EMIR review
What are the priorities for the AMF?

On 23 November 2016, the European Commission published a report on the EMIR review. This report, prepared on the basis of article 85 of EMIR, falls within the extension of the consultation initiated by the European Commission in May 2015 on revising EMIR. A project of modification is expected to be published soon.

<u>What is EMIR?</u>

EMIR is Regulation (EU) No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories. It harmonises the European law applicable to CCP and constitutes one of the components of implementation of the G20 commitments made at the Pittsburgh summit on derivatives. Its main obligations are as follows:

1. An obligation to clear derivatives that ESMA regards as sufficiently liquid and standardised;
2. Obligations to mitigate operational and credit risks associated with contracts that are not cleared in CCP;
3. An obligation to declare contracts to trade repositories.

The AMF, in its role as a supervisor, wishes to reiterate the priorities that, in its view, would seem essential when reviewing the Regulation.

Implementation of this text did in fact reveal the need for greater proportionality, consistency and efficiency in implementing the obligations specified by the Regulation. Finalisation by the majority of jurisdictions of their regulations also made it possible to highlight potential arbitrages, strengthening the need for proportionality. It also showed a need for improved articulation between the various European regulations.

Finally, the European Union needs to rethink its relationships with third countries. The experience gained regarding the procedures for the recognition of CCP (central counterparties, CCP), and their implications, does in fact underpin the theoretical analysis of the current system, which shows structural weaknesses that call for remediation. These considerations must be seen in the context of current market trends: market infrastructures are evolving in a context of increased competition, which in turn encourages concentration in the clearing house sector, which can lead to legitimate questions regarding financial stability. These questions become particularly acute in light of Brexit and the specific challenges that it poses as regards CCP and more generally market infrastructures.

1. The AMF supports the objective of strengthening the proportionality of the obligations specified by the text

In certain respects, the European Union has made more ambitious choices than its foreign partners in implementing the commitments of the G20.

However, the implementation of EMIR has also given rise to friction, exacerbated by possible distortions in competition associated with the non-application of these obligations in other financial centres. Data exploitation, now possible via trade repositories, has also made it easier to apprehend the market in OTC derivatives along with the positions taken by market players.

These elements argue in favour of greater proportionality. Beyond the purely technical aspects (doing away with backloading or frontloading, which the AMF supports), two areas of reform need to be prioritised:

1.1. The obligation to report derivative contracts to trade repositories needs to be rationalised

What is the scope of the obligation to report derivatives to trade repositories?

Article 9 of the Regulation specifies an obligation, for each counterparty to a contract, to declare their derivative contracts, whether OTC or listed, to one or more trade repositories. The particular feature of this obligation is that it applies to:

1. All contracts, whether OTC or listed, including intragroup transactions;
2. All counterparties, whether financial or non-financial, irrespective of the volume of their activity on derivative market;
3. Each of the counterparties, which means that both counterparties must report the contract and that, in the event of delegation, the delegating party retains its responsibility.

The particularly broad scope of the reporting obligation as specified in EMIR, and unmatched in some other jurisdictions (notably in the United States), can represent a heavy legal and operational burden on market participants which might be disproportionate to the risk they pose to the system. This also leads to data inflation, which can increase the complexity of the work on the part of regulators to exploit data and make it more reliable.

The AMF supports the following simplifications:

- Intragroup transactions of non-financial counterparties (NFCs-) (whose positions do not exceed one of the clearing thresholds) should be exempted from the reporting obligation.

- Transactions on listed derivatives should no longer come under declarations to trade repositories, since the declaration system specified by MiFID is sufficient. The AMF takes the view, however, that the current declaration of positions to trade repositories on commodity derivatives must be retained since it enables the end beneficiary to be identified, which is not always possible under MIFID, and is necessary if the AMF is to discharge its duties, in particular that of detecting manipulative practices on the market.

- While the AMF remains attached to the declaration by each of the parties to the contract to a trade repository, in itself an indispensable element of making data more reliable, moving to a system based on declaration by just one counterparty can be justified when a contract is concluded between a financial counterparty and a non-financial counterparty that does not exceed the clearing thresholds or a UCITS or AIF manager that deals marginally in derivatives.

1.2. The implementation of the clearing obligation can generate operational, financial or legal complexities for players who hold minor position in the OTC derivatives market

What is the clearing obligation in the European Union?

The clearing obligation applies to all financial counterparties who are regulated institutions (banks, investment service providers, UCITS or AIFs managed by an authorised fund manager under the AIFM directive), or non-financial counterparties (mainly but not exclusively industrial or commercial companies). It is ESMA which, on the basis of criteria fixed in EMIR, determines the products eligible for central clearing.

The following have now been declared eligible for central clearing: interest rate swaps denominated in euros, pounds sterling, yen and US dollars, then those denominated in Polish, Norwegian and Swedish currencies, as well as credit default swaps (CDSs) based on certain indices. A register available on ESMA's website makes it possible to identify these products without ambiguity. Entry into force of the obligation is phased depending on the type of players and their volume of activity, and in November 2016 ESMA sent the European Commission draft regulatory technical standards aimed at postponing the clearing obligation to June 2019 for financial counterparties whose volumes do not exceed €8 billion.

According to BIS data (December 2016 quarterly review), at the end of June 2016 75% of dealers' open positions on interest rate derivatives were open with respect to a central counterparty, the rate being 37% for credit derivatives and less than 2% for foreign exchange and equity derivatives .

The prospect of implementing central clearing has highlighted many difficulties for clients: some come under contractual negotiation or understanding the mechanisms specified to the clearing of OTC derivatives, others are of a more structural nature, particularly when they relate to difficulties in gaining access to CCP.

There are plans to overcome these difficulties. For example, ESMA recently finalised its regulatory technical standards related to indirect clearing arrangements, which should enable clients to access clearing via direct clients of clearing members while at the same time benefiting from an equivalent level of protection. Modification of the European prudential framework to remove certain disincentives to clearing (in particular, by not taking into account margins of clients for the leverage ratio) could partially remedy access difficulties. Finally, CCP have initiated plans aimed at enabling clients to directly access their services. The fact remains that these plans are unlikely to remove access difficulties for the smallest financial players, particularly funds, which, moreover, do not always have assets eligible to be accepted as collateral with CCP.

Exploitation of trade repositories' data has made it possible to gain a more precise picture of the positions taken on derivatives depending on the categories of players. Thus according to analysis by ESMA (*Consultation Paper on the clearing obligation for financial counterparties with a limited volume of activity*, 13 July 2016) it was confirmed that the market is very concentrated: for example, at European level, ona given trading day – 29 February – 50 counterparties represented 95% of the volume on credit and interest rate derivatives, for an average number of counterparties of 6,000 on interest rate derivatives and 2,000 on credit derivatives. For interest rate derivatives alone , 490 counterparties (whose interest rate derivatives portfolio exceeds €5 billion) represented 99.4% of activity. For credit derivatives, 399 counterparties (with a portfolio greater than €500 million) represented 98.6% of activity. Therefore the question of the proportionality of the clearing obligation for small financial counterparties is indeed legitimate, given the low risk they pose at European level. The other major jurisdictions provide such exemptions.

For these reasons the AMF supports the principle of the exemption of non-significant users of derivatives from the clearing obligation.

2. The AMF takes the view that the EMIR review needs to be the occasion to rethink the European Union's relationships with third countries

<u>In the area of market or post-market infrastructures, what is the European Union's approach as regards third countries?</u>

Like other European texts (particularly MiFID/MiFIR), EMIR is based on a principle of openness to third countries, provided such openness does not create an increased risk of regulatory arbitrage or for financial stability. This risk is apprehended by the principle of equivalence, which means that an institution located in a third country state may, complying with the legislation applicable in this third country state and being exclusively supervised by its local regulator, offer its services in the European Union without having to apply the law of the European Union or to apply for an authorisation/be subject to the supervision of the competent authority of the European state in which it is based or proposes to offer its services. The analysis is outcome-based, i.e. it closely follows the equivalence of the results and covers both regulation (equivalence of rules) and supervision. This principle is often accompanied by a principle of reciprocity but this is not automatic.

In the European Union, this principle is applicable, with variants, to market infrastructures (trading platforms, CCP, trade repositories, central custodians), to counterparties to a derivative and to investment service providers wishing to offer their services to professional clients or eligible counterparties.

The European Commission has now recognised 16 jurisdictions as equivalent: Australia, Hong Kong, Singapore, Japan, the Republic of Korea, Switzerland, South Africa, Mexico, Canada, the United States (for houses supervised by the CFTC), Brazil, Dubai, India, the United Arab Emirates, New Zealand), and ESMA had, in January 2017, recognised more than 20 CCP located in these jurisdictions.

An analysis of the texts shows the limits of the equivalence mechanism, underpinned by the practical implementation of this principle for the CCP of third countries. The EMIR review need not be a purely technical revision: the third-country regime specified for post-market infrastructures must be reviewed in depth. The AMF also takes the view that this regime is not suited to infrastructures that offer their services first and foremost in the European Union. On the contrary, the presence of critical infrastructures clearing products denominated in euros outside the European Union poses a risk for the financial stability of the European Union.

2.1. The reform of the equivalence of third-country regimes is in any case necessary

By taking the first steps towards the harmonised European regulation of the post market, in particular CCP, EMIR has also addressed the question of infrastructures located in a third country state outside the European Union and which wish to offer their services within the European Union. This question is all the more resonant since implementation of the clearing obligation in the European Union not only helps strengthen the role of the infrastructures but also increases the competitive pressures weighing on them. In general terms, the third-country regimes specified in the various concerned European texts merit being rethought; on 27 February 2017, the European Commission also published, an assessment of the equivalence mechanism in the various texts related to financial services.

This European approach, based on an outcome-based equivalence, is not retained by all the jurisdictions: thus, certain jurisdictions apply their own rules to third-country infrastructures, while others allow some form of substituted compliance but carry out a line-by-line evaluation or do not waive their right to supervise these infrastructures.

While the AMF has substantial experience in terms of cooperating with third-country infrastructures' regulators, the initiative and the assessment of equivalence now rests with the European Commission. As such, this mechanism is relatively new, and its recent implementation for third-country CCP has revealed possible areas for improvement.

The profound change in the industry of post-market infrastructures, the competitive pressures to which they are subject but also the concentration of risks in these infrastructures make these improvements all the more necessary. The United Kingdom's exit from the European Union obviously cannot be disregarded having regard to the volume of activity represented by the London market and the number of infrastructures based there.

In addition, aside from the precedents from which a number of lessons may be learnt, the AMF takes the view that the current context necessitates a review of the equivalence procedure for all the texts applicable to post-market infrastructures. To this end it has made recommendations in a document published today (*Third countries: What form of equivalence for post-market infrastructures?*).

These recommendations are aimed at rationalising the equivalence process, setting out the criteria to be taken into account by the European Commission in the initial evaluation, and strengthening this initial evaluation as well as the equivalence monitoring mechanism over time to prevent regulatory or competitive biases becoming established over the long term. The role of ESMA should be also enhanced. The size of the infrastructures should be taken into account to distinguish in particular between (1) infrastructures whose activities on euro denominated products are critical for the European Union should not benefit from the equivalence regime (2) infrastructures of significant size that should be the subject of an approach based on line-by-line equivalence and supervision by ESMA and (3) smaller infrastructures for which the outcome based evaluation should prevail. Reciprocity should in each case be an indispensable condition of equivalence.

2.2. Infrastructures of critical importance that carry out activities denominated in euros need to be located in the European Union

Brexit potentially leads to an unprecedented situation in which the equivalence regime could be applied to third-country infrastructures first and foremost offering their services in the European Union. This equivalence regime was not conceived for this purpose; on the contrary, it is a mechanism conceived to be applied in infrastructures that do not significantly offer their services first and foremost in the European Union, and hence more for the purposes of control of risk taken by European market participants in these infrastructures and not for regulation of these infrastructures.

The application of the third-country regime to CCP that clear euro denominated products and trade repositories presents risks in terms of financial stability, fragmentation and data protection and exploitation in a context of competition between financial centres.

These risks must be assessed according to the volume of activity in euros represented in particular by the London market and the number of infrastructures based in the United Kingdom. This potential situation would be in fact quite unprecedented, since it would result in the application of the third-country regime to a state that now concentrates, in actual fact, the largest volumes of activity in euros particularly for clearing OTC derivatives and reporting transactions on derivatives. This regime, which has not been conceived to that end, is not suitable for managing such risks for the financial stability of the European Union.

The AMF takes the view that it is undesirable to apply the equivalence regime when the infrastructure clears products denominated in euros and which represent volumes such that pose a stability risk for the European Union.

For example, given the volumes currently cleared in London, and if the United Kingdom benefited from the equivalence regime arising from the status of third country, the largest positions of clearing members and European clients would be cleared in infrastructures that would not be, in the future, supervised in the European Union. These extraneous factors can be sources of day-to-day concerns for the supervisors of these entities and exacerbated in the event of a crisis if it was necessary to access to ECB liquidity, particularly since the equivalence regime of the CCP specified in EMIR does not require the existence and equivalence of a regime for the recovery and resolution of third-country infrastructures.

The same observation can be made for trade repositories that cease to be directly supervised by ESMA. It will in fact be necessary to reflect on the appropriateness of seeing most of the European data declared in an entity subject to requirements and supervision that may be different from those specified in the European Union, whilst the access to these data is fundamental to the accomplishment of their mission by regulators.

The AMF takes the view that for their euro denominated activity, these infrastructures must be located in the European Union even though variants can be envisaged in its implementation.

3. The AMF will pay particular attention to client clearing

The prospect of implementing the central clearing obligation has highlighted areas of friction between the regulations: EMIR is in fact a cross-functional text that applies to contracts, but regulations tend to be elaborated in isolation, giving rise to inconsistencies, particularly with the rules specified by the UCITS and AIFM directives.

Similarly, the prospect of central clearing in the area of OTC derivatives, which is completely unprecedented for clients, has likewise revealed new legal and financial models capable of giving rise to difficulties of interpretation as regards the role and exact obligations of the clearing member.

3.1. The consistency of UCITS/AIFM and EMIR regulations needs to be improved

The UCITS directive specifies various provisions whose articulation with the obligation for central clearing of OTC derivative contracts raises difficulties that need to be remedied by amending the UCITS directive:

- Limitation of the counterparty risk of UCITS that conclude OTC derivative contracts to 5% or 10%: when these contracts are cleared under EMIR, the funds are forced to concentrate their transactions with a restricted number of players (clearing members and central counterparties), which jeopardises the funds' ability to respect these ratios. When the derivative contracts of a UCITS are cleared with respect to authorised or recognised central counterparties under EMIR, an alternative approach with a specific ratio needs to be adopted, and the method of segregation should be taken into account.
- The obligation for UCITS of ensuring that the OTC derivative contracts concluded can be sold, liquidated or unwound by a symmetrical transaction, at any time and at their fair value: inclusion of such clauses in derivatives subject to central clearing would now be impossible, on account of the functioning of clearing members and central counterparties. It is therefore necessary to provide a derogation for contracts subject to central clearing given the liquidity of these products.
- The obligation for UCITS to only conclude OTC derivative contracts with institutions subject to prudential supervision and that belong to categories approved by the competent authorities of the UCITS (the 'eligible counterparties'): UCITS may conclude OTC derivative contracts only with institutions whose financial strength is ensured by a specific regulatory framework, recognised at national level. With central clearing, the clearing house itself, or the clearing member, or indeed a client of the latter, become the counterparties of the funds. This could threaten the ability of UCITS to clear certain contracts.
- UCITS are subject, under the sectoral regulations, to constraints concerning the to reuse collateral. These constraints include in particular (i) a ban on selling, reinvesting or pledging financial guarantees other than in cash and (ii) strict requirements on the possibilities of reinvesting financial guarantees in cash. These latter requirements are intended to ensure that collateral in cash is not invested in a risky manner liable to threaten its recovery. When the fund has opted for individual segregation, the obligations applicable to CCP make it possible to guarantee, in principle, that the fund will be able to recover its assets. The AMF also takes the view that it is important to expand the possibilities for using the guarantees received by a UCITS to meet the clearing obligation.

Similarly, the categorisation of securitisation vehicles needs to be improved. EMIR does in fact include within 'financial counterparties' AIFs managed by fund managers authorised under the AIFM directive. Those excluded from 'financial counterparties' are therefore AIFs whose fund manager is not authorised under this directive. Securitisation vehicles are currently categorised as 'non-financial counterparties' for the purposes of EMIR.

While more flexible preferential treatment does not seem justified for non-STS vehicles, simple, transparent and standardised (STS) securitisation vehicles conclude OTC derivative contracts only for hedging purposes, on exchange rates or interest rates. For this reason, and given the rules of transparency and the constraints on the simplicity of the structures to which they will be subject, it would be appropriate to adopt with respect to them the categorisation of 'non-financial counterparty' with a view to submitting them to the strengthened regime specified by EMIR, particularly for the exchange of margin, only if the volume of their portfolio of derivatives is liable to generate significant risks. Conversely, for a securitisation that does not meet the conditions to be categorised as STS, there is no reason to apply a more favourable regime than that specified for investment funds. They should therefore be systematically categorised as 'financial counterparties' and be subject to the relevant obligations. The EMIR review should offer the opportunity to clarify the current categorisation of non-financial counterparty for non-STS securitisation vehicles.

3.2. Clearing members' obligations need to be clarified and strengthened at European level

With EMIR having forced clients to have recourse to CCP, improved accessibility for asset management players should be guaranteed. Professionals have in fact mentioned significant obstacles threatening the ability of asset management players to comply with the central clearing obligation:

- offers of segregation remain not readily comparable between the various clearing members; tariffs would be very variable and likewise not readily comparable. The price imposed in particular for individual segregation by clearing members is, according to these players, prohibitive;
- certain clearing members could, for legitimate reasons linked to credit risk management , refuse certain funds or small credit institutions as clients on account of the excessively low volumes of contracts to be cleared or the risk profiles presented by these clients. They may also limit the volume of contracts that they agree to clear. The same reasons may lead members to apply stricter collateral requirements than those of the central counterparty. These reasons are legitimate and are part and parcel of an institution's management of its risks. On the other hand, these practices may lack the predictability and readability for buy side players;
- the relationship between the clearer and its client is not regulated at European level, unlike the approach retained in certain jurisdictions (for example the status of FCM in the United States), which may introduce a certain degree of confusion over the exact role of the clearing member. Introduction of the principal-to-principal model for clearing OTC derivatives has complicated the question, the agency model being predominant in the market for listed derivatives.

For the AMF, it is appropriate to propose obligations to improve disclosure to and protection of the clients of these clearing members, following the example of the US regulations that provide a status of Futures Commission Merchant (FCM) which is bound in particular by a certain number of disclosure obligations with respect to the client. Such obligations would make it possible to clarify clearing members’ obligations with respect to their clients, make these obligations homogeneous between the various European countries and ensure improved predictability for clients.