FESE Technical Analysis of MiFIR "Non-discriminatory" Access Articles

This note outlines the practical issues that would arise from the implementation of ETD "Non-discriminatory" Access under MiFIR on trading and clearing activities in the EU. For each-sub-type of "Non-discriminatory" Access, we base our analysis on the following scenarios:

- **Scenario 1: Trading venue access to CCPs** (MiFIR Article 35 – increased potential for systemic risk);
- **Scenario 2: CCP access to trading venues** (MiFIR Article 36 – risks arising from liquidity fragmentation);
- **Scenario 3: "Non-discriminatory" access to benchmark licenses** (MiFIR Article 37 – incompatibility with EMIR framework);
- **Scenario 4: Access for third country CCPs and trading venues** (MIFIR Article 38 – systemic risk issues arising from potential equivalence agreements).

These scenarios would pose significant practical issues if implemented across trading and clearing infrastructures within the European Union. While scenarios 2 and 3 will not materialise until 2020 – either as a result of MiFIR's transitional exemptions or the deferred application of Article 37 –, scenario 1 is already possible under the current framework as not all European CCPs and TVs have requested a transitional exemption.

Scenario 1: Trading venue access to CCPs (MiFIR Article 35)

MiFIR Article 35 provides the basis by which trading venues can request CCPs to clear contracts deemed 'economically equivalent' on a non-discriminatory basis in terms of collateral requirements, netting and cross-margining. Critically it requires that **economically equivalent contracts from different trading venues become part of a fungible pool of open interest within the chosen CCP**.

Under a **contractual netting arrangement**, ETDs from all trading platforms subject to the arrangement are mixed and none of the trading platforms can disaggregate 'their' trading from that originating on other platforms or the original Regulated Market (RM). The implications of such arrangements can be best assessed via the following example:

Clearing Member A buys an ETD from **Clearing Member B** on trading venue 1.

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Clearing Member A sells an equivalent ETD to **Clearing Member C** on trading venue 2.

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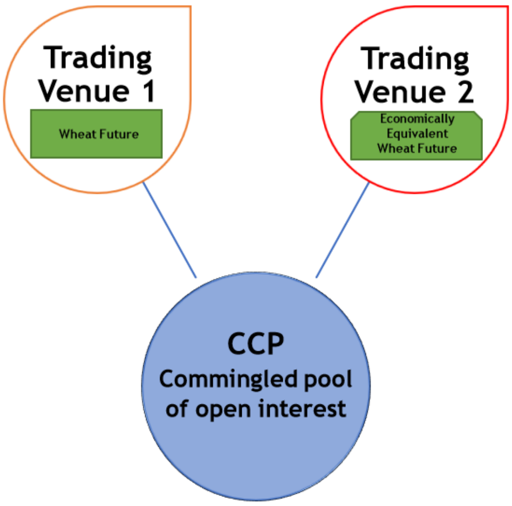
Both transactions are cleared by a **single CCP** which applies contractual netting.

⇩

This will result in Clearing Member C being long, Clearing Member B being short and Clearing Member A having no position.

Clearing Member C's contract was traded on trading venue 2 and Clearing Member B's contract was traded on trading venue 1, under the respective markets' contract terms, rules and arrangements to ensure settlement of buyer and seller's rights and obligations. Notwithstanding the "economic equivalence" of the two contracts, the two markets each retain regulatory responsibilities in relation to the outstanding contracts which were traded through their facilities.

Let's use a practical example (like the detailed below). A trading venue requests a CCP to clear an 'economically equivalent' contract, for instance a certain type of milling wheat future, on a non-discriminatory basis.



Practical Issues

- Loss of ability to perform effective position management.
- Regulatory arbitrage as a result of diverging position limits, transparency requirements, and prudential treatment of open positions.
- Question mark over responsibility for market integrity (Northern Rock precedent).

As described above, such contract and any other economically equivalent milling wheat contract **become part of a fungible pool of open interest within the CCP**. This outcome would be required 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.**

In the event that a **CCP were to treat such positions as fungible**, it would be exposed to a significant financial risk as this assumption – fungibility – would be challenged. To be deemed economically equivalent, two ETD contracts designed by two different trading venues would have to match all their detailed contract specifications which can be fairly complex in the case of commodities delivery. It is the responsibility of the Risk Committee and Chief Risk Officer of the CCP to analyse and decide upon the fungibility of similar contracts, independently from the trading venue. **Critically, in a physically delivered market, the test of fungibility would be very high because the contracts would need to have the exact same arrangements for delivery.**

Moreover, in a fungible model the RM would lose the ability to exercise regulatory control over open positions (e.g. position management controls under MiFID II Article 57) because, in this example, positions created in its market could be reduced or increased by activity on the economically equivalent milling wheat contract over which it would have no oversight or control.

This inability to exercise oversight over contracts opened on its systems would be particularly exacerbated for those contracts that go to physical delivery e.g. soft commodities, and some of the energy, emissions, government bond and equity market segments. Where provision exists for physical delivery in those classes of contract, RMs monitor the delivery to ensure orderly pricing, expiry and settlement, but would be completely unable to do this under a "non-discriminatory" access arrangement because their contracts would be indivisible from those of the other trading venues.

In the event that conventional settlement of the contracts is complicated or frustrated by circumstances, a trading venue will seek to facilitate - and, ultimately, will dictate - alternative arrangements. With individual equity derivatives, this is a relatively "business as usual" issue in respect of Corporate Actions and there are generally common industry standards as to how contracts should be adjusted to reflect e.g. rights issues, bonus issues, special cash dividends etc. However, during particular periods of stress in the financial system, less straightforward issues can emerge which pose significant risks if there is a mismatch in the potential treatment of the net longs and shorts that result from a CCP having applied contractual netting to contracts which were only "economically equivalent" in a "business as usual" environment.

Furthermore, the collapse and nationalisation of Northern Rock in 2008 is an example in which such a risk crystallised. As a result of nationalisation, there was no means of settling the exercise of outstanding (put) options contracts by physical delivery. The relevant trading venue, NYSE Liffe, needed to react to that situation and suspended exercise and settlement, pending alternative cash settlement arrangements.

The opinion of the Independent Valuer appointed by the UK Treasury was that Northern Rock shares were worth zero at the point of nationalisation and this opinion was taken by the OTC market in settling outstanding OTC contracts. However, recognising the appeal process – which ultimately lasted several years – NYSE Liffe did not move to settle the NYSE Liffe Northern Rock options. This difference of approach in the treatment of these contracts between NYSE Liffe and the OTC markets is an example of how it should not be assumed that "economically equivalent" positions traded through different venues are fungible, particularly in terms of their treatment in crisis situations. That difference in treatment is an example of how it is dangerous to treat "economically equivalent" positions traded through different venues as being fungible. Furthermore, in the event that a CCP treats such positions as fungible, it is exposed to a significant financial risk that this correlation breaks down. The 'demerging' of merged contracts cannot be accomplished and those risks would need to be dealt with by the financial counterparty i.e. the CCP.

Such potential for systemic risk may become even more acute in the future given the prospect of UK based market infrastructure seeking to avail itself of the access requirements pursuant to the equivalence provisions in MiFIR Article 38.

FESE Policy recommendation:
Amend MIFIR Article 35 to remove ETDs from the scope given the significant potential for systemic risk, which cannot be adequately mitigated by the MiFID II framework.

Scenario 2: CCP access to trading venues (MiFIR Article 36)

Under MiFIR, CCP access to a trading venue can only be granted in situations where it would not require an interoperability agreement[1]. The consequent inevitable absence of interoperability between CCPs which clear ETDs risks leading to serious liquidity fragmentation in ETD markets. This is because, at this stage, the industry has not yet identified – nor tested – a way to allow multiple CCPs to access a single trading venue **without fragmenting liquidity.**

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 either 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). So, for example, a Euribor Futures Contract traded on 'Regulated Market X' would fragment into:

(i) Euribor Contract I, clearing through Regulated Market X's 'CCP X';
(ii) Euribor Contract II, clearing through 'CCP A'; and
(iii) Euribor Contract III, clearing through 'CCP B'.

[1] MiFIR Art 36(4), in respect of ETDs

It should be noted that in each of these now separate products, there are likely to be unfilled orders which would have been matched with one another in the original consolidated market cleared by a single CCP. This would be problematic enough in markets in which trading is relatively simple, i.e. where participants trade outright delivery months only. However, that is not the case for many ETDs, such as the market in the Euribor Futures Contract. In such markets, most transactions are combinations of different delivery months, reflecting the fact that market participants mainly engage in spread/strategy trading. In order to maximise liquidity and trading opportunities in such products, exchanges have created links between the order books for the outright delivery months and those for the strategies. The maximisation of liquidity in this way would be undermined if a separate set of outright and strategy order books were required for each CCP destination. The practical reality, therefore, is that what is today a coherent market composed of product and variations would be fragmented into multiple products, reflecting the different destination CCPs.

The alternative to creating separate order books per CCP – i.e. retaining a single order book to which all orders would be submitted irrespective of CCP – would be impracticable from the perspectives both of market participants and the trading venue itself, and would not resolve the issues described above. Users that intend to hold positions at different CCPs could not be matched in a single order book as the trade would subsequently need to be reversed to prevent the long and the short being cleared by different CCPs. As well as this structural problem, from the point of view of transparency a "single order book" in which multiple CCPs may be used for clearing would almost certainly create a misleading impression of liquidity, market depth and activity.

These burdens and calls on additional resources would be replicated across the **broader financial markets ecosystem** as "non-discriminatory" access would deliver similar challenges for members and their clients in managing the new market structure. The introduction of "non-discriminatory" access would also disrupt the **operations of CCPs and clearing members**. As "non-discriminatory" access to trading venues effectively allows two or more CCPs to compete for a single trading franchise in ETDs, CCPs would need to adjust fees and margin requirements to attract business from clearing members. While lower fees could be beneficial to end users, competition on margin requirements might introduce the temptation of a race to the bottom in terms of risk management. This would clearly not be in the interests of the market as a whole.

On **the user side**, CCPs competing on margin requirements would also impact clearing members' portfolios. This is because clearing members would have to handle several CCPs, differentiated margin requirements, and potentially more frequent changes to CCPs' risk policies. In turn, clearing members would also need to adjust their risk models, which is not a simple task and would create an additional operational burden for them
This situation could be further aggravated post Brexit, in the event that CCPs based in the UK were allowed to benefit from the equivalence provisions in MiFIR Article 38. Handling such multiple arrangements with CCPs, including ones based in a third country would represent a significant further challenge to the operation of smooth and orderly markets.

FESE Policy recommendation:
Amend MIFIR Article 36 to remove ETDs from the scope given the inevitable liquidity fragmentation the policy would create.

Scenario 3: "Non-discriminatory" Access to benchmark licenses (MiFIR Article 37)

In assessing the benchmark licence provisions in MiFIR and the issues they raise, it is instructive to compare them with the **EMIR framework.** In establishing similar requirements for licences to be made available on proportionate, fair, reasonable and non-discriminatory terms, important framing principles were, nonetheless, included in the legislation. In particular, **Recital 36** caveats the licence requirement by reference to: *'instances where such property rights relate to products or services which have become, or impact upon, **industry standards**'*.

MiFIR, in contrast, **omits any reference to industry standards**, even when it refers back to EMIR in MIFIR Recital 40, where it is stated that: '*(EMIR) identifies that where commercial and intellectual property rights relate to financial services related to derivative contracts, licences should be available on proportionate, fair, reasonable and non-discriminatory terms*'.

There is, therefore, a clear disconnect in the underlying policy objective of the respective legislative frameworks: EMIR, on the one hand, sought to introduce licencing requirements in respect of property rights relating to products or services which have become, or impact upon, industry standards, while MIFIR, in contrast, expands this to all property rights relating to financial services concerning derivatives contracts. 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.

Therefore, FESE believes that consideration should be given to the possibility, in **a post Brexit environment**, of trading venues using the equivalence provisions under MiFIR Article 38 to gain licences for benchmarks and offer trading of products based on them under different regulatory and supervisory conditions than those applied in the EU.

FESE Policy recommendation:
Amend MIFIR Article 37 to align the scope of access requests to that included in EMIR in order to acknowledge properly the intellectual property rights of existing benchmarks. Furthermore, ensure that any access request to benchmark licences by third country infrastructure does not facilitate the emergence of an unlevel playing field underpinning competiting 'equivalent' ETDs based on the benchmark. This requires an extension of the MIFIR Article 38 equivalence mechanism to cover trading and transparency regulation and supervision in the third country concerned before any access requests can be consideredremove ETDs from the scope given that EMIR already provides a sufficient framework.

Scenario 4: Access for third country CCPs and trading venues (MiFIR Article 38)

Brexit magnifies the complexity of the already inefficient and damaging access arrangements by its potential to exacerbate volatility which puts trading and clearing under increased stress but also by undermining the legal basis of cross-border multiple links. The consequences of Brexit are not yet clear from a legal perspective. However, they certainly have the potential to undermine the legal basis of clearing and introduce unnecessary uncertainty that could also have destabilising effects on the market leading to volatility and even to default. RMs must be allowed to take every necessary step to ensure that their contracts are subject to a legally robust environment over their entire term, until expiry. A question mark over the ongoing legality of a clearing link has the potential to cause disruption not only for those participants clearing through the new link or links, but indeed also for participants using the existing clearing facilities.

It is possible that the legal uncertainty regarding the future legal basis of EU/UK commerce leads to stressed market conditions. Under such market conditions, defaults of clients or clearing members cannot be excluded.

As noted in the sections above, FESE believes there are significant issues attached to leaving ETDs within the scope of MiFIR Article 38 governing the equivalence regime for access for third country CCPs and trading venues, these being:

i) **MiFIR Article 35** – introducing contractual netting arrangements across EU and non-EU trading venues (the latter deemed as equivalent) would further increase systemic risk.

ii) **MIFIR Article 36 -** adding third country CCPs under an equivalence arrangement would further complicate RM arrangements with CCPs, posing further challenges to the operation of smooth and orderly markets.

iii) **MiFIR Article 37** – the potential for third country trading venues using the equivalence provisions to gain licences for benchmarks and offer trading of products based on them under different regulatory and supervisory conditions than those applied in the EU.

FESE Policy recommendation:
Delete Article 38 to remove the possibility for third country infrastructures to employ Title VI of MiFIR to access EU markets under a different regulatory environment.