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ESMA finalises draft RTS on trading obligation for certain OTC derivatives

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Brief Overview

On 28 September 2017, the European Securities and Markets Authority ("ESMA") issued its final report containing draft Regulatory Technical Standards[1] (the "RTS") in respect of the trading obligation for derivatives under the Markets in Financial Instruments Regulation[2] ("MiFIR"). MiFIR implements part of the MiFID II framework. Consequently, assuming that the RTS are published in their current form, certain interest rate swaps ("IRS") and certain credit default swaps ("CDS") (being sub-sets of those classes of OTC derivatives which have already been mandated for central clearing pursuant to the European Markets Infrastructure Regulation[3] ("EMIR")) will be required to be traded on a European Union ("EU") trading venue or equivalent third country trading venue possibly as early as 3 January 2018 for certain market participants.

What is the trading obligation?

At its meeting of 25 September 2009 at Pittsburgh, the G20 pledged to reform over-the-counter derivatives markets, including that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate"[4].

Requirements for the trading obligation to apply

Article 28 of MiFIR introduces a trading obligation for OTC derivatives which is intended to give effect, in the EU, to that pledge. It requires that those OTC derivatives which are:

(1) entered into between the following pairs of counterparties:

(a) any combination of 'financial counterparties' ("FCs") and 'non-financial counterparties' exceeding the clearing threshold ("NFC+s") (each as defined in EMIR);

(b) entities established outside the EU which would be FCs or NFC+s if they were established in the EU ("Hypothetical FCs" and "Hypothetical NFC+s", respectively) and FCs or NFC+s; 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; and

(2) declared subject to the trading obligation in accordance with the procedure set out in Article 32 of MiFIR; and

(3) listed on an ESMA-maintained register;

may only be traded on an EU regulated market, a multilateral trading facility ("MTF"), an organised trading facility ("OTF") or a third country trading venue deemed by the European Commission (the "EC") to be equivalent.

Which classes of derivatives are subject to the trading obligation?

The two approaches

Article 32 of MiFIR sets out the procedure for establishing which classes of derivatives should be declared subject to the trading obligation. This procedure may comprise either:

1. a 'bottom-up' approach (Article 32(1)) whereby once a class of derivatives is required to be cleared pursuant to EMIR, ESMA will within six months of such date submit draft regulatory technical standards to the EC specifying which of those classes of derivative or sub-sets thereof should be subject to the trading obligation; or
2. a 'top-down' approach (Article 32(4)) whereby ESMA may of its own initiative advise that a class of derivative or individual derivative contracts be made subject to the trading obligation.

Under each approach, two additional prerequisites apply, namely that the class of derivatives must be: (i) admitted to trading or traded on at least one trading venue[5] and (ii) sufficiently liquid[6].

The RTS

The RTS the subject of this client alert have been developed under the bottom-up approach (indeed, ESMA has previously stated that it does not intend at this stage to utilise the top-down approach). They follow a 20 September 2016 Discussion Paper titled "The trading obligation for derivatives under MiFIR"[7] and a June 2017 Consultation Paper titled "The trading obligation for derivatives under MiFIR"[8] (the "Consultation Paper") and set out ESMA's approach for determining which derivatives should be subject to the trading obligation.

Pursuant to the RTS, ESMA has determined that the following fixed-to-float IRS and CDS index contracts (together, the "TO RTS Derivative Classes") should be subject to on-venue trading (as more fully set out in Annex IV to the RTS):

- 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.

When will the trading obligation take effect?

The RTS were submitted to the EC on 28 September 2017. The EC now has up to three months to decide whether or not to endorse them. Assuming the EC does endorse the RTS, there is then a further 'non-objection' period of the European Parliament and the European Council before the RTS are finally published in the Official Journal.

Timing

The RTS specifically envisage that the trading obligation will become effective from the later of:

- 3 January 2018; and
- the date from which the EMIR clearing obligation for the relevant TO RTS Derivative Class takes effect in relation to a category of counterparty.

Despite the tight timeline, ESMA has noted that the EC is committed to applying the trading obligation from the start date of the MiFID II

framework. ESMA also points out (at paragraph 53 in its final report presenting the RTS) that it is "…. fair to state that the advent of the trading obligation for derivatives in 2018 has been transparent and clear to market participants for a long time".
However, ESMA also recognises in its final report (see paragraph 51) that "it is aware of the large number of new rules taking effect already from 3 January 2018 for market participants and regulators alike" and, as such, ESMA "would not be opposed to a short delay" of up to three months. Whether this delay materialises, or not, remains to be seen.

Clearing obligation and trading obligation

Even if the RTS were to apply from 3 January 2018, the trading obligation for the TO RTS Derivative Classes will not be effective for all market participants from that date. It is recognised that, as the clearing obligation and the trading obligation are inextricably linked, an entity should not be subject to the mandatory trading obligation with respect to a class (or sub-class) of derivatives before it is subject to the clearing obligation in respect of that same class (or sub-class).

Phase-in

As such, the RTS import the concept of four 'phase-in' categories of counterparties identified in the regulatory technical standards for the purposes of the EMIR clearing obligation in order to ensure that the trading obligation for the TO RTS Derivative Classes will take effect vis-à-vis a category of counterparty only once the clearing obligation for those same class (or sub-class) of derivatives has also been phased-in for that same category of counterparty. The trading obligation for the TO RTS Derivative Classes will be phased-in as follows:

- 'Category 1' and 'Category 2' counterparties – with effect from the date the RTS take effect (as the corresponding EMIR clearing obligation is already in effect for these categories of counterparties);
- 'Category 3' counterparties – with effect from 21 June 2019; and
- 'Category 4' counterparties – with effect from: (i) 21 December 2018 in relation to those TO RTS Derivative Classes which are IRS; and (ii) 9 May 2019 in relation to those TO RTS Derivative Classes which are CDS.

Counterparties covered by each category[9]

To recap, the criteria for determining which category a counterparty falls within are as follows:

- Category 1 – 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 ("CCPs") authorised or recognised to clear at least one of those classes;
- Category 2 – FCs and NFC+ Alternative Investment Funds ("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*;
- Category 3 – FCs and NFC+ AIFs which are not included in Categories 1 or 2; and
- Category 4 – NFC+s which are not included in Categories 1, 2 or 3.

(*Each regulatory technical standards specifies the assessment period according to which a counterparty must assess whether it belongs to Category 2.)

The register

Pursuant to Article 34 of MiFIR, ESMA must publish and maintain on its website a register specifying, in an exhaustive and unequivocal

manner: (i) the derivatives that are subject to the trading obligation; (ii) the trading venues where they are admitted to trading; and (iii) the dates from which the trading obligation takes effect. In its final report (at paragraph 60), ESMA has stated that, with regard to trading venues where the relevant instruments may be traded, it will maintain a separate register with the list of trading venues which are trading IRS and CDS. However, it will not specify on which specific trading venue a given granular instrument is traded.

Some final thoughts

Third country venues and cross border trading

For those entities which are also subject to a mandatory trading obligation under a third country regime, the recognition of third country trading venues as 'equivalent' by the EC is a key issue. For example, where an in-scope US firm and an in-scope EU firm trade a contract that is subject to both the Commodity Futures Trading Commission's ("CFTC") trade execution requirement and the MiFIR trading obligation, they will not be able to meet their respective local regulatory obligations in the absence of an equivalence decision (save for a venue being a dual-registered US swap execution facility ("SEF") and a MFT/OTF) or substituted compliance being available.

Therefore, in order to prevent fragmentation of the derivatives market along geographic lines and any adverse impact on liquidity, it would be necessary to ensure that: (i) the MiFIR trading obligation can be satisfied by trading on a SEF or designated contract market declared equivalent under MiFIR; or (ii) the CFTC trade execution requirement can be discharged by trading on an MTF or OTF or by substituted compliance with the CFTC regime.

The absence of any such equivalence decisions at this stage, and the potential resulting cross-border impact, has led to calls for the trading obligation to be delayed until such equivalence decisions are in place. ESMA notes the importance of the impact of equivalence determinations and states in its final report (at paragraph 51) that it "agrees that in order to ensure an orderly implementation of the [trading obligation], a sufficient number of equivalence determinations will need to be completed before the [trading obligation] comes into effect".

Possible announcement in November

Interestingly, ESMA states in its final report (at paragraph 63 of Annex I) that it expects that the EC will "finalise its equivalence decisions, covering at least the most important jurisdictions, sufficiently ahead of 3 January 2017[10]". Regarding the US specifically, on 20 September Tilman Lüder, Head of the Securities Market unit at the EC, confirmed that the EC "are in discussions with [the] CFTC on the need for the recognition of all MiFID venues and for the EU to authorise all CFTC venues" and that they "hope to make an announcement in November"[11]. We will wait to see if that transpires, but in any event the longer these decisions are delayed the more likely it is that market participants will need to commit resources to ensuring access to EU trading venues which ultimately may not be required following any equivalence decision being finally made.

Revoking or amending the trading obligation

If it becomes necessary in the future to revoke, amend or suspend the trading obligation in respect of the TO RTS Derivative Classes (for example to address significant drops in liquidity), then ESMA must submit further regulatory technical standards to the EC. This may lead to a situation whereby a class of derivatives subject to the trading obligation can no longer be traded on a venue and the requisite technical standards have not been produced, in which case market participants would have to cease trading such contracts to avoid breaching the provisions of MiFIR.

Whilst a similar concern over the inability to quickly revoke or suspend a clearing obligation in an emergency situation under EMIR has been proposed to be rectified in the EC's recent proposal to amend EMIR[12], in the context of MiFIR ESMA has noted that it "shares the

view expressed by many stakeholders that some emergency procedure should be available to suspend the [trading obligation] in case of significant drops of liquidity. However, neither MiFIR nor the ESMA Regulation[13] empower ESMA to make use of such an emergency procedure.… In the absence of further powers, ESMA is not in a position to take alternative measures."[14].

Contact Us

If you have any queries in relation to the above, or would like to discuss any aspect of EMIR or MiFIR more generally, please contact Antony Bryceson.

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[1] Available at https://www.esma.europa.eu/sites/default/files/library/esma70-156-227_final_report_trading_obligation_derivatives.pdf.

[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] 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.

[4] 19 July 2010, Consultation paper on 'Standardisation and exchange trading of OTC derivatives'

[5] ESMA has issued an opinion to clarify the meaning of the term 'traded on a trading venue'. Available at: https://www.esma.europa.eu/sites/default/files/library/esma70-156-117_mifir_opinion_on_totv.pdf.

[6] See Articles 32(2)(b) and 32(3) of MiFIR and Commission Delegated Regulation 2016/2020 of 26 May 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards on criteria for determining whether derivatives subject to the clearing obligation should be subject to the trading obligation. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2020&from=EN.

[7] https://www.esma.europa.eu/sites/default/files/library/2016-1389_dp_trading_obligation_for_derivatives_mifir.pdf.

[8] https://www.esma.europa.eu/press-news/consultations/consultation-trading-obligation-derivatives-under-mifir-0.

[9] http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=uriserv:OJ.L_.2016.103.01.0005.01.ENG

[10] Presumably this is a typo in the final report and should refer to 2018.

[11] https://marketsmedia.com/eu-equivalence/

[12] https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-208_en.

[13] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p.84).

[14] See paragraph 102 of the Consultation Paper.