Challenges and priorities in the regulation of EU post-trade infrastructures

This document was drafted by Eurofi with input from its members. It does not engage in any case the EU Polish Presidency or the Polish financial authorities.

Context:

The Commission published the draft EMIR (European Market Infrastructure Regulation) in September 2010, a project to regulate OTC derivatives, central counterparties and trade repositories. The regulation when finalised will introduce an obligation to report information on OTC derivative contracts to trade repositories which should be accessible to supervisory authorities, a clearing obligation for eligible OTC derivatives, measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives, common rules for central counterparties (CCPs) and for trade repositories, and rules on the establishment of interoperability between cash CCPs.

Although EMIR was originally focused on OTC derivatives it also provides rules for regulating the main activities of central counterparties and trade repositories in the EU and their interconnections with other infrastructures which may apply in the future to other instruments.

A draft version of EMIR was adopted in May 2011 by the ECON Committee of the EU Parliament but negotiations with the Council will not start until after the summer. EMIR is scheduled to come into force by the end of 2012 and as a regulation will apply directly in member states without the need for transposition.

In parallel the EU Commission has launched an initiative to regulate CSDs (Central Securities Depositories) on a EU level and to harmonize certain aspects of securities settlement in the European Union. A consultation was conducted at the beginning of 2011 and the draft legislation is due to be published by the EU Commission in November 2011.

CSDs allow the registration, safekeeping, settlement of securities in exchange for cash and efficient processing of securities transactions in financial markets. They assume a critical role in guaranteeing a safe and efficient transfer of securities that now exist to a large extent only in book entry form. Given the systemic importance of CSDs, the Commission believes that there is a strong need for an appropriate framework for CSDs.

The EU Commission is proposing a common legislation for EU CSDs that would include common definitions of CSD services, common rules on authorization and on ongoing supervision of CSDs, high prudential standards for CSDs and rules on access and interoperability. In addition measures are envisaged to improve the functioning of securities settlement following up on the initiatives conducted to lift the legal and technical Giovannini barriers (eg measures to improve settlement discipline and harmonise settlement periods which vary at present between EU member states)[1].

The T2S (Target 2 Securities) platform being developed by the ECB to facilitate and harmonize settlement across EU markets is due to be implemented by the end of 2014. It will strongly impact CSDs by processing in a centralized way the settlement of EU securities on a DVP mode and in central bank money. Negotiations with CSDs are still on-going as well as discussions on the extension of T2S to other currencies than the Euro. T2S is expected to foster cross-border settlement and to lead CSDs to develop additional custody services.

On-going market developments such as the emergence of more silo organizations (ie stock exchanges controlling a central counterparty and / or a CSD) and transatlantic or regional stock exchange mergers could also have a strong impact on the functioning and business model of post-trade infrastructures and may therefore need to be taken into account in the developing legislation.

The current projects for regulating CCPs and CSDs have in common the objective of developing an appropriate regulatory framework for post-trading activities in order to improve the integration, efficiency and safety of EU post-trading processes and share questions as to how more competition can develop in the post-trading space in a safe way. The pending issues regarding clearing on one hand and settlement on the other are however quite different given the specificities of these activities and the differences in the timetables of the two legislative texts.

Issues remaining to be clarified regarding the CSD legislation project:

Regarding CSDs many issues remain to be clarified particularly given the differences in the views expressed by custodian banks, CSDs and ICSDs in the consultation recently led by the EU Commission. At this stage, the main ones are:

- The types of services that should be recognized as core or main CSD functions in the CSD legislation (ie the notary function, the settlement function, the safekeeping function), the way they should be defined and what exactly they cover
- The scope of the legislation: should the CSD legislation regulate functions or specific entities? How should the non core services performed by CSDs be addressed in the legislation?
- The measures required to ensure the safety of CSDs performing a more diversified range of activities: the extent of a possible

1. The settlement period is the time between the conclusion of a transaction and settlement. Currently, European securities markets do not follow a common settlement period (e.g. for equities, regulated markets either settle two days or three days after trade (T+2 or T+3)).

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CSD license, the possible need for a banking license and for what kind of activities …

- Whether the combination of T2S and the proposed CSD legislation will increase competition among CSDs and possibly with other players (custodians, local agents) and what this could entail

- Whether the current measures regarding CSDs can achieve a sufficient level of harmonization.

Main outstanding issues regarding EMIR and CCPs:

Several outstanding issues remain to be solved regarding EMIR, but they mainly concern the political positioning of the regulation, the timing of its implementation and discrepancies between approaches in the EU and the US. On the technical side, most questions have now been solved:

- The scope of the EMIR legislation: should it be limited to OTC derivatives, or extended to all derivatives? The EU Parliament, according to the rapporteur of the text W. Langen, is in favour of limiting the scope of EMIR to OTC derivatives in line with G20 requirements. Mr Langen recently asserted this position in a response to T. Geithner's letter sent to the Hungarian Presidency urging the EU to extend the scope of EMIR to exchange-traded contracts in order to avoid regulatory arbitrage and loopholes. Meanwhile the idea of enlarging the scope to all derivatives to include exchange traded ones has been supported by several public stakeholders in the EU.

- Concerns have been expressed by several member states regarding the division of responsibility in the implementation and ongoing application of regulation between ESMA and the regulatory bodies of each member state. This has been most apparent in proposals from some member states to reduce the role of ESMA in favour of an increased responsibility for the local regulator, in the authorisation of CCPs.

- How to ensure sufficient consistency between EU and US legislations regarding derivatives clearing: apart from the issue mentioned above divergences between US and EU legislative projects are reported in several key areas including rules on membership and access to clearing houses. This creates uncertainty as to what rules will apply to cross-border business (ie the rules of the jurisdiction where the infrastructure provider is located, those of the intermediary or those of the client) and potential issues if the rules decided are incompatible. These issues should be addressed by a specific joint EU / US working group.

- How to manage the extra-territorial provisions of the Dodd-Frank Act (DFA) and ensure sufficient international consistency of rules related to OTC derivatives. Although there is some uncertainty as to how extra-territorial provisions of the DFA might be applied, non-US regulators will potentially be faced with indemnification requirements when accessing US-based trade repositories, possibly impeding the development of global trade repositories. In addition. EU dealers selling derivatives to US-based counterparties may also be required to comply with DFA rules for collateral and margin requirements leading them potentially to provide collateral both in the jurisdiction where they operate and in the US.

- Whether the risk management measures defined in EMIR are sufficient to mitigate the potential systemic risks created by mandatory clearing of eligible OTC derivatives and the resulting concentration of positions in CCPs.

In addition a certain number of other issues need to be addressed regarding efficiency improvements that were not directly covered by the scope of EMIR:

- How to implement interoperability among CCPs for cash instruments[2]. Interoperability of CCPs is considered by many observers as a key step towards developing competition between central counterparties since it allows users of trading venues to clear through the central counterparty of their choice, Implementing interoperability requires that CCPs interconnect but also obtain non-discriminatory access to trade feeds from the stock exchanges. So far progress has been very limited since there is no particular incentive for CCPs to interoperate, particularly where they have an exclusive relationship with a particular trading venue, such as that found in a vertical silo. Some observers believe that the announcement by some MTFs such as BATS to introduce a "preferred CCP" concept may trigger some progress.

- How to move towards more harmonization in the clearing space: a certain number of operational questions, which were not covered by EMIR need to be further worked on: for example pending issues regarding the lifting of the technical and legal Giovaninni barriers, cross-EU collateral arrangements, differences in insolvency provisions across EU member states…

2. As for interoperability among CCPs for derivatives, it is acknowledged both by regulators and the market to exacerbate systemic risks. Mitigating these risks is a pre-requisite before pursuing developments in this area according to most players.