CAPITAL MARKETS

EMIR AND MIFID II

Connecting the dots

EU derivatives legislation may fall short of delivering a cohesive regime

1 MINUTE READ

The new set of rules that governs derivatives trading in the EU - the revised Markets in Financial Instruments Directive (Mifid II) and European Market and Infrastructure Regulation - aims to address concerns about stability of financial markets globally. It also introduces risk mitigation measures.

But while these two new pieces of legislation go a long way in restructuring the operation of markets in financial instruments including derivative, they don't work together seamlessly in a number of areas. This could cause market disorder and liquidity fragmentation instead of improving market stability.

When the provisions under the revised Markets in Financial Instruments Directive (directive 2014/65/EU) and the new Markets in Financial Instruments Regulation (together, Mifid II) relating to the trading of derivatives take effect, on January 3 2018, the regime for derivatives trading in the EU will have significantly progressed toward a point of being substantially complete. The new body of rules governing derivatives trading across Mifid II and the European Market and Infrastructure Regulation (regulation (EU) 648/2012 or Emir) is complex, and continues to be subject to adjustments and revisions.

The policy objective for introducing a legal framework to regulate the trading of derivatives was to enable the detection and monitoring of the build-up of systemic risk associated with the trading of derivative contracts outside regulated trading venues (over-the-counter or OTC derivatives). Emir sought to achieve this by introducing reporting requirements which allowed regulators to monitor transactions and therefore risk by mandating the central clearing of OTC derivatives (to reduce the risk of counterparty failure between completion and settlement of the trade), and by introducing certain risk mitigation measures in respect of OTC derivatives. While the risk mitigation measures seek to reduce the potential impact of a counterparty's default on other market participants, they also serve the purpose of encouraging market participants to move their derivatives trading onto a regulated trading venue. As the industry bemoans the increased operational costs, the trading of derivatives is moving closer to an on-venue model as a result of the direct effects of regulation and the increased cost of compliance in OTC markets.

Concerns about the stability of the financial markets and the global financial system as a whole are also reflected in Mifid II. While the original Mifid focused on firm-level conduct and consumer protection, Mifid II also introduces requirements that aim to restructure the operation of markets in financial instruments including derivatives. Some of these requirements, such as the trading obligation (see below) should work in tandem with the definitions and concepts under Emir. In principle, the derivatives trading requirement under Mifid II supports the Emir risk mitigation measures in seeking to encourage

market participants to move an increasing proportion of their derivatives trading onto a regulated EU trading venue (or an equivalent third country venue). However, as discussed in more detail below, the two pieces of legislation do not work together seamlessly, and could risk causing market disorder and liquidity fragmentation instead of improving market stability.

Shaky steps toward standardised trading

The key structural change Emir brought about was to introduce the central clearing requirement in respect of certain OTC derivatives contracts (the clearing obligation). Mifid II includes provisions on the provision of indirect clearing, and straight-through-processing, but also addresses other aspects of the trading process.

A key requirement under Mifid II is that certain market participants must conclude transactions in designated classes of derivatives on a regulated EU trading venue or on a designated equivalent non-EU trading venue (the trading obligation).

The European Securities and Markets Authority (Esma) will determine which classes of derivatives will be subject to the trading obligation. That determination is made with reference to the derivatives that are subject to the Emir clearing obligation, subject to additional criteria and consideration by Esma. The Mifid II requirement is therefore fundamentally anchored in Emir.

However, despite the interconnectedness of the two pieces of legislation, there is no mechanism to align the requirements in Mifid II to any changes made to Emir, or vice versa. A case in point is the lack of alignment between the clearing obligation under Emir and the trading obligation under Mifid II. Such lack of alignment may result in the regulatory framework creating real problems to market counterparties balancing conflicting regulatory instructions. The potential for such operational conflicts raises fundamental questions about how firms are to be affected by legal and regulatory requirements.

The proposed revisions to Emir would, among other things, allow Esma to suspend the clearing obligation in certain circumstances – for example, in times of market stress, or where parts of the market are cut off from central clearing. As Mifid II provides Esma with no corresponding suspension power with respect to the trading obligation, even if Esma were to suspend the clearing obligation, the trading obligation would continue to apply. Given that market conditions for trading derivatives when the clearing obligation is suspended may well be unsuitable for mandatory on-venue trading, it would seem sensible to empower Esma in the same way in respect of the trading obligation.

A separate issue relating to the interaction between the Emir clearing obligation and the Mifid II trading obligation arises in terms of the persons subject to each obligation. The trading obligation applies to financial counterparties (FCs) and to those non-financial counterparties whose derivatives trading activities exceed the threshold set under Emir (NFC+s). However, the proposed revisions to Emir would change the way the clearing obligation applies to counterparties under Emir. The Emir revisions would introduce a clearing threshold for FCs so that smaller FCs would not be required to clear their OTC derivatives transactions. Additionally, NFC+s would be required to clear only the asset classes for which they have breached the clearing threshold, rather than all asset classes as is currently the case. However, the trading obligation would continue to apply to all FCs, and to all asset classes of NFC+s, regardless of whether such counterparties were subject to the clearing obligation.

A further consideration arising from the trading obligation is the impact it has on counterparties' cross-border trading. The trading obligation mandates trading on an EU trading venue even if the counterparty is a non-EU person. While it is possible to trade on an equivalent non-EU trading venue, the European Commission will have to make the equivalence determination to allow EU counterparties the option to execute on the most appropriate venue. It may not be possible to obtain best price for instruments on an EU trading venue, for example, because a non-EU trading venue has deeper liquidity and thus better pricing. Requiring market counterparties to comply with the trading obligation in such circumstances would create liquidity fragmentation, and present practical difficulties to firms required to provide best execution.

While the pending revisions to Emir will introduce significant changes, it is unlikely that these would be reflected in Mifid II without the primary legislation being amended. Given that the overarching policy objective is to enhance systemic stability, the hurried drafting and implementation of Mifid II could risk bringing about the opposite.

> **The definition of derivatives under Emir will also derive from Mifid II, once this takes effect**

"What's in a name? That which we call a derivative…"

Another example of the critical interconnectedness of Mifid II and Emir can be observed in another perimeter issue. Mifid II defines what a financial instrument is for the purposes of many European and domestic laws. Consequently, the definition of derivatives under Emir will also derive from Mifid II, once this takes effect.

In some areas Mifid II brought long-awaited clarity, for example, in providing an EU-wide definition for a spot contract. As spot contracts are excluded from the scope of the Mifid II definition of derivatives, Emir will not apply to contracts that satisfy the criteria for spot contracts under Mifid II.

Emir's reporting requirements are principally intended to ensure the delivery of information to regulators to enable them to monitor the build-up of risk in the financial system. By contrast, the transparency requirements under Mifid II aim to provide regulators with information to identify and investigate potential market abusive behaviour. Consequently, the reportable data under each only overlaps partially. Therefore, as extensive as the reportable data is under Emir, there is no waiver to allow firms to discharge their – even more extensive – transparency obligations under Mifid II by complying with the Emir reporting requirements.

Emir requires firms to report to the

relevant regulator details of any derivative contract entered into, as well as any modification or termination of that derivative contract. The trade reports must be made to a trade repository registered or recognised under Emir, rather than the authorised reporting mechanism required under Mifid II. There is hope yet that both mechanisms could be housed within the same entity at some future point.

The scope of the reporting obligations for derivatives under Mifid II, however, is still unclear. This is largely due to the fact that a number of provisions in Mifid II include an undefined term: traded on a trading venue (TOTV). The term is particularly relevant for pre-trade and post-trade transparency requirements on market operators and investment firms operating a trading venue, as well as for Mifid firms that undertake OTC dealing. The concept of TOTV is also relevant for transaction reporting obligations.

As the trade reporting and transaction reporting requirements under Mifid II apply to instruments traded on a trading venue, regardless of whether the trade is executed on-venue or OTC, it is important to understand in respect of which trades and instruments a firm must make the relevant reports. As the transparency requirements do not apply to financial instruments that are only traded OTC, it will be equally important for firms to understand which trades are not required to be reported.

While determining which instruments are traded on a trading venue when the instruments are equities and debt securities is quite straightforward, this is not the case with respect to derivatives. Shares and bonds trading on a trading venue will generally have an international securities identification number (Isin) or another unique identifier. If a Mifid firm enters into a trade in shares or bonds that have the same Isin as that of a security that is traded on a regulated market or a multilateral trading facility, or in the case of bonds, an organised trading facility, the firm will be required to report that trade. Although the trade is entered into and executed on a bilateral basis, and the terms may be negotiated, it is clear that the bilateral OTC trade relates to an instrument that is traded on a trading venue and the reporting obligations thus apply.

However, when it comes to derivatives, determining what is traded on a trading venue is not quite so easy. The details of derivatives contracts are typically subject to variation reflecting the often counterparty-specific requirements. This means that there is a broader bracket of derivatives that may be for commercial purposes deemed to be the same instrument. For example, a 10-year swap contract with a maturity date of today is, from a commercial point of view, substantially the same contract as a 10-year swap with an expiry date of tomorrow, regardless of the technical change in the maturity date.

Esma has recognised this complication in the language of Mifid II. In light of the importance of firms understanding the scope of their obligations, Esma issued an opinion in May 2017 to clarify the meaning of the term with respect to derivatives. It stated that while

> "*the concept of TOTV is clear for instruments that are centrally issued and that are fully standardised, such as shares and bonds as well as exchange traded derivatives, it is less clear for OTC derivatives*".

The Esma opinion specifies that only OTC derivatives sharing the same reference data details as derivatives for which a trading venue has submitted reference data should be subject to the transparency and transaction reporting requirements. Notably, Esma specifies that the only data fields to be excluded from the determination are the trading venue and issuer-related fields, as these only apply to exchange-traded derivatives.

The one-year delay in Mifid II taking effect was in significant part attributable to the technical implementation challenges faced by Esma and the national regulators regarding essential data infrastructures required to enforce the new rules on derivatives trading.

When it comes to derivatives, determining what is traded on a trading venue is not quite so easy

The rules concerning and affecting derivatives trading under both Emir and Mifid II, however, will require further refinement still before the January 2018 implementation cut-off and, most likely, periodically, as specific issues with implementation are uncovered in the course of the implementation process. The old adage about the horse and the cart rings true when it comes to the ambitions of the European legislators.

The task of the regulators to provide guidance to market participants on the proper application of the rules is difficult when dealing with complex requirements affecting a number of markets and different trading practices. These difficulties are likely to be exacerbated by the rules that, by virtue of the drafting reflecting their broad application, risk not delivering appropriate regulation in order to achieve the commendable policy objectives.

Ezra Zahabi
Financial Regulatory Counsel
Akin Gump Strauss Hauer & Feld (London)