18 July 2017

London Stock Exchange Group

London Stock Exchange Group response to the European Commission proposal for a regulation amending EMIR (Part I – REFIT)

Introduction

London Stock Exchange Group ("LSEG" or "the Group") is a financial market infrastructure provider with significant operations in Europe, North America and Asia. Its diversified global business focuses on capital formation, intellectual property and risk and balance sheet management. LSEG operates an open access model, offering choice and partnership to customers across all of its businesses.

LSEG operates today multiple clearing houses. It has majority ownership of the multi-asset global CCP operator, LCH Group ("LCH"). LCH has legal subsidiaries in the UK (LCH Ltd), France (LCH S.A.), and the US (LCH LLC). It is a leading multi-asset class and international clearing house, serving major international exchanges and platforms as well as a range of OTC markets. It clears a broad range of asset classes, including: securities, exchange-traded derivatives, commodities, energy, freight, foreign exchange derivatives, interest rate swaps, credit default swaps and euro, sterling and US dollar denominated bonds and repos.

In addition, LSEG operates Cassa di Compensazione e Garanzia S.p.A. ("CC&G"), the Italian clearing house, providing clearing services for a range of European securities as well as exchange traded equity and commodities derivatives.

The Group also includes Monte Titoli, a CSD successfully migrated in Target 2 – Securities settlement platform; and globeSettle, the Group's CSD based in Luxembourg.

LSEG further operates UnaVista Ltd ("UV"), an authorized and regulated EMIR trade repository ("TR") operating across all asset classes for both exchange traded derivatives ("ETD") and over the counter ("OTC") derivatives.

In this context, LSEG welcomes the opportunity to respond to the European Commission legislative proposal amending EMIR.

Part A. General remarks

LSEG is fully supportive of the G20 commitments to promote financial stability and reduce systemic risk in the OTC derivatives markets. In line with these commitments, EMIR introduced significant improvements to financial markets, such as increased transparency and standardisation in derivatives markets. EMIR framework has strengthened the resilience of CCPs and the financial system and we share the European Commission's view that no fundamental change should be made to the nature of its core requirements.

As expressed in its report of November 2016, we share the Commission's aim to simplify and increase the efficiency of the requirements where possible, and to keep costs and burdens proportionate. We are very grateful to be able to respond to the Commission's proposal and provide feedback on the legislative proposal.

In line with this background, we would like to share the following views on the adjustments proposed by the European Commission:

1. **Pension Scheme arrangements (PSA):** We welcome the extension of the exemption for pension funds from the clearing obligation by 3 years. We support a global solution to facilitate PSA access to clearing and requisite liquidity, involving CCPs, PSA and clearing members, and suggest considering a wider range of participants, such as Central Banks and third party providers (e.g. commercial banks).

2. **Small financials:** Exempting a large subset of small financials counterparties from the clearing obligation goes against the general G20 principle, and the introduction of materiality thresholds should be handled with care to ensure the aggregate level below the clearing obligation remains immaterial, be it at product, country or asset class level. ESMA seems best placed to ensure the right level of any threshold and has already provided detailed figures on the matter. We respectfully suggest that ESMA utilises its access to trade repositories data and experience studying the market structure (in particular when determining the need for clearing obligations), to determine the scope of any so-called 'small financials' category.

3. **Suspension of the clearing obligation:** We understand and support the need for a suspension of the clearing obligation under very specific and limited circumstances. Such exemption is expected to materialise as a macro-prudential response involving all relevant authorities under remote circumstances resulting from significantly disruptive market events. As such, the text would benefit from clarifying the capital treatments during an exemption, to avoid unintended knock-on impacts.

4. **CCP transparency:** We welcome the proposal for increased transparency and simulation tools as a means to assist members to manage their margin requirements. However, full public transparency of clearing models can have unintended consequences (such as creating conditions for adverse selection and moral hazard based on margin levels) and should be framed appropriately in order to avoid any detrimental effect on market stability. As for the need to restrain CCPs from modifying their initial margin models in ways that could appear

procyclical, we would like to highlight that CCPs are subject to a high level of supervisory oversight provided by both the regulators and CCP risk governance (which includes clearing member representations). Such oversight offers a degree of assurance to clearing members in situations where full transparency is not advisable for the reasons mentioned above.

5. **Amendments with a view to incentivise clearing and to increase access to it:** We are supportive of the codification of the requirement for clearing members and clients which provide clearing services, to provide those services under fair, reasonable and non-discriminatory commercial terms. We equally support Commission objectives to ensure that CCPs can transfer client positions where a clearing member defaults, or pay the proceeds of a liquidation directly to clients. However, the proposed drafting would in fact impede a CCP's ability to manage liquidity and porting during default, and negatively impact its ability to meet liquidity obligations under EMIR. We would therefore suggest revisiting the wording of such amendment in a more granular manner in order to provide further clarity with respect to its legal effects, as explained in Part B below.

6. **Amendments to the reporting obligation:** We support the Commission in its efforts to streamline reporting requirements to ensure proportionality and reduce costs for counterparties. However, we are concerned about certain aspects of the proposal related to CCPs being responsible and legally liable for reporting of both legs of ETDs which would benefit from further clarification.

Part B. Specific comments

1. **Pension Scheme Arrangements ("PSA")**

There is a long-standing issue around the development of practical solutions for pension funds to access clearing services due to their investment structure.

We believe the **exemption for pension funds from the clearing obligation is relevant until an appropriate market solution (including guaranteed access to repo facilities in all market circumstances) is organised to facilitate their access to clearing**. There are significant benefits to clearing, including decreased counterparty risk, better execution pricing, enhanced risk management processes and increased transparency. If pension funds can't appropriately access clearing and requisite liquidity, their derivative transactions will have to remain in the bilateral world, with reduced transparency and increased counterparty risk. This would also imply higher costs of hedging for pension funds, which would be at odds with the objectives of the Commission.

We consider that the proposal of the Commission is well balanced as it sets a reasonable timeframe of 3 years to overcome clearing access challenges, while maintaining clearing objectives in line with the G20 commitments.

As the necessity to maintain the payment of cash-only VM for risks reasons cannot be solved by a CCP technical solution, both pension funds and CCPs believe that we should consider the involvement of a third party to ensure that pension funds would **access on a reliable and consistent manner facilities allowing the repo of Pension Funds' assets against cash**. This would allow pension funds to post adequate variation margins to the CCPs without changing their investment profile or introducing undue risks in the CCP risk management.

Indeed, when considering requiring CCPs to accept non-cash variation margins, as suggested by Article 85(2)(a), one has to be mindful that this would fundamentally change their business model and risk profiles and have systemic implications for the CCPs and their membership and clients:

- **Imposing CCPs to accept non-cash collateral for variation margin would fundamentally change CCP business model and risk profile.** One of the features of the CCPs' business model is the facilitation of multilateral netting and the passing through of variation margin amongst the clearing members on a daily basis. If non-cash collateral is accepted for variation margin, CCPs would have to run an investment book consisting of securities sales and repurchase agreement in order to convert the non-cash assets provided by the pension funds as variation margins to pay out cash to facilitate to the variation margin gainer. **This would directly expose CCPs to market and counterparty credit risks** on these investments: in case of underperformance of the investment the CCP would not have the necessary cash to facilitate pension funds' posting of non-cash collateral as variation margin. This would thereby (i) compromise the CCP's own risk metrics (ii) force the pension fund to default on its obligations to the CCP to post variation margins. **Such arrangement would be dangerous for a CCP's resilience as it undermines the premise of maintaining a <u>neutral flat book</u>, increases its exposure to <u>non-default loss</u>, and alters its role as a <u>pass-through entity</u>.** These additional risks are driven by the investment choices of the PSA, and it is therefore inappropriate for the CCP to be made responsible for them.

- **It may be possible to develop new membership models to accommodate the requirements of large PSAs, and these must be consistent with current CCP risk management standards and must respect the risk profile of existing members. Such model could address some challenges but does not itself fix the cash collateral transformation issue.**

There are viable market based solutions available to pension scheme arrangements for cash transformation. A number of third party providers operate business models to convert non-cash collateral into cash, and are used by many non-pension fund arrangements (often through prime brokerage arrangements). Use of these commercial arrangements or ad-hoc arrangements with central banks (at least as a last resort, in case of reduced market liquidity) would be a more appropriate vehicle for pension funds to convert their assets into cash available for variation margins.

The task of identifying potential technical solutions should not be assigned solely to CCPs and PSAs. In this sense, the proposal of the Commission is helpful, as it includes clearing members as potential actors to find technical solutions facilitating PSAs access to clearing. **However, clearing members are not the only alternative, and a wider range of entities should be considered (e.g. central banks, third party providers etc.). <u>Article 85(2) should allow for a broader review of viable technical solutions.</u>**

2. Small financial counterparties

EMIR requires all financial counterparties, regardless of the size of their derivative portfolios to clear transactions pursuant to clearing requirements. This obligation is phased-in by types of financial counterparties based on quantitative thresholds of clearing activity. In its proposal amending EMIR, the European Commission proposes to introduce clearing thresholds for financial counterparties by reference to the current thresholds applicable to non-financial counterparties.

Small financial firms struggle with accessing clearing services, either directly as clearing members or indirectly as clients of clearing members, to cover risks related to their portfolios. The extent of client clearing offered by clearing members is not currently sufficient to meet the market demand of all potential clients and the costs can still be seen as significant for small financials.

However, any permanent exemption would run contrary to the G20 commitments, and maintain bilateral transactions with reduced transparency and increased counterparty risk. **An exemption from the clearing obligations is not appropriate in our view. Instead, reasonable phase-in periods to allow small financials to arrange client clearing structures would be the most efficient course of action.** This would enable progress on removing impediments to clearing access, notably revisions in the regulatory capital structure as rightly pointed out by the European Commission in the explanatory memorandum.

If **thresholds** for financial entities were to be introduced as proposed by the European Commission, it **should be carefully and specifically assessed. A simple reference to the**

threshold for non-financials might indeed not be appropriate depending on elements of the market structure such as: jurisdictions, products and distribution of trade participants.

For example, there are certain member states where relatively small financial counterparties constitute the majority or the entirety of trade participants, as highlighted by ESMA in its [Consultation paper on the clearing obligation for financial counterparties with a limited volume of activity](). The consequence is that, in those countries, exempting small financial counterparties without considering the market structure could result in exempting the entire member state from the application of the clearing obligation. The calibration of a threshold should avoid such situation, and we would advise to adapt the Proposal in view of the concrete and accurate data developed by ESMA in this consultation paper.

3. Suspension of clearing obligation

Under EMIR, the suspension or the termination of the clearing obligation for a specific class can only be performed through the amendment of the relevant Regulatory Technical Standards. Such amendment could take up to several months through the standard legislative validation cycle.

We therefore understand the view of certain authorities and market participants that there might be a need for specific tools or emergency powers, to suspend a clearing obligation within a shorter timeframe, if appropriate. However, we believe it should only be used in very specific and **remote circumstances resulting from significantly disruptive market events such as the resolution of a CCP.** The central clearing mandates result from the G20 commitments and are established to secure market stability, the suspension of such mandates should be decided from a **macro-prudential perspective, and be the result of dialogue and discussions between all relevant authorities** potentially impacted by the decision. Elements of consideration could include the benefits of central clearing in terms of systemic risk reduction, the current market conditions, the implications of reverting to bilateral transactions and the corresponding margining framework.

Finally, **suspension of clearing obligations could have a knock-on impact on capital requirements**, which should also be taken into account. The proposal would benefit from greater clarity on this aspect.

4. Amendments to requirements for CCPs' transparency

We welcome the Commission's proposal for increased transparency in CCPs margin models. Clearing members should be in a position to assess the potential impacts of bringing new positions to a CCP and understand the underlying model driving their margin requirements. However the Commission's proposal would benefit from additional clarity in the level and way such information is disclosed.

There are **key concerns about the level of information which should be considered public**, limited to clearing members and that which is the private intellectual property of the CCP. Further, publicly divulging all sensitive information could have **unintended consequences** and lead, for example, to reverse-engineering of margin requirements, create adverse selection of CCPs or products cleared and induce moral hazard behaviours, thereby **undermining the actual robustness of the CCP**. As for the need to restrain CCPs from modifying their initial margin models in ways that could appear procyclical, we would like to highlight that CCPs are subject to a high level of supervisory oversight provided by both the regulators and CCP risk governance (which includes clearing member representations). Such oversight offers a degree of assurance to clearing members in situations where full transparency is not advisable for the reasons mentioned above.

We, therefore, welcome the fact that the simulation tool is only accessible on a secured access basis and the results of the simulation shall not be binding. However these conditions should be extended to information CCPs have to provide on the initial margin models they use. A tailored approach to these disclosures, such as **restricting some information to be accessible on a secured access basis, would bring additional flexibility in the communication channels**, without undermining the desire for transparency. These communications should indeed allow clearing members to predict more accurately the margins they would be expected to post with the CCP, but should not allow the broader market or other actors to put pressure on certain aspects of the margin models, potentially affecting the dynamics of the market. In this sense, Article 38(7) needs to be framed appropriately.

Finally, it is not clear to us what the "**gross basis**" refers to and would suggest clarifying the requirement. In particular, we suggest specifying whether this requirement refers to the additional initial margin requirement applicable to each single new transaction cleared by the CCP, or rather to the new transaction aggregated on a portfolio basis (in which case calculated solely on the positions within that particular portfolio).

5. Amendments with a view to incentivise clearing and to increase access to it

We are supportive of the proposed amendments which would incentivise the use of CCPs and, facilitate access to a clearing route. In particular, depending on how it is specified in the Commission's delegated act, the requirement for clearing members and clients which provide clearing services to provide those services under fair, reasonable and non-discriminatory commercial terms is likely to help develop more client clearing and indirect clearing offer, if it is backed by an appropriate capital treatment of clients margins under CRR.

We support the <u>aim</u> of the clarification provided by the proposed Article 39(11) that assets held in omnibus or individually segregated accounts are insolvency remote as there was legal uncertainty on the matter. This uncertainty has kept (amongst other things) clearing members from accepting portability arrangements. Offering certainty to clients and indirect clients that in the case of default (of either a clearing member or a client providing clearing services), their assets are protected and can, thus, be ported to other clearing members or clients that provide indirect clearing services provides undeniable incentive for the development of such arrangements, central to default management. **We welcome the <u>aim</u> of the proposal as described in recital 18 to promote legal certainty in default management, hence contributing to safer and more efficient markets.**

That said, in our perspective, the current drafting introduces new issues for CCPs.

Under proposed new article 39(11) of EMIR: "Where the requirement referred to in paragraph 9 is satisfied, the assets and positions recorded in those accounts shall not be considered part of the insolvency estate of the CCP or the clearing member". Under this proposal, all the customer positions and customer margin assets would be subject to this insolvency remoteness principle.

Under the CCP RTS (153/2013), article 45(2), CCPs must invest 95% of cash assets that they receive in non-cash assets. CCPs typically fulfil this obligation via repurchase agreements which means that the assets need to be transferred on the books of the CCP.

Increased ability to protect and port customer positions to reduce contagion is a goal that CCPs also pursue, but careful consideration should be put into the design of how these goals are achieved. Factors to consider include the cost and practicality of implementation, the legal certainty and enforceability of the arrangements across jurisdictions, and last but not the least, the impact to the CCPs should be analysed to ensure that the CCP's ability to manage liquidity and porting during default nor its ability to meet liquidity obligations under EMIR will not be negatively impacted.

We would therefore suggest revisiting the wording of such amendment in a more granular manner in order to provide further clarity with respect to its legal effects. In particular, we understand from recital 18 that the European Commission's intention was to **provide more legal certainty to CCPs so that they can transfer client positions where a clearing member defaults, or pay the proceeds of a liquidation directly to clients**. The amendment to article 39 EMIR should therefore clarify **that these mechanisms override national insolvency laws and avoid a general obligation that could affect other obligations of CCPs**.

6. Amendments to the reporting obligation

We support the Commission in its efforts to streamline the Exchange-traded derivatives (ETDs) reporting requirements to ensure proportionality and reduce costs for counterparties, while safeguarding transparent derivative markets in Europe.

Whist we agree with the principle of simplification, we believe that the Commission needs to clarify several issues before any obligation of this magnitude is put in place, in particular we would suggest considering the following, in order to maintain the ability to assess systemic risk:

- **Counterparty data:** we understand that the Proposal of the Commission would impose an obligation on CCPs to report both counterparty and transaction data. We are concerned that this would create undue duplications and significantly increase operational risk.
- **Client-level data:** Since we understand that CCPs would have to report counterparty data, we would like to point out that CCPs lack the visibility of the client leg trade (clearing member to client), particularly the collateral exchanged between them**.** The clearing members only report against the CCPs, and the CCPs only against the clearing members.
- **Third country CCPs**: A counterparty using a third country CCP would need to maintain the mechanisms and connectivity report and would not be able to benefit from this simplification.

Should the CCP indeed report both sides of a market side transaction, then the CCP would be free to choose the TR that it reported to, in order to avoid increased costs stemming from connecting to several TRs.

We support the proposal for FCs to report both legs of a FC-NFC(-) OTC trade. We believe that this would provide an appropriate degree of proportionality for non-financials, reduce burden and costs, without affecting the stability and transparency of the European derivative markets. **We also welcome expanding the definition of FC** to include AIFs and SSPEs whereas **we oppose the inclusion of non-bank CSDs** within the financial counterparties definition, since those entities do not bring systemic risk for the financial system.

We support the proposal for removal of intragroup transactions where at least one party is NFC. We agree that such trades represent a relatively small proportion of all OTC derivative transactions, it is used mainly for hedging and do not significantly contribute to systemic risk.

We welcome that certain backloading is no longer required. Removal of the reporting obligation of the historical transactions entered into on or after 16 Aug 2012, but no longer outstanding on 12 Feb 2014, will ease the burden on market participants. We acknowledge the need to backload the rest of the transactions.

We welcome the clarifications that the management company or the manager has the responsibility for reporting in UCITS and AIF derivative transactions.

We understand that the European Commission strives to improve the quality of data reported to trade repositories. Therefore, the TRs have been supportive and been establishing procedures for reconciling (i.e. cross-checking and comparing) data with other trade repositories in cases where the other counterparty reported their side of the transaction to a different trade repository. We also understand that TRs will be required to allow counterparties which delegated reporting to another entity to view the data which was reported on their behalf.

We believe that data quality responsibilities cannot be outsourced solely to TRs. TRs enforcing the quality of the data reported is not an efficient method of addressing the data quality concerns. Requiring TRs to detect potential errors (especially since they may not be aware of the nature of the reporting counterparty) is an abrogation of responsibility by the NCAs. Trade repositories have no power to force firms to correct their data; we would suggest that this is an area where the NCAs have to take ownership of the issue. Any additional resources TRs would have to deploy to satisfy this responsibility, would naturally translate into higher costs for reporting firms. These additional resources could not work as efficiently as NCAs (not having the powers and local knowledge of the NCAs)

We welcome that he scope of the technical standards on reporting which ESMA can develop is expanded to allow further harmonisation of reporting rules and specification of the details of the new requirements for trade repositories. In particular we welcome covering data standards, including entity, instrument and trade identifiers, and the methods and arrangements for reporting.

- We suggest ESMA works alongside the TRs on establishing procedures for the orderly transfer of data to another trade repository following customer requests. Mandating

TRs to create these standards among themselves is not sufficient (e.g. the recent ESMA CP on the topic)
  - We suggest ESMA pursues the current market standards, i.e. ISIN, LEI as standardisation in the field of identifiers is the most cost effective approach.

We believe *tenfold* increase of the upper level of fines of TRs is not constructive against the backdrop of the new requirements. The Commission has proposed increasing the upper limit of the basic amount of fines ESMA can impose on trade repositories, with the aim of increasing the deterrent effect of the sanctions system.

We call for further synergies between the EMIR and SFTR TR models. While we welcome the proposal to introduce a simplified application process for the extension of registration for trade repositories that are already registered under SFTR, we would appreciate further confirmation regarding effectively no need for their operational separation.

We acknowledge the Commission intention to reduce barriers to access between EU and third country TR data

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We hope that the European Commission finds this submission useful and we look forward to engaging further as policies are developed. Should you have any questions on the response or wish to discuss it in detail, please do not hesitate to contact us at Corentine Poilvet-Clediere: cpoilvetclediere@lseg.com; Fabrizio Plateroti: Fabrizio.plateroti@borsaitaliana.it; Jean-Philippe Collin: jean-philippe.collin@lch.com; Julien Jardelot jjardelot@lseg.com; Quentin Archer: qarcher@lseg.com; Isabella Tirri: Isabella.Tirri@lseg.com; Paola Fico: paola.fico@borsaitaliana.it