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1 Rule-making and Implementation – EMIR and MiFID II

- ESMA is dealing with the two main European legislative projects affecting derivatives regulation – EMIR and MiFID II – for a number of years now. While EMIR has already entered the review stage, MiFID II still has 1.5 years to go before it applies in practice and during which ESMA will have to finalise its legislative implementing measures and work towards practical implementation along with the European national supervisors. These two projects show the different phases of ESMA regulatory work and I will talk about aspects of both of them today.
- For EMIR, ESMA is very much in the implementation stage. The initial work on technical standards has been completed and we are now working to ensure stringent implementation of the legislation. For example, we are working on the review of reporting to Trade Repositories building on the experience of the start of TR reporting in February 2014. We expect to submit draft technical standards to the European Commission after this summer. The revised ESMA standards should become applicable in the second half of 2016. I will elaborate on this a bit later.
- In addition, under EMIR, ESMA continues working on the clearing obligation for derivatives and again I will say a bit more about the current work on this implementation topic a little later on.
- At the same time, EMIR is already undergoing a review. Like for most legislative measures, a review clause was included in EMIR and the Commission has launched

a public consultation recently. ESMA will be actively contributing to the review, building on its experience in implementing EMIR.

- For MiFID II, the decisive date for application remains 3 January 2017. ESMA is therefore very much still in the rule-making stage with regards to this project. The initial date for ESMA to deliver its main set of technical standards to the European Commission is 3 July 2015. While ESMA is in full flow trying to finalise its package of standards, the timetable has recently been slightly amended due to ESMA and the European Commission agreeing on an early legal review.
- Under the European set of rules, any technical standard proposed by ESMA has to be adopted by the European Commission and one prerequisite for such adoption is the standard passing the review by the Commission Legal Services.
- Given that MiFID II is of a size unprecedented in terms of number and volume of technical standards, ESMA and the European Commission considered it important for the standards to be legally reviewed before final and formal submission of draft standards from ESMA to the European Commission. That way, the risk of having potentially a number of standards rejected for legal drafting reasons which would render the subsequent implementation timetable for MiFID II unworkable should be diminished.
- The early legal review will take place over the course of the summer and ESMA expects to submit its draft technical standards for formal adoption by the European Commission at the end of September 2015. At that point in time there will be clarity for stakeholders as to the exact content of ESMA's proposals relevant for the regulation of derivatives trading.

2 MiFID II - Transparency regime for derivatives

- Transparency is a central element of MiFID II and will be extended in the new world to equity-like instruments and non-equity instruments. As you know, MiFID II mandates ESMA with calibrating the details of the transparency regime.
- I am aware that many of you are concerned that the new transparency regime, and in particular the calibrations of the waivers and deferrals available to orders and transactions may undermine liquidity. I can assure you that ESMA's approach is not solely to maximise transparency for its own sake. Our approach is to determine the

appropriate amount of transparency that benefits market functioning, while at the same time respecting co-legislators' intention to increase transparency. We therefore conducted an extensive data analysis and are considering carefully the feedback from three public consultations, the DP last May and the CPs in December and February.

- I cannot provide you at this stage with details regarding our final drafts, but I'd like to react to some of the key concerns in the area of derivatives that ESMA received and which are and remain also our main focus points when finalising our RTS following the consultation. In particular, I would like to highlight four areas:
    - Data issues, in particular the use of data from trade repositories (TRs)
    - The concept of a "liquid market";
    - Calibration of thresholds for orders or transactions that are large in scale (LIS) or of a size specific to the instrument (SSTI); and
    - The treatment of package transactions.
- 1) Data issues: Many respondents raised concerns in this area and considered that three months of data was too short a period and that the analysis often didn't sufficiently distinguish between OTC derivatives and exchange traded derivatives (ETDs). One particular concern related to the use of TR data which was considered to be of too low a quality and not granular enough.
- We have put an enormous effort on evidence-based regulation in this project. No other EU rule that I know has been subject in the last few years to such an extensive test, against real market data. However, we acknowledge that TR data, also after performing intense cleaning, suffers currently from deficiencies. We have worked with stakeholders on some specific cases, like on Forex or Commodities, where data shortcomings were particularly problematic. We are aware that we need to find an acceptable solution for today's situation, where only TRs have comprehensive information on OTC transactions but the quality of reporting by firms is still poor.
- Looking forward, these problems should not affect the calibration of the liquidity regime in future, because: 1) ESMA is constantly working on improving the quality of TR data (including important reviews of the reporting rules that I will explain later); and 2) once MiFID II applies more data sources will be available, such as transaction data from Approved Publication Mechanisms (APAs) for OTC transactions.

- 2) The concept of a *liquid market*: MiFIR provides for waivers and deferrals for instruments or classes of instruments not having a liquid market. In the CP, ESMA proposed determining liquidity on the basis of a static COFIA approach and determining which classes are liquid or illiquid in the RTS. Any reclassification would, under this approach, require an amendment of the RTS. Feedback focussed on two elements. First, stakeholders supported generally the COFIA approach for derivatives but asked for more granularity and higher liquidity thresholds to avoid the problems of false positives, i.e. illiquid derivatives wrongly classified as being liquid. Second, stakeholders argued the static approach should be replaced by a periodic liquidity assessment to reflect the dynamic market environment for derivatives.
- 3) SSTI and LIS thresholds: ESMA proposed, in the CP, to set identical thresholds for both pre- and post-trade transparency purposes and to set the size specific to the instrument (SSTI) threshold equal to 50% of the large in scale threshold. Furthermore, ESMA suggested determining the thresholds annually, based on a methodology specified in the RTS which would kick-in in the second year of application. Overall, respondents supported the periodic determination of thresholds, but considered it necessary to set different thresholds for pre- and post-trade purposes, and in particular to improve the methodology for setting the SSTI-threshold.
- 4) Package transactions: Finally, a number of stakeholders asked for a specific treatment for package transactions, i.e. transactions that are composed of a number of interlinked and contingent trades. In particular, it was considered important to exempt those transactions from the transparency regime. ESMA understands these concerns, but recognises at the same time that co-legislators did not provide for a tailored regime for package transactions and that the possibilities of introducing such a regime at Level 2 are limited.
- As I said before, I can’t give you more information on the final draft RTS at this stage but I can say at least that your feedback triggered significant changes.

3 MiFID II - Position limits for Commodity Derivatives.

- Another key area of our current MiFID II work is the regime for position limits for commodity derivatives.
- We are, in the EU, on the verge of implementing the world's most ambitious and comprehensive position limits regime to date.
- Spot month and *other months* position limits will apply to all commodity derivative contracts traded on an EU trading venue – Regulated Market, MTFs, OTFs – and to contracts traded OTC which are deemed to be *economically equivalent* to the contracts traded on a trading venue. Because of some unknowns such as the new category of OTFs, the number of contracts captured is not known but we do know that we are talking about thousands of contracts.
- It's worth turning to probably the most well-known position limits regime today which is that of the US and has been in place for several decades. The CFTC intends to expand its existing position limits regime, applying to 9 agricultural contracts, to 28 core physical commodity contracts - the most liquid contracts - and to contracts which are economically equivalent to them. The scope of the new EU regime compared to even the new, beefed-up, US regime is vast.
- The comparison to the US regime is important because it shows that in the EU we are putting in place something on a scale which has not been done before and are doing so in record time (a couple of years). ESMA is charged with the herculean task of crafting a methodology which has to bring a number of contradictory elements together:
  - it has to apply to, and work for, both very liquid and very illiquid contracts;
  - it has to provide for a consistent approach to avoid arbitrage opportunities whilst allowing sufficient flexibility to deal with a wide range of contracts;
  - it has to ensure limits are low enough to avoid squeezes without killing off contracts with only two or three participants.
- All these elements mean that this is one of the most controversial areas of MiFID II and one of the most scrutinised parts of ESMA's work.

- ESMA's approach is what we call, informally, *the snake in the tunnel approach*: the methodology needs to allow enough flexibility or *wriggle room* for the competent authorities to set limits on a vast array of contacts but within constraints – *the tunnel* – so that the competent authorities do apply limits in a consistent way and reach similar levels for similar contracts.
- ESMA outlined this approach in the December CP: limits would be based on 25% of deliverable supply with competent authorities being able to adjust this baseline by 15% either way depending on a number of factors, listed in level 1, such as maturity, number and size of market participants etc. Feedback was generally supportive with main comments being: the other months' limits should be based on open interest (not deliverable supply) and for new contracts and illiquid contracts, a maximum of 40% limit may still be insufficient.
- In the interim, ESMA has gathered further data for a cost benefit analysis and some competent authorities have further analysed their own markets to inform the final approach and quantitative limits in its draft RTS.

4 EMIR - Clearing Obligation.

- Before coming back to MiFID II in a minute, let me briefly talk about the Clearing Obligation – one of the key areas of ESMA's current work in the implementation of EMIR.
- The clearing obligation is one of the pillars of EMIR and constitutes the European response to the G20 commitment to "clear all standardised OTC derivatives with central counterparties".
- ESMA started to work on the clearing obligation in March 2014, following the authorisation of the first European CCP under the new framework introduced by EMIR[1]. Since that date, ESMA has analysed most of the contracts that are currently offered for clearing by European CCPs, to determine whether they meet the criteria defined in EMIR to be subject to the clearing obligation. Those criteria relate to standardization, liquidity, and availability of pricing information.

[1] List of CCPs authorised in Europe: http://esma.europa.eu/system/files/ccps_authorised_under_emir.pdf
16 CCPs authorised as of 28 May 2015, of which 10 are authorised to clear OTC derivatives.

- This work, which has been increasingly supported by data retrieved from European Trade Repositories, led to several proposals for mandatory clearing. The proposals have reached various stages now and they can be summarised per asset classes (interest rate rates, credit and foreign exchange).
- Starting with interest rate derivatives, which concentrate approximately 80% of the total volumes of OTC derivatives, we launched a public consultation in July 2014[2] and in October 2014 we submitted to the European Commission our final proposal[3] to impose a clearing obligation on several classes of interest rate swaps denominated in the G4 currencies (EUR, GBP, JPY and USD).
- The European Commission is expected to endorse this proposal shortly, although there has been some delay mainly due to the need to amend the timeline of entry into force and introduce a special carve-out for intragroup transactions concluded with non-EU counterparties[4].
- Continuing the work on interest rate derivatives, we have launched a public consultation in May 2015[5] with a proposal to extend the scope of IRS to 6 other currencies, namely the Czech Koruna (CZK), Danish Krone (DKK), Hungarian Forint (HUF), Norwegian Krone (NOK), Polish Zloty (PLN) Swedish Krona (SEK)[6]. The consultation is running until 15 July 2015.
- Turning to the other asset classes, we have also consulted stakeholders in July 2014 on a proposal for mandatory clearing on certain CDS indices[7]. Although the feedback received to this consultation was broadly positive, we are holding the delivery of the final proposal to the European Commission until the first rules on the clearing obligation for IRS are finalised.
- Finally, we have issued a consultation paper in October 2014[8] which detailed a proposal of mandatory clearing for certain FX products, namely non-deliverable forwards, or NDFs. This segment of the market is significantly smaller than the IRS market and participants have less experience with clearing those contracts. Based on

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[2] ESMA/2014/799 published on 11 July 2014.
[3] ESMA/2014/1184 published on 1 October 2014
[4] 1st ESMA Opinion (ESMA/2015/223) published on 29 January 2015 and revised ESMA Opinion (ESMA/2015/511) published on 6 March 2015
[5] ESMA/2015/807 published on 11 May 2015
[6] [Fyi the names of the currencies were taken from the ISO website.]
[7] ESMA/2014/800 published on 11 July 2014. The index CDS included are untranched iTraxx Europe Main and iTraxx Europe Crossover with 5Y tenor.
[8] ESMA/2015/1185 published on 1 October 2014

the feedback received, ESMA has concluded that more time would be needed to address the concerns raised in the responses, and has decided not to propose a clearing obligation on those classes at this stage[9].

- To sum this up, we expect the clearing obligation to be implemented in Europe in the coming months, first with IRS denominated in the G4 currencies and then with index CDS, ensuring an important level of international convergence. We believe this scope could expand in the future, to other currencies but also possibly to other classes as CCPs gradually develop their clearing offer.

5 MiFID II - Trading Obligation.

- The trading obligation for derivatives is closely linked to the clearing obligation. Just like MiFID II is behind EMIR in the legislative timetable also ESMA is dealing with the trading obligation as a second step - only after it has developed significant parts of the clearing obligation.
- The implementation of the trading obligation will be a technically complex and data intensive challenge which will become an on-going task for ESMA. This task has been rendered even more challenging by the timelines set in MiFID II.
- The general design of the trading obligation in MiFID II can be found in the directly applicable regulation part – commonly referred to as MiFIR – and the standard process will be that ESMA looks at the classes of derivatives declared subject to the clearing obligation, checks whether those classes are already traded on-venue and then performs a liquidity test.
- If the respective class of derivatives is considered sufficiently liquid, ESMA would draft a technical standard declaring the class subject to the trading obligation which would have to be adopted by the European Commission.
- While Europe is undoubtedly late in implementing the trading obligation for derivatives as per the Pittsburgh Accord, the timetable envisaged in MiFIR is nonetheless problematic.
- The trading obligation will not apply until 3 January 2017, which is the date for all MiFID II obligations to go live. However, ESMA shall nonetheless be obliged to

[9] See: Feedback Statement (2015/ESMA/234) published on 3 February 2015.

develop technical standards already within 6 months of the European Commission adopting a clearing obligation standard. As I mentioned a few minutes ago, for interest rate derivatives such an adoption is expected soon, and thus ESMA would be required to conduct a liquidity assessment on such derivatives, to conduct a public consultation and to draft technical standards in the second half of 2015.

- However, ESMA will not have data available to check how liquid the relevant derivative classes are post-imposition of the clearing obligation and will not be able to assess the arrival of the new organised trading facilities (OTFs). This means an important piece of the puzzle is missing at a time when ESMA has to make its first assessments.
- This is problematic and, given the fact that any technical standard drafted by ESMA in 2015 or 16 would in any case not apply any earlier than 3 January 2017, we consider it necessary to find a different timing solution for dealing with the trading obligation.

6 EMIR - Reporting Review.

- EMIR reporting requirements have been in effect since February 2014. The six TRs are now processing over 300 million trade reports on a weekly basis with more than 16,5 billion reports (relating to 4,3 billion new trades) since the reporting start date of end-May 2015 being stored in TRs systems. The reporting system is up and running. And overall, I would say, no major hiccups have occurred in terms of reporting flows and connections with TRs and regulators.
- However, 15 months after the introduction of any major data reporting system (think of MIFID I or other jurisdiction's reporting on derivatives) it is rare to see data quality at an acceptable level. The practical experience acquired so far together with valuable feedback provided by the reporting community and trade repositories during the implementation phase, allows us to identify a number of shortcomings and limitations that need to be addressed so that EMIR reports better fulfil their objective.
- There are three main areas on which the ongoing review of the reporting rules by ESMA is focused:
  - Clarifying the description and purpose of certain reportable fields;
  - Aligning existing fields to the reporting logic prescribed in the Q&As document or to reflect specific ways of populating them; and

- Introducing a number of new fields and values to reflect market practice of trading in specific derivative contracts or accommodate specific regulatory requirements.

- The review also aims at achieving a more consistent and harmonised population of fields and reporting of complex derivatives.
- But let me be clear: beyond clarifying and improving the rules, reporting parties need to comply with those that are actually in force, like assigning a mutually agreed code to the report (UTI) which is not always the case. We have agreed with the national competent authorities to increase the supervision efforts on this important obligation.

7 International derivatives convergence

- Let me finally conclude by mentioning how much international progress we have made since the Pittsburgh declaration. We have worked closely with other regulators in multiple fora to achieve a consistent and robust regulation of the derivatives markets and, in that collective effort, we especially value the cooperation with the US authorities and especially the regulator of the largest part of that market, the CFTC.
- As is well known, we also have some sticking points of international consistency that need to be tackled in a market as globalised as this one. CCP margins for futures is the most obvious of those issues. This has prevented full equivalence and thus has not yet opened doors (as we all desire) across the Atlantic for the clearing of venue-traded derivatives.
- We can each talk about how we believe our respective rules are 'better' than those in other jurisdictions, but I don't think that is a very productive way to proceed. What we need is full understanding of where the differences are, what the impact of those differences might be to the entities subject to the respective rules and how we can – in that environment – ensure we create as level a playing field as we can and the conditions for a global derivatives markets to operate in a way that supports financial stability – as our political masters in Pittsburgh desired.
- Allow me to explain briefly from my perspective what we know already and what we learnt also from the US experience.
- First, there is an essential difference between margins collected to protect the clearing members' own account positions and the one collected to protect clients'

positions, since client margins cannot be used to protect the CCP from the clearing member's default. This difference is key because if the margins collected by the CCP for house accounts are not sufficient, the CCP and the non-defaulting clearing members are at risk.

- Second, during the Lehman default, as evidenced by the Valukas report, the margins collected by CME on the Lehman's own account position were insufficient to close the positions without losses in 3 asset classes out of 5. So it was a pure (lucky) coincidence that the default fund was not impacted.
- In our view it is not prudent to assume that the portfolio composition of a clearing member will ensure that, if the margins collected in one asset class are insufficient, the margins collected in other asset classes will be sufficient to compensate that.
- This episode is in our view truly *educational* on why 1 day MPOR for clearing member own account is not sufficient. We are open to recognising that we can learn from each other's experience, for instance on the benefits of gross collection of margins (as done in the US) for the protection of clients. I would hope however that also the CFTC will want to reflect further on the benefit of 2-days MPOR on house accounts for the protection of the CCP and the non-defaulting clearing members.
- I remain confident that we will be able to disentangle this in a reasonable timeframe.
- We have plenty of other issues to work on with our fellow regulators from the US and the rest of the world (on very important topics like implementation of bilateral margins, aggregation of data, evolution of LEI or recovery of CCPs, to name but a few) and we are looking forward to continued close cooperation in addressing those issues.

Conclusion

I hope my short review today of some of the key work streams and topical issues in the rule making under MiFID II and the implementation of EMIR has been useful. As you can see, there are plenty of important reforms in our plate that are essential for the orderly functioning and the safety of derivatives markets. We look forward to working with our fellow international regulators and also expect to count on your input and cooperation from the market user and participant perspective to make them successful.

Thank you very much for your attention. Wish you a good rest of the day!