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Round-up of Some Key Topics

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OTC Derivatives Trading Obligation: The Road to Equivalence is Paved with Good Intentions

As reported in our last Briefs for the Buy side[1], the European Securities and Markets Authority ("ESMA") has issued its final report containing draft Regulatory Technical Standards (the "RTS") specifying which OTC (over-the-counter) derivative contracts will be subject to the mandatory trading obligation for derivatives under the Markets in Financial Instruments Regulation[2] ("MiFIR"). These RTS are currently under consideration by the European Commission (the "EC") before then moving onto the final endorsement stages, but it is possible that 'category 1' and 'category 2' market participants will be required to trade those identified contracts on a European Union ("EU") trading venue or equivalent third country trading venue as early as 3 January 2018.

As we previously noted, given the cross-border nature of the OTC derivatives market, determination of third country venues as 'equivalent' is a vital step in ensuring that market participants subject to two regulatory regimes are not faced with an impossible compliance burden by having to trade the same contract on two different trading venues.

In a significant step towards reconciling the effective operation of the mandatory trading obligations in the EU and the United States of America (the "US"), on 13 October 2017 a common approach regarding certain derivatives trading venues authorised in the EU and in the US[3] was jointly announced by the EC and the US Commodity Futures Trading Commission (the "CFTC"). In summary, the approach will operate as follows:

- EU counterparties will be able to satisfy the EU mandatory trading obligation by executing relevant contracts on either (1) authorised EU trading venues or (2) CFTC authorised swap execution facilities ("SEFs") and designated contract markets ("DCMs"). It is intended that the EC will adopt an equivalence decision covering the CFTC authorised SEFs and DCMs that are notified to it by the CFTC (pursuant to the procedure set out in Article 28(4) of MiFIR); and
- US counterparties will be able to comply with the current US trade execution requirement by executing contracts on certain EU authorised trading venues that are exempted from SEF registration as well as on SEFs and DCMs. The CFTC intends to exempt those EU trading venues notified to it by the EC from the SEF registration requirement (pursuant to the powers derived from Section 5h(g) of the US Commodity Exchange Act).

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Next Steps

The above is currently only an announcement – the first phase of the procedure. The CFTC and the EU will now "work as expeditiously as practicable to ensure that this arrangement is put into place and operating in a coordinated manner". The immediate next step is for the CFTC to notify the EC of its list of eligible SEFs and DCMs and for the EC to notify the CFTC of its list of eligible compliant trading venues. We understand that, as of 1 November 2017, the EC has drafted its required list. However, how long in practice it will take for the

approach to become reality remains to be seen (although CFTC Chairman Giancarlo has said that he feels "confident" it will be in place by 3 January 2018) and may ultimately have an impact on the final compliance date for the EU mandatory trading obligation in respect of OTC derivatives.

More to Come?

Although the US is the key jurisdiction in terms of ensuring an equivalence ruling, there may be more work for the EC to do to ensure cross-border harmonisation of trading obligations. Other jurisdictions (such as Japan) have a mandatory trading obligation in place or will in due course enact similar rules (given that the trading, where appropriate, of standardised OTC derivative contracts on exchanges or electronic trading platforms was a key G20 pledge). Non-EU entities will also be subject to the EU mandatory obligation in many instances and will be forced to use EU trading venues in the absence of an equivalence determination in respect of their home country trading venues. We expect that the EC will continue to work with other regulators to ensure an orderly global functioning of the trading mandate.

International Co-operation in All Things?

Cross border co-operation between regulatory agencies and deference to comparable foreign regulatory frameworks is crucial in ensuring a functioning and efficient global derivatives market. The CFTC under Chairman Giancarlo continues to show that the CFTC is focussed on ensuring firms can transact on a cross border basis. There are, of course, far more contentious issues that will need to be agreed between international regulators – such as the EU proposal to forcibly relocate non-EU clearinghouses to the EU in certain circumstances.

Legal Entity Identifiers ("LEIs"): Why Do I Need an LEI?

This question has a simple answer: no LEI, no trade. A firm that is required to obtain an LEI but has not done so by 3 January 2018 will find itself unable to trade with an in-scope EU investment firm. LEIs are a key requirement of the MiFIR transaction reporting regime – indeed, an in-scope investment firm cannot provide a service triggering the obligation to submit a MiFIR transaction report for a transaction entered into on behalf of a client who is eligible for an LEI, prior to obtaining the LEI from that client[4]. (So, the requirement to have an LEI will apply even if the firm is a non-EU firm or is not directly covered by the MiFIR transaction reporting regime.)

On 9 October 2017, ESMA reminded the market of the importance of obtaining an LEI where required in a published briefing[5]. Many investment managers and their funds will already have an LEI as a result of regulatory reporting obligations pursuant to other European legislation, such as the European Markets Infrastructure Regulation[6] ("EMIR"), but for those that do not it is critical to determine now whether one is required and to take steps to obtain one.

An LEI can only be issued by a Local Operating Unit, a full list of which is available at the Global LEI Foundation website[7], and any such LEI issuer in any country may be used for this purpose. There is usually a fee associated with the initial registration and an annual maintenance change (as the LEI must be renewed annually, or else it will lapse).

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Quick and Simple

Obtaining an LEI is quick and simple to do, but as more and more firms (predominantly non-EU entities) become alive to this issue, LEI issuers may face a processing backlog. A common turnaround time for issuing an LEI is 24-48 hours – but expect this to increase commensurate with demand.

Satisfying MiFIR Reporting Obligations

To the extent they have not done so already, we would expect EU sell side counterparties to contact their clients to require information they believe will be needed to enable them to meet their own MiFIR reporting obligations (along with additional legal documentation). It is worth making the point that, in order for a sell side counterparty to satisfy its own MiFIR reporting obligations, it should require only its counterparty's LEIs (in respect of decision makers and underlying clients) and the short selling flag information. (In which case, a plethora of intrusive personal information from its client will not be relevant to its own reporting obligations.)

ISDA Master Agreement: New Governing Laws

Currently, the standard ISDA Master Agreements (1992 and 2002 versions) envisage that the governing law of such agreements will be English law or the laws of the State of New York. Although we have seen Australian law and Singapore law specified as the governing law on rare occasions, it remains very unusual to depart from either English law or New York law, not least because the ISDA close-out netting opinions are drafted on the assumption that one of these governing laws applies.

However, ISDA has now written to its members requesting comment on whether a further two governing law options should be added: namely, Irish law and French law (along with Irish and French jurisdiction clauses).

AB Trading Advisors View and Comment

Brexit Concerns

Issues relating to the choice of governing law of contracts, jurisdiction clauses and enforcement and recognition of judgments between the United Kingdom ("UK") and the European Economic Area ("EEA") are key matters to be resolved as part of the Brexit negotiations and any transitional arrangements (the UK government has previously published a position paper in this regard[8]). Perhaps the prime concern in this context is that, if no agreement is reached between the UK and the EU, a jurisdiction clause specifying English courts may not be followed by an EU court – rather, the relevant EU Member State national law would be applied to the question of whether that EU court should respect the jurisdiction of the English courts. By sounding out members now, ISDA is taking a proactive step should no suitable Brexit deal be made in this regard.

ISDA Brexit FAQs

We will be circulating a 'Brief for the Buy side' covering Brexit-related derivatives issues during the course of next year, as the nature of Brexit and any applicable transitional arrangements becomes clearer. In the meantime, parties interested in the implications of Brexit on ISDA Master Agreements and related documentation generally should read the excellent Brexit FAQs published by ISDA[9].

ESMA Overview of the EU Derivatives Market

ESMA has published an article which provides data for the first time on the EU interest rate, credit, equity, commodity and foreign exchange derivative markets[10]. Pursuant to EMIR, counterparties are required to report details of both OTC derivative contracts and exchange-traded derivative ("ETD") contracts to a trade repository, and this study combined the data submitted to all six EU authorised trade repositories (as at 24 February 2017). The study makes interesting reading setting out the number of participants in each asset class as well as a breakdown between ETD and OTC derivative transactions (by number of transactions and notional size) and the share of transactions within the EEA, against cross-border transactions.

By way of brief summary:

- in terms of the number of total open transactions:
  - overall, the equity derivatives class was the largest (with 48% of the total transactions reported) followed by FX, interest rate, commodity and credit derivatives;
  - for all asset classes other than commodity derivatives, OTC trading was prevalent;

- in terms of notional amounts of each class:
  - interest rate derivatives are by far the largest market (at Euro 282 trillion) followed by FX, equity, credit and commodity derivatives; and
  - OTC is the dominant market for interest rate, credit and FX derivatives whereas for equity and commodity derivatives a majority by notional were standardised contracts.

A further observation that will be of no surprise to the industry is that "an important part of EU derivatives trading activity [occurs] with non-EEA counterparts".

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Quality of Data

Any study of this nature is reliant on the quality of the underlying data collected by the trade repositories. Indeed, the article notes that there is "… substantial work yet to be carried out on enhancing data quality…" and that (inter alia) this is a key priority for ESMA in the coming years. The United Kingdom Financial Conduct Authority (FCA) has stressed the importance it places on this type of trade reporting and, in the first example of an enforcement action for failure to comply with the EMIR reporting requirements, it has recently fined a major dealer £34,524,000 for failing to report 68.5 million ETD transactions between 12 February 2014 and 6 February 2016[11].

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.

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[1] Available at https://abderivs.com/530-2/

[2] 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.

[3] Available at https://ec.europa.eu/info/sites/info/files/171013-joint-statement-ec-cftc_en.pdf

[4] See Article 13(2) of Commission Delegated Regulation (EU) 2017/590 of 28 July 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the reporting of transactions to competent authorities. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0590&from=EN

[5] Available at: https://www.esma.europa.eu/press-news/esma-news/esma-highlights-importance-lei-mifidiimifir-compliance

[6] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories. Indeed, from 1 November 2017, trade repositories will be obligated to reject EMIR trade reports with no LEI included.

[7] Available at: https://www.gleif.org/en/about-lei/how-to-get-an-lei-find-lei-issuing-organizations

[8] “Providing a cross-border civil judicial cooperation framework”. Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/639271/Providing_a_cross-border_civil_judicial_cooperation_framework.pdf

[9] Available at: https://www2.isda.org/functional-areas/legal-and-documentation/uk-brexit/

[10] Available at: https://www.esma.europa.eu/sites/default/files/library/esma50-165-421_eu_derivatives_markets_-_a_first-time_overview.pdf

[11] FCA Final Notice available at: https://www.fca.org.uk/publication/final-notices/merrill-lynch-international-2017.pdf