**European Securities and Markets Authority** ([www.esma.europa.eu](http://www.esma.europa.eu))

Response of the Institute for Agriculture and Trade Policy to the ESMA Consultation Paper: “Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion of provisions of EMIR [European Markets Infrastructure Regulation]”

September 16, 2013

The Institute for Agriculture and Trade Policy (IATP) is a nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minn., with an office in Washington, D.C. Our mission states, “The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems.” To carry out this mission, with regards to Over the Counter derivatives market regulation, IATP has submitted several comments on U.S. Commodity Futures Trading Commission rulemaking, and on consultation papers of the International Organization of Securities Commissions, the European Securities and Markets Authority and the European Commission’s Directorate General for Internal Markets.

IATP is grateful for the opportunity to comment on this Consultation Paper, which seeks responses to questions concerning Regulatory Technical Standards (RTSs) to implement the European Markets Infrastructure Regulation (EMIR). These RTSs concern the specification of contracts whose cross border transactions by non EU counterparties may have a “direct, substantial and foreseeable effect within the Union”. The RTSs also concern specification of those contracts whose design and/or implementation results in the evasion of EMIR clearing, trade data reporting, margin collateral and other requirements.

ESMA further requests stakeholders to provide quantitative cost-benefit data to support the Impact Assessment statement whose requirements are outlined in Annex III of the Consultation Paper. ESMA describes cost-benefit analysis as “one essential element” (executive summary) of the RTS.[[1]](#endnote-1) The data is requested to help ESMA carry out a cost benefit analysis of the application of EMIR to cross-border transactions with counterparties outside the European Union. Our comment begins with general remarks on the quantitative cost benefit analysis request, followed by responses to four questions in the Consultation Paper.

*General comment*

As you are aware, ESMA and other European financial regulators have been criticized for neglecting to put non-financial services industry representatives on advisory committees for EU financial reform, particularly of the Over the Counter derivatives market and OTC dealer brokers.[[2]](#endnote-2) IATP is neither European nor a financial services organization. We appreciate that ESMA wishes to elicit the views of financial services industry stakeholders on the cross-border compliance costs of OTC dealer brokers with EMIR. However, we hope that ESMA will take into consideration these comments of a public interest stakeholder concerned that the transatlantic resistance to effective regulation of cross-border OTC transactions leaves the financial system vulnerable to the herd behavior and rumor trading of markets that are still dark to regulators, as well as to retail market investors. The number and variety of foreign branches, subsidiaries, and affiliates of EU OTC dealer brokers presents a huge regulatory challenge to ESMA. The seven largest U.S. OTC dealer brokers have over 5,700 branches, subsidiaries and affiliates that conduct cross-border transactions within the parent firm, with other OTC dealer brokers and with non-financial corporations.[[3]](#endnote-3) The universe of OTC trading in the EU is very likely as large and complex, so we appreciate the difficulty of the task that the Commission has presented to ESMA.

U.S. regulators are besieged by estimates of financial firm compliance costs, which are inflated by including under “compliance” estimates of loss anticipated profits ‘lost’ due to ‘regulatory takings’. Indeed a major strategy of resistance to the implementation of the “Dodd Frank Wall Street Reform and Consumer Financial Protection Act of 2010” (DFA) has been to demand a priori “least trade burdensome” cost-benefit analyses for each and every major rule, even though U.S. financial regulatory agencies are not required by statute to carry out such analyses under Dodd-Frank.[[4]](#endnote-4) (The Commodity Exchange Act, which the DFA amends, does require post-implementation cost-benefit analyses of rules, once there is sufficient data to determine whether a rule requires modification.) Industry generally considers the costs of regulation to be “overly burdensome” while the benefits to the industry, as well as to the public, of a well-regulated financial services industry, are far more difficult to quantify.

We urge EMIR not to be persuaded to grant exemptions, exclusions and waivers to implement EMIR because of claims of regulatory costs (other than capital reserve, collateral and clearing costs), or the perennial industry threats of trade migration to so-called ‘light touch’ regulation jurisdictions.[[5]](#endnote-5) According to Simon Johnson, a former chief economist at the International Monetary Fund, foreign regulators and central bankers told him that cross-border regulation would “never” occur or “not in my lifetime.”[[6]](#endnote-6) IATP hopes that enforcement of stringent ESMA RTSs will help prove that prediction wrong.

Because IATP is neither an OTC dealer broker nor a non-financial corporation swaps counterparty, we will convey only briefly research of others on the requested quantified estimates of costs and benefits of OTC derivatives regulation as they pertain to the public. As the Financial Stability Board reported two weeks ago to the G-20 financial ministers, the Bank for International Settlements (BIS) has estimated the macro-economic benefit of OTC derivatives regulatory reform at about +0.12 percent of global Gross Domestic Product (central scenario).[[7]](#endnote-7) Econometric estimates based on policy scenarios and the past response of global counterparties to the default cascade make such estimates conjectural. But what IATP found particularly striking in the BIS report is that ***benefits were estimated to be about four times the costs of regulation***.[[8]](#endnote-8) From a macro-economic viewpoint and subject to scenario assumptions, the BIS finds quantified net benefit of the G-20 agreed OTC derivatives reforms to be large and compelling.

However, although ESMA references the FSB and BIS reports, ESMA wishes to have more “granularity” in its estimate of costs and benefits than what the BIS provides, and so requests quantitative estimates from its financial industry stakeholders. Given the October 1 deadline for ESMA to submit cross-border RTSs to the European Commission,[[9]](#endnote-9) the complexity of EMIR’s mandate to ESMA (Annex II of the Consultation Paper) and the myriad foreign affiliates of European OTC dealer brokers[[10]](#endnote-10), IATP believes that quantitative justification of the cross-border RTS is an exceedingly difficult task. To expedite that task, ESMA may aggregate the claimed costs to OTC dealer brokers of compliance with cross-border clearing, trade data reporting, margin collateral and capital reserve requirements to determine whether OTC regulation results in a net benefit. It should resist the temptation to make that determination in comparison to a baseline of purported benefits to industry of ‘light touch’ or unregulated OTC markets.

If ESMA decides to determine the net benefit of future cross-border OTC regulation in comparison to the era of ‘light touch’ regulation, it also should attempt to quantify the damage to the European Union economies of non-regulation and regulatory exemptions, exclusions and waivers (e.g. the Securities and Exchange Commission waiver of capital reserve requirements for Goldman Sachs and six other transatlantic OTC broker dealers[[11]](#endnote-11)) during the ‘light touch’ era. Absent a historical understanding of the costs of ‘light touch’ regulation to the European Union member states, a focus exclusively on the prospective claimed costs to industry in comparison to the ‘light touch’ compliance costs will yield a distorted quantified justification for the cross border RTS.

The U.S. General Accountability Office has estimated the damage to the U.S. economy of the financial services industry collapse in 2008-2009, largely triggered by OTC derivatives default cascades, to be about $13 trillion.[[12]](#endnote-12) We are unaware of a similar official European institutional study, but assume that ESMA can draw on academic estimates of the cost to the European public of ‘light touch’ regulation. And, of course, without the $19 trillion of U.S. Federal Reserve Bank ultra-low interest rate loans to U.S. and foreign Banks (about $8 trillion to European headquartered banks) and $10 trillion to central banks ($8 trillion to the European Central Bank alone) from 2007 to 2010, the economic damage would have been far greater.[[13]](#endnote-13)

According to a recent Bank for International Settlements report, “We find no evidence that that rescued banks reduced the riskiness of their new lending more than non-rescued banks in response to the crisis and the public rescues.”[[14]](#endnote-14) ESMA is bound by the EMIR mandate to provide an impact assessment of the cross-border RTS on non EU counterparties, including the foreign affiliates of EU OTC dealer brokers. But it must not ignore the benefits to the public of OTC derivatives regulation nor overlook the costs to the public of ‘light touch’ regulation applied to still unreformed OTC dealer brokers.

*Comments on ESMA questions and the Consultation Paper concerning contracts considered to have a direct, substantial and foreseeable effect within the Union*

The Consultation Paper responds to the desire for legal certainty by OTC dealer brokers and investors as to how cross-border transactions by non-EU counterparties, guaranteed against default by EU registered OTC dealer brokers, will be regulated. Article 13 of EMIR allows OTC transactions between such non-EU counterparties to be regulated under third country jurisdiction, provided that ESMA judges the third country’s regulatory regime to produce equivalent outcomes to EMIR regarding clearing, trade data reporting, margin collateral and other EMIR requirements. While the Consultation Paper flow charts provide clarity about the applicable regulatory jurisdiction, there is less clarity about what constitutes “equivalent outcomes” between that of EMIR and corresponding regulation in foreign jurisdictions and about how that equivalence determination will be verified.

ESMA has proposed that the “direct” effect of cross-border OTC dealing by counterparties guaranteed by an EU member country financial counterparty be defined in terms of the guarantee against counterparty default provided by that firm in a Derivative Master Agreement. To determine whether potential defaults will have a “substantial” impact on the EU headquartered OTC dealer, ESMA, per the EMIR mandate, quantifies “substantial”. Cross-border OTC transactions guaranteed by an EU financial counterparty will be exempt from the EMIR RTS unless “the amount of the guarantee should exceed two cumulative thresholds related to the value of the OTC derivatives contracts guaranteed and the value of the guarantee compared to the OTC derivatives activity of the EU financial counterparty providing the guarantee” (paragraph 27). The first of the cumulative thresholds is eight billion euros of gross notional value outstanding per EU financial counterparty. The second threshold that would trigger application of the RTS is if more than five percent of the EU financial counterparty’s total OTS activity is in cross-border transactions in non-EU jurisdictions guaranteed by the EU financial counterparty.

ESMA asks:

Q. 1 Do you agree that a full or partial guarantee issued to the benefit of a third country counterparty by an EU guarantor, whatever is its form, be considered in order to specify the direct, substantial and foreseeable effect of the contract?

Q 2. Do you agree with the 2 cumulative thresholds proposed in the draft RTF? Do you consider that the proposed value of the thresholds is set at an appropriate level in order to specify the direct, substantial and foreseeable effect of the contract? Please provide relevant data to justify your answer.

We do not have data to justify our answers to the latter question, which also bears on the former. This lack of data notwithstanding, we would like to raise a methodological question. ESMA adopts, on the grounds of “international consistency” (paragraph 28), the eight billion euro threshold from an agreement on “Margin Requirements for Non-Centrally Cleared Derivatives” by the members of the Basel Committee for Banking Supervision and the International Organization of Securities Commissions. The logical consequence of this adoption is that ESMA believes that the only risk to EU financial counterparties, and hence to the broader EU economy, is from non-centrally cleared OTC swaps. This belief ignores other sources of risk to the financial system as a whole that ESMA should consider in establishing the quantitative thresholds to define “substantial”, as required by EMIR.

Indeed, if the only sources of risk to EU financial counterparties in the RTS are uncleared OTC transactions, however defined and however much they may be guaranteed by the EU financial counterparty, the “foreseeable effect” of such transactions will be difficult to specify. Because ESMA’s proposed RTS allows the OTC dealer broker to define the legal nature of the guarantee and the amount of the guarantee, the heterogeneity of guarantees makes their aggregate effect, in the event of non-European counterparty defaults, all the more difficult to predict. Another methodological question obviated by the 8 billion euro de minimis, is whether the sub- 8 billion euro OTC dealer brokers pose an aggregate cross-border transaction risk to the European financial system, to the extent that smaller dealer brokers more likely would trade in uncleared and unmargined swaps, given the added expenses of clearing and collateral margins.

We, as a member of Americans for Financial Reform, were dismayed when the Commodity Futures Trading Commission set an $8 billion de minimis level for OTC derivatives activity before OTC dealer brokers would be subject to all the proposed CFTC OTC regulatory disciplines.[[15]](#endnote-15) One estimate held that about 60 percent of OTC derivatives activity in U.S. markets would be exempted by this very large de minimis exemption.[[16]](#endnote-16) While regulating 40 percent of OTC derivatives activity is better than the pre- DFA non-regulation of all OTC derivatives, ESMA’s proposed 8 billion euros de minimis ups the ante of exempting regulation EU financial counterparty OTC activity, but does so without criteria that would make the result of the exemption “predictable”.

Rather than judging risk to the European financial system in terms of each EU financial counter-party, ESMA should propose to the Commission that it be allowed to study how to estimate the aggregate and interactive risk, rather than just the per EU financial counterparty risk exposure to cross-border transactions. Here is one consideration to argue for an aggregate and interactive approach for regulating against counterparty default. Nine of the “G-16” largest banks in the BIS study on macro-economic benefits of OTC derivatives regulation are European headquartered.[[17]](#endnote-17) If each of those banks, the systemically important OTC dealer brokers, is allowed to trade up to five percent of its total OTC derivatives in third countries, the aggregate risk to the European financial system could be great but unpredictable indeed. The risk would not, of course, amount to 45 percent of uncleared and unmargined transactions, since not all of the European OTC derivatives trades are among the nine largest European OTC dealer brokers and since not all of those non-European counterparties will default, but the risk would be substantial.

However, in light of the foregoing argument, our answer is simply “yes” to “Q 3. Do you agree that OTC derivatives contracts entered into between two EU branches of third country entities would have direct effect within the Union?”

The fourth question that ESMA poses has direct relevance to IATP’s work on commodity derivatives market regulation: “Do you agree that criteria related to the currency or underlying of the OTC derivatives contracts should not be used to specify the direct effect of the contract within the Union?” The Consultation Paper presents remarkably little argument for not using the currency or underlying asset to specify “the direct effect of the contract”: “ESMA considers that using this type of criteria would entail using a broad definition of the direct nature of the effect of the contract within the Union” (paragraph 37).

ESMA does not have a mandate to define “direct” in such a way that the currency of OTC derivatives contracts, or the underlying asset should be excluded from the definition of direct. According to the latest BIS statistics, 35.5 percent of all foreign currency OTC derivatives contracts are denominated in euros.[[18]](#endnote-18) Given that more than a third of OTC foreign exchange derivative contracts expose the value of the euro to risk, it is difficult to understand why ESMA would choose not to include the currency of OTC derivatives as a criterion for defining and characterizing the “direct” effect of OTC derivatives contracts on the Union.

The gross notional value of commodities and other underlying assets of OTC derivatives contracts continue to be a small fraction of the global $600 trillion plus OTC derivatives gross notional value. Nevertheless, ESMA should consider how to include commodities and other underlying assets in the definition of the “direct” effect of OTC derivatives on the economy of the European Union, and not just on the largest banks in the Union. Third country counterparty defaults, even when guaranteed by an EU financial counterparty, can have a devastating impact on contracts in the relatively lightly capitalized OTC commodity derivatives market. Because OTC dealer brokers are allowed by law to warehouse and trade physical energy and metals contracts (as well as land affecting agricultural production) in commodities where they make a market in OTC derivatives, OTC dealer brokers in commodity derivatives have strong and highly controversial price influential market power.[[19]](#endnote-19) When traders of physical commodities fix prices in physical commodities, the direct and negative effect of price fixing to commodity consumers in the EU is amplified through their corresponding commodity derivatives contracts. In sum, ESMA should include currency and underlying asset criteria in the characterization of OTC derivative contract risk to the Union.

Conclusion: a few remarks on prevention of evasion

IATP regrets that this comment was begun too late to respond to ESMA’s other important questions on the “direct, substantial and foreseeable effect” of cross-border OTC derivatives transactions. We greatly appreciate, however, the opportunity to have commented on the first four questions.

In closing, we wish to indicate our support for ESMA’s proposed “criteria-based approach” to preventing evasion of EMIR (Q. 9). The perverse creativity of OTC dealer brokers in designing contracts that elude regulation is testified in broad claims of “customization” of contracts and their consequent idiosyncratic reporting that makes trade data surveillance and contract enforcement a regulatory struggle. A criteria based approach can better capture the general strategies and practices of regulatory evasion and arbitrage.

1. <http://www.esma.europa.eu/consultation/Draft-Regulatory-Technical-Standards-contracts-having-direct-substantial-and-foreseeabl> [↑](#endnote-ref-1)
2. E.g. John Kenchington, “EU ‘snubs investors’ on reform”, *Financial Times*, August 25, 2013. <http://www.ft.com/intl/cms/s/0/c93b2a36-0bfa-11e3-8f77-00144feabdc0.html?siteedition=intl#axzz2ehu73frA> [↑](#endnote-ref-2)
3. Dafna Avraham, Patricia Selvaggi and James Vickery, “A Structural View of Bank Holding Companies,” *Federal Reserve Bank of New York Economic Policy Review,* July 2012, Table 1: Number and Distribution of Selected Top Fifty Bank Holding Companies, at 71. <http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf> [↑](#endnote-ref-3)
4. Dennis Kelleher, Stephen Hall and Katelynn Bradley, “Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC”, Better Markets, July 30, 2012. <http://www.bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf> and Silla Brush, “Wall Street Wins Under Swap- Rule Changes Moving in House,” Reuters, March 20, 2013. <http://www.bloomberg.com/news/2013-03-19/wall-street-may-win-swap-rule-reprieve-in-u-s-house-legislation.html> [↑](#endnote-ref-4)
5. E.g., Patrick Jenkins and Megan Murphy, “Goldman in Europe warning,” *Financial Times*, September 30, 2010. [↑](#endnote-ref-5)
6. Simon Johnson, “Big Banks’ Tall Tales,” *Gulf Times*, April 26, 2013. <http://www.gulf-times.com/opinion/189/details/350483/big-banks%E2%80%99-tall-tales> [↑](#endnote-ref-6)
7. “OTC Derivatives Reform Progress”, Financial Stability Board, September 2, 2013, footnote 2 at 3. <http://www.financialstabilityboard.org/publications/r_130902a.pdf> [↑](#endnote-ref-7)
8. “Macro-economic costs and benefits of OTC derivatives regulatory reform”, Bank for International Settlements, August 2013, 2. <http://www.bis.org/publ/othp20.pdf> [↑](#endnote-ref-8)
9. Letter to Steven Majoor, Chair of ESMA from Emil Paulis, European Commission, concerning the deadline for ESMA Regulatory Technical Standards applied to non-European Union counterparties to cross-border OTC derivatives transactions, June 13, 2013. [↑](#endnote-ref-9)
10. We are making an educated guess that the foreign affiliates of EU headquartered OTC dealer brokers are myriad. The seven largest U.S. OTC broker dealers have about 5,700 subsidiaries, according to Dafna Avraham, Patricia Selvaggi and James Vickery, “A Structural View of Bank Holding Companies,” *Federal Reserve Bank of New York Economic Policy Review,* July 2012, Table 1: Number and Distribution of Selected Top Fifty Bank Holding Companies,, at 71. <http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf> A cross border RTS that does not cover clearing, trade data reporting, margin collateral and capital reserve requirements for these global entities will not, of course, provide effective regulation of them. If the European Central Bank cannot provide ESMA with foreign affiliate data, ESMA should request the Council of Financial and Economic Ministers to ask the European Central Bank to produce a study similar to that of the Federal Reserve Bank of New York’s. [↑](#endnote-ref-10)
11. Stephen Labaton, “Agency’s ’04 Rules Lets Banks Pile Up New Debt”, *The New York Times*, October 2, 2008. <http://www.nytimes.com/2008/10/03/business/03sec.html?pagewanted=all> [↑](#endnote-ref-11)
12. “Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act,” General Accountability Office, January 16, 2013. <http://www.gao.gov/assets/660/651322.pdf> [↑](#endnote-ref-12)
13. James Andrew Felkerson, “”$29,000,000,000,000: A Detailed Look at the Fed’s Bailout by Funding Facility and Recipient,” Levy Economics Institute, Working Paper 698, December 2011. <http://www.levyinstitute.org/pubs/wp_698.pdf> [↑](#endnote-ref-13)
14. Michael Brei and Blaise Gadanecz, “Have Public Bailouts Made Banks’ Loan Books Safer?” *Banks for International Settlements Quarterly Review*, September 2012, 62. <http://www.bis.org/publ/qtrpdf/r_qt1209h.pdf> [↑](#endnote-ref-14)
15. <http://ourfinancialsecurity.org/2011/02/afrs-comment-letter-on-seccftc-definitions/> [↑](#endnote-ref-15)
16. <http://www.bettermarkets.com/blogs/industry%E2%80%99s-bogus-arguments-de-maximus-exception-swap-dealer-rules#.UjcoKcakrEQ> [↑](#endnote-ref-16)
17. “Macro-economic costs and benefits of OTC derivatives regulatory reform”, *op cit.* Table 3. [↑](#endnote-ref-17)
18. “Statistical release: OTC derivatives statistics at end-December 2012”, Bank for International Settlements, May 2013, at 2. <http://www.bis.org/publ/otc_hy1305.pdf> [↑](#endnote-ref-18)
19. David Sheppard, “After Goldman’s oil burned, banks face a day of reckoning on commodities”, Reuters, September 11, 2013; Evan Weinberger, “JP Morgan, Glencore Fixed Aluminum Prices, New Law Suit Says”, Law 360, August 7, 2013 and a long etc. [↑](#endnote-ref-19)