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| 17 November 2021 |

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| Reply form for the Discussion Paper on the review of the clearing thresholds under EMIR |
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| Date: 17 November 2021 |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the Discussion Paper on the review of the clearing thresholds published on the ESMA website.

*Instructions*

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

* use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
* do not remove the tags of type <ESMA\_QUESTION\_DP\_EMIR\_CTs> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
* if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

* if they respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

**Naming protocol**

In order to facilitate the handling of stakeholders’ responses please save your document using the following format:

ESMA\_DP\_EMIR\_CTs\_NAMEOFCOMPANY\_NAMEOFDOCUMENT.

e.g. if the respondent were ESMA, the name of the reply form would be:

ESMA\_ DP\_EMIR\_CTs\_ESMA\_REPLYFORM

***Deadline***

Responses must reach us by **19 January 2021.**

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input - Consultations’.

***Publication of responses***

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

***Data protection***

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the headings ‘Legal notice’ and ‘Data protection’.

# General information about respondent

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| --- | --- |
| Name of the company / organisation | Citadel |
| Activity | Other Financial service providers |
| Are you representing an association? |  |
| Country/Region | International |

# Introduction

Please make your introductory comments below, if any:

<ESMA\_COMMENT\_DP\_EMIR\_CTs>

Citadel and Citadel Securities appreciate the opportunity to respond to this consultation.

The derivatives clearing obligation is a central pillar of the post-crisis financial reforms, designed to mitigate systemic risk and increase market liquidity, transparency, and competition. The scope of the clearing obligation determines not only how many OTC derivatives are centrally cleared, but also impacts a number of related reforms, including the derivatives trading obligation, the FRANDT clearing access requirements, and the post-trade consolidated tape recently proposed by the European Commission. As such, it is critically important that the EMIR clearing thresholds, which set the perimeter of small financial counterparties eligible for an exemption from the clearing obligation, are appropriately calibrated.

Data shows the EMIR clearing thresholds have resulted in a lower overall clearing rate for newly executed OTC interest rate derivatives in the EU as compared to in the US. For example, an ESRB working paper using flow data found that the EU had a clearing rate of less than 50% for new interest rate derivatives contracts by notional.[[1]](#footnote-2) In comparison, the US has a clearing rate of approximately 88% by notional.[[2]](#footnote-3) This apparent disparity suggests that the EMIR clearing thresholds may be exempting too much trading activity from the EU clearing obligation given that the scope of instruments subject to the clearing obligation in the EU and US is largely identical.

However, the data analysis performed by ESMA in the Discussion Paper does not directly address the question of whether the clearing thresholds for small financial counterparties are appropriately calibrated. We recommend two enhancements:

1. **Isolate Clearing Member Activity in the Trade State Data Analysis.**

Using trade state data, ESMA found that financial counterparties (“FCs”) subject to the clearing obligation account for **95%** of total outstanding notional executed by FCs in interest rate derivatives, suggesting that the clearing thresholds provide broad coverage. However, ESMA has previously found that clearing member banks alone account for **94.5%** of total outstanding notional executed by FCs in interest rate derivatives.[[3]](#footnote-4) This suggests that non-clearing member clients subject to the clearing obligation only account for 0.5% of this coverage statistic.

As a result, the 95% coverage statistic does not demonstrate whether the clearing thresholds appropriately delineate between large and small FCs, as this statistic is almost entirely based on clearing member bank trading activity. Indeed, if the thresholds were entirely eliminated and the clearing obligation was solely applied to clearing member banks, this statistic would barely change and would apparently still show 94.5% coverage.

Importantly, however, the co-legislators made a clear decision to apply the clearing obligation more broadly than just to clearing member banks for a variety of reasons, including mitigating systemic risk and increasing market transparency and competition.

Recognizing the clear intent to capture more than just clearing member bank trading activity, the key question when evaluating the clearing thresholds is: how much of the client segment of the market should be subject to the clearing obligation?In other words, do the clearing thresholds appropriately distinguish between large FC clients (subject to the CO) and small FC clients (eligible for an exemption)?

Clearing member bank trading activity is not relevant for answering these questions. Instead, the relevant data points (using trade state data) are that clients account for 5.5% of total outstanding notional in OTC interest rate derivatives and the current clearing thresholds provide coverage of 0.5% of such outstanding notional. This suggests that the current clearing thresholds only cover **9%** of the client market segment.

1. **Incorporating Flow Data**

In order to evaluate whether the clearing thresholds appropriately distinguish between large FC clients and small FC clients, it is important to assess how much trading activity is actually being cleared. Relying solely on trade state data does not provide this answer- the 95% coverage statistic referenced in the Discussion Paper does not mean that 95% of total outstanding notional has actually been cleared or that 95% of new transactions are being cleared on an ongoing basis.

Flow data is critical to this analysis. By looking at the actual transactions that are executed on a daily basis, ESMA can determine how many transactions and counterparties are actually subject to the clearing obligation, and whether any adjustments to the scope of the regime are warranted.

When focusing on the client segment of the market, it is clear that the current thresholds capture only a limited number of FC clients. We recommend that ESMA conduct further analysis, focusing on the impact that different clearing threshold levels would have on the client segment of the market and the broader suite of post-crisis financial reforms.

<ESMA\_COMMENT\_DP\_EMIR\_CTs>

1. Please explain if you see a need for further clarification on how to identify OTC contracts for the purpose of the calculation of the positions to be compared to the clearing thresholds.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_1>

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<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_1>

1. Please explain if you see a need for further clarification to identify OTC contracts that can be considered as reducing risks directly relating to commercial activity or treasury financing activity. And please mention any additional aspects to be further considered with regards to the hedging exemption.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_2>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_DP\_EMIR\_CTs\_2>

1. Please provide information and examples on how counterparties count fungible ETDs and OTC derivatives for the purpose of the calculation of the clearing thresholds?

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_3>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_3>

1. Please provide data and arguments to illustrate the potential impact of the lack of an equivalence decision under Article 2a of EMIR and what could be done to alleviate your concerns (besides an equivalence decision)? Please specify the kind of transactions and activities that would be affected and the purpose of those, and whether there are alternatives.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_4>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_4>

1. Please describe the scenarios when transactions do not qualify as hedging transactions.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_5>

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<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_5>

1. Please describe your views on how the EMIR framework works (also compared to other regimes) for the purpose of the clearing thresholds and the requirements triggered by those? Please provide examples and supporting data.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_6>

The EMIR clearing thresholds have resulted in a lower overall clearing rate for newly executed OTC interest rate derivatives in the EU compared to in the US. This is because, in contrast to EMIR, US rules only have a narrow exemption from the clearing obligation for credit institutions with less than $10 billion in assets and there is no exemption for other types of financial counterparties, such as investment funds, asset managers, and insurance companies, regardless of their size or trading activity.

An ESRB working paper using flow data found that the EU had a clearing rate of less than 50% for new interest rate derivatives contracts by notional.[[4]](#footnote-5) In comparison, the US has a clearing rate of approximately 88% by notional.[[5]](#footnote-6) We urge ESMA to monitor and publish the EU clearing rate using flow data (in addition to the statistics currently calculated by ESMA using trade state data), as this apparent disparity suggests that the EMIR clearing thresholds may be exempting too much client trading activity from the EU clearing obligation given that the scope of instruments subject to the clearing obligation in the EU and US is largely identical.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_6>

1. Considering the current coverage provided by the clearing thresholds in relation to credit derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_7>

Please see our response to Question 8 below.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_7>

1. Considering the current coverage provided by the clearing thresholds in relation to interest rate derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_8>

Three issues deserve particular attention:

1. **Isolate Clearing Member Activity in the Trade State Data Analysis**

The current analysis of trade state data suffers from a critical flaw: clearing member positions are not isolated and presented separately in the analysis. This results in misleading data that does not directly answer the question of whether the clearing thresholds for small financial counterparties are appropriately calibrated.

Using trade state data, ESMA found that financial counterparties (“FCs”) subject to the clearing obligation account for **95%** of total outstanding notional executed by FCs in interest rate derivatives, suggesting that the clearing thresholds provide broad coverage (*see page 54, Figure 52*). However, ESMA has previously found that clearing member banks alone account for **94.5%** of total outstanding notional executed by FCs in interest rate derivatives.[[6]](#footnote-7) This suggests that non-clearing member clients subject to the clearing obligation only account for 0.5% of the coverage statistic, as shown in the chart below.

As a result, the 95% coverage statistic does not demonstrate whether the clearing thresholds appropriately delineate between large and small FCs, as this statistic is almost entirely based on clearing member bank trading activity. Indeed, if the thresholds were entirely eliminated and the clearing obligation was solely applied to clearing member banks, this statistic would barely change and would apparently still show 94.5% coverage. This is the reason why the various simulations of different threshold levels detailed in the Discussion Paper result in seemingly insignificant changes for financial counterparties.

Importantly, however, the co-legislators made a clear decision to apply the clearing obligation more broadly than just to clearing member banks for a variety of reasons, including mitigating systemic risk and increasing market transparency and competition. In particular:

* **Systemic Risk**. Despite apparently only accounting for 5.5% of total outstanding notional in OTC interest rate derivatives based on trade state data, clients are estimated to account for **over 50%** of ongoing trading activity.[[7]](#footnote-8) In addition to these significant trading volumes, clients are often more likely to hold directional positions, meaning the level of market risk associated with client positions can often be higher than implied by relative notional levels.

Furthermore, the client segment accounts for approximately 98% of total counterparties.[[8]](#footnote-9) This means an extremely large number of bilateral trading relationships, as each client has multiple liquidity providers. In aggregate, if left outside of central clearing, these bilateral trading relationships risk propagating systemic risk in the event of a significant dealer default.

For these reasons, even though trade state data may suggest that it would provide 94.5% coverage, a clearing obligation solely applied to clearing member banks would not adequately mitigate systemic risk. Implementing central clearing broadly in the client segment of the market is an important component of mitigating systemic risk; more so than the outstanding notional figures may suggest.

* **Increasing Market Transparency and Competition**. In addition to mitigating systemic risk, the clearing obligation is intended to increase market transparency and competition. Central clearing enables market participants to access a wider range of execution counterparties and encourages the entry of new liquidity providers. Academic research confirms these benefits, with a study of the index credit default swap market finding that “the reduced counterparty risk and increased post-trade transparency associated with central clearing have beneficial effects on liquidity,”[[9]](#footnote-10) and a study of the interest rate derivatives market finding that the clearing and trading reforms led to a significant reduction in execution costs, with market participants saving as much as $20 million - $40 million per day.[[10]](#footnote-11)

These benefits are only realized by end clients if the clearing obligation is broadly applied to the client segment of the market. In contrast, a clearing obligation solely applied to transactions between clearing member banks (which are largely hedging transactions) would not increase transparency and competition for the rest of the market, where actual price formation occurs.

Recognizing the clear intent to capture more than just clearing member bank trading activity, the key question when evaluating the clearing thresholds is: how much of the client segment of the market should be subject to the clearing obligation?In other words, do the clearing thresholds appropriately distinguish between large FC clients (subject to the CO) and small FC clients (eligible for an exemption)?

Clearing member bank trading activity is not relevant for answering these questions. Instead, the relevant data points (using trade state data) are that clients account for 5.5% of total outstanding notional in OTC interest rate derivatives and the current clearing thresholds provide coverage of 0.5% of such outstanding notional. This suggests that the current clearing thresholds only cover 9% of the client market segment. According to simulation 1, decreasing the interest rate derivatives threshold by EUR 500 million would expand the client segment coverage significantly to 2.5% of total outstanding notional (or 45% of the client market segment).

We urge ESMA to conduct further analysis, focusing on the impact of the clearing thresholds on the client segment of the market. The clearing thresholds were not intended to alter the application of the clearing obligation to clearing member banks, nor were they intended to create a clearing member-only clearing obligation. Therefore, it is critical that the clearing thresholds are appropriately calibrated to capture a material portion of the client segment of the market, while still allowing truly small financial counterparties to be eligible for an exemption.

1. **Incorporating Flow Data**

In order to evaluate whether the clearing thresholds appropriately distinguish between large FC clients and small FC clients, it is important to assess how much trading activity is actually being cleared. Relying solely on trade state data does not provide this answer- the 95% coverage statistic referenced in the Discussion Paper does not mean that 95% of total outstanding notional has actually been cleared or that 95% of new transactions are being cleared on an ongoing basis.

The clearing obligation is a transaction-level requirement that only applies (i) to new trading activity (not legacy positions) and (ii) if *both counterparties* to a given transaction are considered to be in-scope. Therefore, it is critical to understand the percentage of new trading activity that is in-scope when analysing whether the clearing thresholds capture a sufficient percentage of client trading activity.

Flow data is critical to this analysis. By looking at the actual transactions that are executed on a daily basis, ESMA can determine how many transactions and counterparties are subject to the clearing obligation, and whether any adjustments to the scope of the regime are warranted.

While we appreciate that data quality represents an ongoing challenge, we note that third-party data vendors are successfully analysing flow data from EU OTC derivative markets, including in preparation for the introduction of a post-trade consolidated tape. We hope ESMA can leverage these efforts in order to incorporate flow data in its consultation papers and statistical analysis.

1. **Analysing the Full Impact of the Clearing Thresholds**

While the clearing thresholds set the scope of the clearing obligation, they also meaningfully impact other important financial regulations. Indeed, the clearing obligation is a central pillar of the G-20’s post-crisis OTC derivative market reforms, and its scope has several knock-on consequences. For example:

* + **DTO**. Clients exempted from the clearing obligation are also exempted from the derivatives trading obligation (DTO). If too much of the client segment of the market is exempted from the DTO, then the intended benefits of increased transparency and competition could fail to materialize. Instead, price formation would continue to occur off-venue via uncompetitive and non-transparent bilateral trading protocols. Indeed, market data suggests that 30% of trading activity in DTO instruments may still be occurring off-venue due to counterparty exemptions.
  + **FRANDT**. EMIR requires clearing members to provide clearing services on fair, reasonable, non-discriminatory, and transparent terms. However, this requirement has been interpreted to only apply to clients subject to the clearing obligation. As a result, if too much of the client segment of the market is exempted from the clearing obligation, then the intended benefits of FRANDT will not be realized, and clearing access may continue to be a challenge for many FCs.
  + **CTP**. The recent European Commission legislative proposal contemplates the establishment of a CTP for OTC derivatives, with a greatly improved deferral framework designed to provide price transparency for all transactions no later than the end of the day (whereas, at the moment, price information is often deferred for four weeks). However, for OTC derivatives, the CTP would be limited to transactions subject to the clearing obligation (see Article 22a(1)). Therefore, if too much of the client segment of the market is exempted from the clearing obligation, a material percentage of trading activity in liquid OTC derivatives would not benefit from the increased transparency envisaged in the Commission’s proposal. This will negatively impact overall market liquidity and competition.

As detailed above, it is critically important that the clearing thresholds are appropriately calibrated and regularly reviewed using both trade state and flow data that focuses on the client segment of the market. Miscalibrated thresholds impact not only the effectiveness of the clearing obligation, but also the broader suite of post-crisis financial reforms.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_8>

1. Considering the current coverage provided by the clearing thresholds in relation to commodity derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_9>

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<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_9>

1. Considering the current coverage provided by the clearing thresholds in relation to equity derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_10>

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<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_10>

1. Considering the current coverage provided by the clearing thresholds in relation to currency derivatives and the different type of counterparties (FCs and NFCs); is there any aspect or issue you consider ESMA should look into or pay attention to? Please, in your answer, provide as granular details and any relevant data to illustrate your response.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_11>

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<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_11>

1. Beyond the different treatments between FCs and NFCs in the calculation, are there differences between the different types of counterparties that might justify a different calibration of the actual clearing thresholds? In addition, please consider if a different calibration of the current clearing thresholds by type of counterparty should apply in the same manner to all asset classes. Please provide any supporting data that might help illustrate your response.

<ESMA\_QUESTION\_ DP\_EMIR\_CTs\_12>

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<ESMA\_QUESTION\_DP\_EMIR\_CTs\_12>

1. Looking at the simulations presented in the paper and at the impact they would have, do you have any views on the sensitivities of the thresholds?

<ESMA\_QUESTION\_DP\_EMIR\_CTs\_13>

Please see our response to Question 8 above.

When focusing on the client segment of the market (and excluding clearing member banks), it is clear that the current thresholds capture only a limited number of FC clients. For example, in the interest rate derivatives market, clients are estimated to account for 5.5% of total outstanding notional, and the current clearing thresholds provide coverage of 0.5% of such outstanding notional (only 9% of the client market segment). Therefore, given this low baseline of coverage, increasing the thresholds will not have much of an impact (as shown in Simulations 2 and 3).

However, decreasing the thresholds will have a material impact that should be more closely analysed by ESMA. According to Simulation 1, decreasing the interest rate derivatives threshold by EUR 500 million would expand the client segment coverage significantly to 2.5% of total outstanding notional (or 45% of the client market segment), while still exempting the vast majority of FCs. This simulation, along with additional simulations that would decrease the thresholds further, should be considered by ESMA in more detail, with an emphasis on the expected impact to the client segment of the market. In addition, we recommend ESMA assess the impact of requiring the clearing thresholds to be calculated at the manager level, instead of on a fund-by-fund basis. .

<ESMA\_QUESTION\_DP\_EMIR\_CTs\_13>

1. Based on flow data pursuant to the methodology developed by the FSB. See Appendix D and page 7 in <https://www.esrb.europa.eu/pub/pdf/wp/esrb.wp72.en.pdf?87d519a1fd278d359b6d5a33499d0e26> [↑](#footnote-ref-2)
2. “Actual Cleared Volumes vs. Mandated Cleared Volumes: Analyzing the US Derivatives Market,” ISDA (July 2018) at page 3, available at: <https://www.isda.org/a/6yYEE/Actual-Cleared-Volumes-vs-Mandated-Cleared-Volumes.pdf> [↑](#footnote-ref-3)
3. See Figure 5, Consultation Paper on the Clearing Obligation for Financial Counterparties with a Limited Volume of Activity (July 13, 2016) at page 20, available at: <https://www.esma.europa.eu/sites/default/files/library/2016-1125_cp_on_clearing_obligation_for_financial_counterparties.pdf>. [↑](#footnote-ref-4)
4. Based on flow data pursuant to the methodology developed by the FSB. See Appendix D and page 7 in <https://www.esrb.europa.eu/pub/pdf/wp/esrb.wp72.en.pdf?87d519a1fd278d359b6d5a33499d0e26> [↑](#footnote-ref-5)
5. “Actual Cleared Volumes vs. Mandated Cleared Volumes: Analyzing the US Derivatives Market,” ISDA (July 2018) at page 3, available at: <https://www.isda.org/a/6yYEE/Actual-Cleared-Volumes-vs-Mandated-Cleared-Volumes.pdf> [↑](#footnote-ref-6)
6. See Figure 5, Consultation Paper on the Clearing Obligation for Financial Counterparties with a Limited Volume of Activity (July 13, 2016) at page 20, available at: <https://www.esma.europa.eu/sites/default/files/library/2016-1125_cp_on_clearing_obligation_for_financial_counterparties.pdf>. [↑](#footnote-ref-7)
7. <https://www.risk.net/derivatives/5310051/monthly-swaps-data-review-analysing-ccp-and-sef-volumes> (“[Dealer-to-client] volumes, which are from Bloomberg, Tradeweb and TrueEx, are larger each month than [Dealer-to-dealer] volumes – Icap, Tradition, Tullet, BGC, Dealerweb”). [↑](#footnote-ref-8)
8. Supra note 1. [↑](#footnote-ref-9)
9. *See* Loon, Y. C., Zhong, Z. K. Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports. Journal of Financial Economics, 119 (3), 645–672 (2016) at page 4, available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443654> [↑](#footnote-ref-10)
10. *See* Staff Working Paper No. 580 “Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act”, Bank of England (January 2016), available at: <http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf> [↑](#footnote-ref-11)