applying to those transactions.

We would urge legislators and regulators of different jurisdictions, including the EU, to alleviate this scope for complexity and conflict by developing and implementing their rules regulating cross-border derivatives transactions in a convergent manner, and then by allowing for substituted compliance/equivalence between their respective rules. In this context, we understand the need for the basic minimum standard set out in the 'stricter rule applies' principle of the G20 OTC Derivatives Regulators Group on Cross-Border Implementation Issues (ODRG) – that is to say, where one applicable jurisdiction applies a clearing or trading obligation to a transaction and the other does not, then the approach should be to apply the first jurisdiction's rule, rather than no rule at all. However, we note that this will unfortunately impact the ability of firms that are subject to such requirements to transact derivatives business on a cross-border basis with counterparties in jurisdictions which are either late to apply the G20 standards, or do not do so at all.

Beyond this though, we would emphasise that where two jurisdictions apply a rule, and there is sufficient convergence between the substantive content and objects of those rules to allow for an equivalence determination between them, it is essential for the relevant authorities in both jurisdictions to apply those determinations using a holistic, outcomes-based approach, in order to grant equivalence for the relevant rules taken as a whole. Determinations that are instead selective and grant equivalence to only parts of another jurisdiction's rules that are found to be as strict as the corresponding domestic rules, will prove to be counter-productive. This will result in firms having to comply with a patchwork or accumulation of rules of different jurisdictions in relation to individual transactions or trading relationships. The resulting patchwork will substantially increase operating costs and complexity to execute such cross-border transactions, and create incentives not to execute them on a cross-border basis, which would in turn increase the risk of market fragmentation and liquidity, as well as increase cost and risk for end users.

We believe that these implications are contrary to a number of explicit policy goals, notably reducing systemic risk, migrating a maximum of suitable OTC derivatives to central clearing, ensuring a viable cross-border derivatives market, and ensuring that the EU is an attractive location with which to transact. Given that the EU seeks to attract investment capital from outside the EU through the Capital Markets Union initiative, we believe it is important to take stock, and consider the relative merits of the risk mitigated against the economic and market risk downsides for market participants of this situation, notably for reducing volatility and risk in cross-border transactions. In order to mitigate the impact and address the concerns caused by the implementation of the G20 commitments, we respectfully request that the Commission adopts positive equivalence decisions in a timely way, and pragmatically, based on broad outcomes as with the Commission's recent Article 25 decisions for the APAC countries. In addition, industry needs more information and transparency in situations where equivalence determinations are delayed, and for the Commission to provide for transitional provisions. This was recently done for the RTS on G4 currency interest rate swap clearing, where the Commission found a pragmatic arrangement to enable intra-group transactions involving third-country affiliates to benefit from a phase-in period during which such transactions would not be subject to the clearing obligation solely by virtue of the Article 13 equivalence determination for the affiliate's jurisdiction still being in progress. We recommend that the Commission should more explicitly be given this power to adopt pragmatic solutions to outstanding, delayed equivalence determinations in the primary Regulation (i.e. level 1 EMIR text), particularly where such delays would result in unintended and significant additional obligations for firms under EMIR.

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