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Brief Round-up of Some Key Trading Related Issues

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EMIR Margin Rules: FX Forwards Margining

Background

As covered in our December 2017 edition of Briefs for the Buy side[1] (the "December Brief"), there was a last-minute change of heart by the European Supervisory Authorities (the "ESAs") as to which market counterparties should be required to exchange variation margin with respect to physically settled FX forward contracts ("FFX") pursuant to the EMIR Margin RTS (regulatory technical standards)[2]. Further to a news statement published on 24 November 2017[3], the ESAs stated that: (i) they are reviewing the EMIR Margin RTS in order to develop amendments which will align the treatment of variation margin for FFX with the approach in other key jurisdictions (more on which, see "Dubious Policy" below); and (ii) in order to apply risk based and proportionate variation margin exchange rules to such contracts it would "most likely imply that the scope should cover transactions between institutions (credit institutions and investment firms)".

Amended Margin RTS

On 19 December 2017, the ESAs published final draft regulatory technical standards amending the EMIR Margin RTS[4] (the "Amending RTS") to address the above issue. It is proposed that where one of the counterparties to a FFX is: (i) not an "institution"; or (ii) established outside the EU and would not be an 'institution' if it were established in the EU, then variation margin does not need to be posted or collected in relation to FFX. An "institution" in this context effectively means a credit institution or an investment firm (within the meaning of the Capital Requirements Regulation). As such, alternative investment funds ("AIFs") and Undertakings for Collective Investment in Transferable Securities (known as UCITS) would be out of the scope of the mandatory exchange of variation margin for such transactions under the proposed amended regime.

Timing

The Amending RTS were not published in the Official Journal in time to be effective from 3 January 2018 (when the requirement to exchange variation margin for FFX came into force). As of the date of this edition of Briefs for the Buy side, the Amending RTS still had not been published (there could be as much as a four month delay before publication – although the market will hope that the process does not take this long). Reflecting the urgency, the Amending RTS will enter into force the day following its publication in the Official Journal instead of the usual 20 day period.

In the meantime, the executive summary attached to the Amending RTS reiterates the ESAs' view that until the Amending RTS come into force "for institution-to-non-institution transactions, the competent authorities should apply the EU framework in a risk-based and proportionate manner".

AB Trading Advisors View and Comment

While We Wait

Given that the prior statements issued by EU national competent authorities (including the UK Financial Conduct Authority and the Central Bank of Ireland) (each, an "NCA") can now be read in conjunction with the Amending RTS, buy-side 'non-institutions' (such as AIFs) may consider not complying (or continuing not to comply) with the EMIR Margin RTS exchange of variation margin rules in respect of FFX. Of course, not all NCAs have made such statements – leaving market participants in the applicable jurisdictions with far less certainty. However, we believe that it would be open to such entities in those jurisdictions to take the same approach in the absence of a contrary NCA statement on the matter.

Clear Documentation Trail

Both in-scope[5] 'institutions' and 'non-institutions' will need to document their election not to exchange variation margin in the permitted scenarios under the Amending RTS in their risk management procedures (required under Article 2(2) of the EMIR Margin RTS) if they wish to avail themselves of this derogation.

Dubious Policy?

As previously reported in the December Brief, one of the key objections to the treatment of FFX under the EMIR Margin RTS was that it diverged from the approach taken in other significant derivatives markets, in which FFX are not subject to mandatory exchange of collateral rules. Nevertheless, the ESAs believe that retaining the variation margin requirements for institutional-to-institutional transactions does "align the treatment of variation margin for [FFX] with the supervisory guidance in other key jurisdictions".

EMIR REFIT Regulation – Further Exemptions?

As part of the European Commission's (the "EC") Regulatory Fitness and Performance programme, and as envisaged by Article 85(1) of EMIR, the EC released a proposal on 4 May 2017 to modify certain aspects of EMIR and in particular to simplify the rules and make them more proportionate (the "Proposal")[6]. The European Parliament's Committee on Economic and Monetary Affairs ("ECON") published a draft report dated 26 January 2018 proposing certain amendments to the Proposal (the "ECON Draft Report")[7]. Amongst other clarifications and improvements, the rapporteur, Mr Langen, specifically mentions the need to harmonise legislation relating to FFX and physically-settled FX swaps at the global level. The explanatory statement to the ECON Draft Report states that:

- the entry into force of the Amending RTS as soon as possible is supported as "changes are necessary in order to establish a similar treatment of such transactions across the globe and therefore address any problem of levelplaying field on the foreign exchange market";
- "in most countries of the world (USA, Japan, Canada, Singapore, Australia, Switzerland, Hong Kong, etc.), there is no mandatory variation margins exchange"; and
- "to achieve a perfect alignment [the Amending RTS] needs to be extended to physically settled FX swaps".

The ECON Draft Report, therefore, proposes exempting FFX and physically settled FX swaps from the mandatory exchange of variation margin other than for "transactions between the most systemic counterparties, such as credit institutions and investment firms" (as per a newly proposed Recital 16(a) in EMIR).

ECON must now vote to finalise the Draft Report which will then be considered by the European Parliament during February.

Later this year, we will be releasing a Brief for the Buy side covering the updating of EMIR, as the compromise text becomes clearer.

MiFIR Double Volume Cap: Double Trouble

Background

One of the central aims of both MiFID II[8] and The Markets in Financial Instruments Regulation ("MiFIR")[9] is to improve the transparency of financial markets and, as such, the new regulatory regime has considerably broadened the existing pre- and post-trade transparency rules.

As set out in Article 4 of MiFIR, equity trades may benefit from a number of waivers from the enhanced pre-trade transparency rules. These are waivers for: (i) system matching orders based on a trading methodology by which the price is determined in accordance with a reference price (the "Reference Price Waiver"); (ii) large-in scale ("LIS") orders compared to the normal market size; (iii) orders held in an order management facility pending disclosure; and (iv) systems that formalise negotiated transactions which are made (a) within the current volume-weighted spread reflected on the order book or the quotes of the market makers of the trading venue, (b) in an illiquid equity instrument and are dealt within a percentage point of a suitable reference price, or (c) subject to conditions other than the current market price of that instrument ("Negotiated Price Waiver").

Article 5 of MiFIR then applies a restrictive mechanism known as the double volume cap mechanism (the "DVC") to limit the availability of the Reference Price Waiver and the Negotiated Price Waiver (together, the "DVC Waivers"). One of the intended effects of this is to 'shine a light' on dark pools.

The DVC is intended to ensure that use of the DVC Waivers does not unduly harm price formation. It operates by restricting trading under those DVC Waivers as follows: (1) the trading volume of a financial instrument carried out on a single trading venue under those DVC Waivers must not exceed 4% of the total trading volume in that financial instrument across all EU trading venues over the previous 12 months; and (2) the trading volume of a financial instrument carried out across all EU trading venues under those DVC Waivers must not exceed 8% of the total trading volume in that financial instrument across all EU trading venues over the previous 12 months.

If the DVC is breached, then the DVC Waivers will not be available for a period of six months, thus pushing trades from such dark pools to 'lit' venues. The European Securities and Markets Authority ("ESMA") is required to publish data (the "DVC Data") for the end of each calendar month so that market participants can know: (i) the total volume of EU trading per financial instrument in the previous 12 months; and (ii) the percentage of trading in a financial instrument carried out across the EU under the DVC Waivers and on each trading venue over the past 12 months.

ESMA Delays Publication of the DVC Data

On 9 January 2018, ESMA announced that it was delaying the publication of the DVC Data for January 2018[10] since "the current quality and completeness of the data [received from trading venues to perform the DVC Data calculations] does not allow for a sufficiently meaningful and comprehensive publication of double volume cap calculations, as required under MiFID II/MiFIR, and ESMA has taken this decision to avoid creating an unlevel playing field". Instead, ESMA expects to publish DVC Data for the first time in March, including DVC Data for January and February.

ESMA stated that it had received data for the 12 month period from January to December 2017 in respect of only 2 percent of the number of financial instruments it was expecting.

AB Trading Advisors View and Comment

The DVC was among the most controversial and least popular of the MiFID II / MiFIR reforms and was initially heralded as a significant limitation to dark pool trading, with a number of studies[11] showing that a significant number of stocks would breach the DVC on 3 January 2018. Whilst that may still be the case, however, our understanding is that the market has responded primarily by: (i) a growth in LIS trading (which, since such trading does not count towards the DVC, also has the effect of freeing up more volume for trading under the DVC Waivers); and (ii) the use of periodic auction venues which are considered as 'lit' and therefore the DVC does not apply. It should also be noted that the DVC does not apply to systematic internalisers.

MiFIR Derivatives Trading Obligation

As covered in our October 2017 edition of Briefs for the Buy side[12], ESMA had previously issued its final report containing draft Regulatory Technical Standards in respect of the trading obligation for derivatives under MiFIR (the "Draft TO RTS"). The final Regulatory Technical Standards were published in the Official Journal on 22 December 2017[13] (to apply from 3 January 2018) and the scope of counterparties and OTC derivatives contracts covered as well as the implementation and phase-in timings have remained as per the Draft TO RTS.

Article 34 of MiFIR provides that ESMA must maintain on its website a register specifying, in an exhaustive and unequivocal manner, the derivatives that are subject to the MiFIR trading obligation, the venues where they are admitted to trading or traded, and the dates from which the obligation takes effect. ESMA published this register, 13 days after the 'go-live' date, on 16 January 2018[14].

Therefore, in summary:

- the following OTC derivative classes may only be traded on an EU regulated market, a multilateral trading facility, an organised trading facility or a third country trading venue deemed by the EC to be equivalent (for more on this, see below):

– Fixed-to-float interest rate swaps denominated in EUR;
– Fixed-to-float interest rate swaps denominated in USD;
– Fixed-to-float interest rate swaps denominated in GBP; and
– Index CDS – iTraxx Europe Main and iTraxx Europe Crossover;

- the trading obligation applies when such in-scope derivative transactions are entered into between the following pairs of counterparties: (a) any combination of FCs and NFC+s; (b) a Hypothetical FC or a Hypothetical NFC facing a FC or a NFC; or (c) any combination of Hypothetical FCs and Hypothetical NFC+s but only where the relevant contract has "a direct, substantial and foreseeable effect" within the EU or where the obligation is necessary or appropriate to prevent the evasion of any provision of MiFIR;
- Category 1[15] and Category 2[16] counterparties are subject to this obligation from 3 January 2018. Category 3[17] counterparties have until 21 June 2019 to comply with the obligation whilst Category 4[18] counterparties have until 21 December 2018 to comply in respect of in-scope interest rate swaps and 9 May 2019 for in-scope credit default swaps; and
- in respect of the non-EU venues where in-scope counterparties can trade in-scope derivative contracts and still satisfy their EU derivatives trading obligation, so far only the legal and supervisory framework of the United States applicable to designated contract markets and swap execution facilities[19] have been declared equivalent by the EC for this purpose.

Brexit Articles

Several papers have been published recently in respect of Brexit's potential impact in the trading space which our readers may be interested in.

The FIA (formerly the Futures Industry Association) has published a white paper entitled "The Impact of a No-Deal Brexit on the Cleared Derivatives Industry"[20], which sets out: (i) the impact of a no-deal Brexit scenario and potential mitigants; (ii) arrangements for a transitional period; and (iii) its recommendations to effect the preferred outcomes. It further identifies seven key steps to minimise disruption and maintain end user access to global markets.

The Financial Markets Law Committee (the "FMLC") has published a paper entitled "Issues of Legal Uncertainty Arising in the Context of the U.K.'s Withdrawal from the E.U. – the Application and Impact of World Trade Organization Rules on Financial Services"[21]. In the paper, the FMLC consider the World Trade Organisation ("WTO") rules applicable to financial services and their impact on the future UK-EU relationship as well as the impact of the WTO rules on the UK's trade agreements with non-EU countries.

However, we are not given insight into the UK's post-Brexit regulatory goals, as the position paper which was intended to provide clarity to the financial industry on that matter has been indefinitely postponed as of 23 January 2018.

Contact Us

If you have any queries in relation to the above, or would like to discuss any related aspects more generally, please contact Antony Bryceson or Richard Chapman.

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[1] Available at: https://abderivs.com/client-news/

[2] Commission Delegated Regulation (EU) 2016/2251 supplementing The European Markets Infrastructure Regulation ("EMIR"). Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN

[3] Available at: https://esas-joint-committee.europa.eu/Pages/News/Variation-margin-exchange-for-physically-settled-FX-forwards-under-EMIR-.aspx

[4] Available at: https://www.eba.europa.eu/regulation-and-policy/market-infrastructures/draft-regulatory-technical-standards-on-risk-mitigation-techniques-for-otc-derivatives-not-cleared-by-a-central-counterparty-ccp-

[5] The EU variation margin rules apply directly to a (i) 'financial counterparty' ("FC") and (ii) non-financial counterparty (each as defined in EMIR) above the EMIR clearing threshold ("NFC+"). The rules also apply indirectly to a third country entity that would be categorised as an FC or as an NFC+ if it were established in the EU (a "Hypothetical FC" and a "Hypothetical NFC+", respectively), which is facing a FC or a NFC+. Two third country entities facing each other may also be in-scope in certain circumstances (not considered further here). The requirement to have risk management procedures covers FCs and NFC+.

[6] Available at: http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-208-F1-EN-MAIN-PART-1.PDF

[7] Available at: http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-616.810&format=PDF&language=EN&secondRef=01

[8] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast).

[9] 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.

[10] Available at: https://www.esma.europa.eu/press-news/esma-news/esma-delays-publication-double-volume-cap-data

[11] See, for example, those reported in these articles: https://www.bloomberg.com/news/articles/2017-06-26/europe-fund-managers-seen-facing-clampdown-in-dark-pool-trading; and https://uk.reuters.com/article/uk-europe-markets-darkpool/tougher-dark-pool-rules-trigger-race-for-alternative-venues-idUKKBN12Z28K

[12] Available at: https://abderivs.com/client-news/530-2/. That edition covers in detail the scope and timing of the obligation.

[13] Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2417&from=EN

[14] Available at: https://www.esma.europa.eu/sites/default/files/library/public_register_for_the_trading_obligation.pdf

[15] Clearing members for at least one of the classes of OTC derivative subject to the clearing obligation of at least one of the central counterparties authorised or recognised to clear at least one of those classes.

[16] FCs and NFC+ AIFs which are not included in Category 1, which belong to a group whose aggregate month-end average notional amount of non-centrally cleared derivatives for January, February and March 2016 is above EUR 8 billion. (Each regulatory technical standards specifies the assessment period according to which a counterparty must assess whether it belongs to Category 2.)

[17] FCs and NFC+ AIFs which are not included in Categories 1 or 2.

[18] NFC+s which are not included in Categories 1, 2 or 3.

[19] See Commission Implementing Decision (EU) 2017/2238 of 5 December, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017D2238&from=EN

[20] Available at: https://fia.org/sites/default/files/FIA_WP_Brexit_NoDeal.pdf

[21] Available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_paper_on_brexit_and_wto.pdf