EFAMA
European Fund and Asset Management Association

POSITION PAPER

Brussels, 14 March 2023

EFAMA's FEEDBACK ON THE EUROPEAN COMMISSION's PROPOSAL FOR THE REVIEW of EMIR (EMIR 3.0)

Executive Summary

We appreciate the opportunity to comment on the EMIR 3.0 proposal reforming the clearing framework in the EU. We share the objectives of this review which seek to ensure financial stability in the EU, and the well-functioning of the existing central clearing framework. We understand the objective to reduce excessive exposure to substantially systemic CCPs over time, though we maintain that any regulatory measures should be proportionate to the regulatory rationale, and should not unduly harm market participants.

The proposal contains some strong points that we readily welcome. These mainly relate to enhancing the regulatory processes that CCPs are subject to in bringing activities and services to market, improvements in CCP margin transparency, clarifications on transaction exemptions, and changes to the Clearing Threshold calculation.

Unsurprisingly, and in line with our previous statements on the subject, we are opposed to any forced relocation policy as this will have a negative impact from a cost perspective on end-investors. We have examined the active accounts proposal with great care and are concerned on a number of fronts:

- the absence of hard figures and potential scenarios on the basis of which to test and quantify the impact of active accounts.

- the very broad mandate for ESMA to define active account thresholds, leaving potential impacts, again, impossible to quantify at this point.

- the absence of clear grandfathering for existing trades, which have already been executed and submitted for clearing through a non-EU CCP, without which there would either be ambiguity as to the treatment of such trades or, in the worst-case scenario, such trades would need to be closed out on one CCP and re-executed and cleared through a European CCP;

- limited liquidity on existing EU CCPs and extensive challenges (including, notably, operational constraints and significant lead-time) in ensuring onboarding for clearing, as well as subsequent clearing, via these entities;

- the underestimation of the cost of operationalizing active accounts for buy-side firms

- the apparent disregard for the difficulties asset managers would face in providing best execution to clients due to fragmented liquidity pools when operating on a dual CCP clearing channel, with set quotas.

II. Positive Elements

We consider that the proposal presents some strong elements that will enhance the attractiveness of EU CCPs, and others which enhance the functioning of the clearing regime/clearing obligation in an international context. We list some of these welcome elements below.

We strongly welcome the package of measures that would simplify product approval and authorizations for EU CCPs (centralized document databases, non objection procedures..)

Under the proposal CCP margin models are subjected to greater transparency on how CCP margin models work (Clearing Members to provide more data), and revisions to margin models are encouraged while taking into account pro-cyclical effects. We welcome these provisions and believe the additional transparency should come directly from the CCPs rather than the Clearing Members as CCPs are the owners of these margin models and are best placed to provide the necessary transparency information to participants.

However clearing members do retain the ability to charge margin multipliers without requirement and do not generally (unless pushed) explain or justify this to their clients. As such we believe that the EMIR 3.0 margin transparency requirements could be enhanced by including a requirement whereby clearing members, to the extent they do apply margin multipliers in their service offering, should disclose to all of its clients the rationale and methodology used to arrive at that value.

For intragroup transactions, we welcome the 'positive list' approach whereby only transactions with a select group of jurisdictions are not granted equivalence, and the remainder of jurisdictions can benefit from an exemption without an equivalence decision. However we do caution against the deletion of Article 13 as developed in section III below. We would also strongly encourage a pragmatic, non-political approach to determining the jurisdictions that can benefit from an exemption without an equivalence decision.

Similarly we agree with the exemption from the Clearing Obligation granted to entities entering into a transaction with a third-country pension scheme where there is no clearing obligation extended to pension schemes under national law.

Clearing Threshold Calculation, UK CCP Equivalence and Risk Exposure Limits

We are supportive of the proposed change (Article 4a) to the Clearing Threshold calculation whereby only OTC contracts that are not cleared on an authorized or recognized CCP will be included in the calculation (to the exclusion of ETDs). We believe that this is a better reflection of true risk exposure, and it creates alignment across EMIR and other financial regulation.

We support a consistent and sustainable calculation method reflective of the risk profile of OTC and ETDs

Since Brexit and the non-recognition of the UK regulated markets, we have had to treat UK ETDs differently depending on their Trade Date: those executed before 01/01/21 were considered ETDs and those executed post-Brexit as OTC. The status of UK ETDs currently depends on a renewal of equivalence for UK CCPs.

However, we are of the firm view that we naturally need to exclude all ETDs (in parallel to other ETDs, notably those executed within the EU) on a permanent basis as the risks associated with ETDs are almost non-existent due to their place of execution (on exchanges and because all ETDs are centrally cleared).

In parallel, to avoid more general uncertainty as to whether UK tier-2 CCP equivalence extension will be extended, which will arise each time a renewal anniversary approaches, we would strongly encourage either permanent recognition of the equivalence of UK CCPs or systematic recognition beyond June 2025, reflecting also the fact that the UK has retained and transposed into national regulation UK EMIR and UK EMIR REFIT.

We are also supportive of revising the risk exposure limits under UCITS and MMFR to OTC transactions not centrally cleared on a CCP as this will incentivize central clearing further.

EFAMA members maintain, as they have in earlier consultations, that the focus in this series of reforms should be on the many valuable improvements introduced under the package which will effectively help to encourage clearing in the EU, make EU CCPs more attractive, resilient and contribute to safeguard financial stability in the EU and in a cross-border context.

III. Active Accounts

Proposal leaves too many undefined elements rendering the impact assessment unreliable

On active accounts, depending on how the methodology underlying the calculations is set out, and what thresholds result from that, the impact on market participants can differ wildly. If the EC had been able to lay out key expected figures, industry would be in a much better position to assess whether the proposed law will meet the EU's objectives or damage EU financial markets.

Active Accounts: Article 7a

Open questions on methodology

ESMA is mandated to develop RTS to define how active accounts will work, with the only parameter in Level 1 being that the resulting threshold should reduce exposure to tier-2 CCPs such that these are no longer substantially systemic.

This leaves open many parameters, including:

- The universe of transactions from which a clearing threshold level will be extracted.
- ESMA's view on the necessary level to downgrade tier-2 CCPs from substantially systemic; will this be 5% of trades, 10% ,50%?
- Will only new trades be in scope of the active accounts? Will legacy transactions be grandfathered?
- At what level will thresholds be applied? Per client/fund, by investment manager?
- What will ESMA's expectation be should the value / percentage of trades cleared through the EU CCP drop below the minimum value / percentage permitted under the regulations?
- Timelines for implementation

Taking account of the stated objectives of the active accounts framework, in-scope entities should be limited to FCs and NFCs subject to the clearing obligation and for instruments which are identified as mandatory clearable under EMIR. Voluntary clearing by SFCs or NFCs which are not under the clearing obligation and/or voluntary clearing by any category of counterparties under EMIR (meaning in or out of scope of clearing obligation) of instruments which are not mandatory for clearing should not be captured by the active account obligation. Articles 7a, and 7b could be usefully amended to discard any ambiguity.

We are also strongly in favour of a clear position being expressed with regard to grandfathering for existing trades, which have already been executed and submitted for clearing through a non-EU CCP. Without this, there would either be ambiguity as to the treatment of such trades (thereby leading to varied market practice as to their treatment) or, in the worst-case scenario, such trades would need to be closed out on one CCP and re-executed and cleared through a European CCP – which would be a costly, time-consuming and in many cases a commercially and operationally unworkable requirement.

Finally it is important that clearing entities that only clear on EU CCPs, that is those authorized under Article 14, should not be in-scope of calculation requirements or applicable thresholds given their status as entities that do not clear on tier-2 CCPs. We therefore recommend the following amendment to Article 7a (1) for added clarity:

1. Financial counterparties or a non-financial counterparties that are subject to the clearing obligation in accordance with Articles 4a and 10 and clear any of the categories of the derivative contracts referred to in paragraph 2 on CCPs that are not authorized under Article 14 shall clear at least a proportion of such contracts at accounts at CCPs authorised under Article 14. ***Entities that clear exclusively on CCPs authorized under Article 14 are exempt from all the requirements under this article.***

In-scope instruments

In-scope instruments should only be those that are subject to mandatory clearing, but we question whether the 3 identified instruments are truly reflective of the clearing volumes found on substantially systemic tier-2 CCPs given that:

- In the CDS segment, there will be no Tier 2 substantially systemic CCPs (as ICE Clear Europe is closing down CDS clearing by Oct 2023).
- The reference to Short Term Interest Rate Derivatives (STIR) appears to reference futures and options. These aren't subject to the EMIR clearing obligation and should remain out-of-scope for the proposal (as above).

Active Accounts: Costs

Bifurcated clearing models carry significant cost, EC figures are surprising

As the buy-side community we do not see ourselves reflected in the EC figures which claim that circa 60% of EU clients for IRS clearing have an EU CCP account, and 85% have an EU CCP account for CDSs.

It is true that many buy-side members will have more than one clearing member relationship, but we are doubtful that this translates into the levels indicated by the EC into accounts opened at two different CCPs for the cited instruments (IRS/index CDSs). From experience we see a mono CCP clearing per instrument subject to internal policies driven by liquidity, margin efficiencies, product offering, risk considerations and collateral optimization.

Therefore the cost of maintaining a dual clearing channel per instrument type should not be underestimated, and as far as we can see is not reflected in the EC's impact assessment report. It will double the infrastructure fixed costs (subscriptions to services with technical set-up), and raise issues with obtaining segregated clearing accounts. It would be especially undesirable and prohibitive, both from a costs and operational perspective, for dual clearing channels to be required to be maintained for each individual (directly or indirectly) in-scope portfolio, particularly as this is not something that is fully supported at this stage by strategic platforms that are widely used in the market by the asset management community.

Unintended Consequences:

I. **the EC should be mindful that under EMIR 2.0 much greater supervisory cooperation is afforded to EU regulators as compared to US tier-1 CCPs.**

II. **The clearing that would result on EU CCPs as a result of the active accounts requirement would actually result in a greater concentration of risk, due to the one-directional positions.**

The active accounts requirement could drive clearing onto US CCPs for clients in search of better spreads. Given how closely aligned the UK and EU CCP regulatory environment is, moving clearing to the US would create a greater risk for the EU: less regulatory alignment, less EU oversight, less US appetite to accept burdensome rules or direct powers, less ability for the EU to control the risks.

We expect considerable negative consequences from the fact that European buy side actors holding similar portfolios and employing similar hedging strategies will find themselves in a market which cannot offer balanced flows as providers offering opposite direction are not present. This greater concentration of risk would actually subvert the risk mitigation purpose of central clearing. If the intention is indeed to clear a proportion of transactions away from Tier-2 CCPs, the remaining clearing options should include recognized Tier-1 CCPs (including those for which equivalence has been granted) and not only EU CCPs.

Active Accounts: Competitiveness and Fiduciary Duty to Clients

Impaired ability to provide best execution to clients:

Active accounts however ultimately defined by ESMA will require the forced splitting of portfolios for client clearing, the cost of which is not negligible. We are therefore 100% supportive of the ESRB's opinion that ESMA should first conduct a cost benefit analysis

For multi-managed accounts having different asset managers for which all activity must be aggregated at client level, there will be the added complication to comply with ESMA's proportion levels and then allocate sub-proportions to different accounts and asset managers.

Asset Managers trade in blocks on behalf of multiple underlying accounts to achieve best execution. A mandatory requirement to clear a portion of those trades at an EU CCP will impact an asset manager's transaction allocation process where some accounts are mandated for clearing and others are not, incurring higher costs for clients.

Having to margin separately at different CCPs will cause a loss of netting benefits, reducing efficiency and increasing risk. We have previously written on this issue which is a major point of concern for buy-side firms. Given the multi-currency and multi-product composition of many of our portfolios, many of our funds will take a direct hit from the active account requirement.

Furthermore, the proposed approach from ESMA will only serve to penalize end user clients and investors by both diluting liquidity, and potentially forcing them to choose between trading all products on a (less liquid) EU CCP, or have to tie up additional assets to meet multiple books of margin at different CCPs. None of this can be seen as benefiting the client.

Finally, active accounts also generate specific capital costs to be borne by market participants for instance in the form of default fund contributions. This would sit on top of the reduced netting benefits and diminished collateral optimization already mentioned above.

The competitiveness of European UCITS funds could also be affected, as the returns on these funds could be reduced making US and other non-EU options more attractive to international investors. This is not a trivial point given the appeal of the UCITS brand and regulatory framework to non-EU investors.

Active Accounts: direct costs of operationalizing active accounts:

Documentation- A lot of existing documentation does not contemplate clearing at an EU CCP. All of these documents will have to be revisited with underlying clients and renegotiated. Clients main clearing member agreement will need to be negotiated with a view to gaining access to an EU CCP. This could take in the region of 9 months and significant legal and business and operational resource to negotiate. Full risk and operational review of the account structures will need to occur, be verified with and/or communicated to clients, and be cross referenced to the clearing agreement. In turn, Prospectus disclosures may need to be examined and amended where necessary to point out differences with current clearing with UK and US clearing. Investment Management Agreements (IMAs) may not envisage or permit the new EU clearing member as an eligible counterparty, so at the very least a review of relevant terms will need to be conducted and in many cases terms will need to be renegotiated with clients. Significant client outreach will need to take place to approve changes to IMAs. An EMIR reporting agreement may need to be separately negotiated with the new EU clearing member, and appropriate oversight arrangements put in place by investment managers keen to ensure that reporting by the clearing member is taking place as expected.

Calculations- As with all cleared products, buy-side firms will have to undertake a significant operational build in order to face an EU CCP. The calculation of thresholds and provision of reports, as required under Article 7a(4) would constitute another cost on top of clearing thresholds calculations and ANNA calculations, increasing operational and oversight costs. The additional infrastructure build will address the need to:

- Monitor liquidity based on split liquidity pools . This is significant as collateral requirements are expected to increase as netting opportunities decrease. Margin requirements will have to be monitored per additional CCP account.

- monitor fund thresholds per CCP

- implement pre-trade controls to determine trading volumes between multiple CCPs (due to splitting book of clearable transactions)

- provide for allocation of trades to the EU CCP (creating specific rules on existing systems to channel certain trades to EU CCPs)

- need to ensure that if trades at the EU CCP are unwound or matured, the in-scope fund does not drop below the threshold requirements.

- market fluctuations must be monitored and managed based on how thresholds are calculated

The required changes to operational infrastructure will be complex and costly.

Active Accounts: requirement to inform clients of clearing opportunities on EU CCPs

The requirement for clearing members and their clients to inform their clearing clients of the possibility to clear on a EU CCP is unclear to us. This proposal would be completely unworkable on a trade-by-trade basis. At the time of onboarding clients, clearing options could be explained and guidance provided then.

Although ultimately, remaining consistent with current market practice we would expect to make the decision on clients' behalf in their best interests unless they come with their own clearing arrangements. A consideration of the possibility to clear through a EU CCP would have already been made as part of a firm's fiduciary responsibilities, therefore any additional information toward the client in that regard, appears redundant.

The requirement to inform seems especially out of place in the context of open ended funds and also why would there be a need to inform a client under a discretionary investment management mandate of the optionality? There is no "client of client clearing" scenario to be covered.

Reporting requirements (7b)

The requirement under Article 7b (2) to report clearing activity on CCPs recognized under Article 25, should be clarified to ensure that buy-side firms are not in-scope of this reporting. More generally, any additional reporting should be carefully considered to avoid any duplication with existing EMIR reporting.

Article 7b requires clients to report on the scope of their clearing activity to their competent authority. This dataset is available daily from trade repositories as part of firms' EMIR reporting.

EMIR reporting already includes exhaustive data, including which CCP the trade is cleared to. Regulators should use the vast amounts of data they already receive (EMIR, MIFIR etc.) rather than creating additional reporting requirements to generate, essentially, bespoke reports.

For any additional transparency that may still be required, this should be applied at CCP level and/or Clearing Member level as the golden source of aggregate data.

IV. Other aspects of EMIR 3.0

Deletion of Article 13

While we are in principle supportive of streamlining legislation and would agree that the current Article 13 equivalence regime has not worked as well as was intended (in part due to the requirement for one counterparty to be 'established' in the third country), it is helpful for firms to avoid having to comply or, more importantly, forcing their clients to comply with two sets of duplicative rules. EU firms currently rely on the existing Article 13 equivalence decisions with respect to risk mitigation techniques/margin requirements. The deletion of Article 13 would therefore need to be accompanied by an alternative mechanism for firms to avoid having to comply with duplicative or conflicting rules going forward. In addition, we also note that if the EU is no longer able to grant equivalence to a third country jurisdiction regarding risk mitigation techniques/margin requirements, some of these third country jurisdictions may reconsider granting the EU equivalence.

Clearing Threshold Exemptions for FCs

We acknowledge the need to review the eligibility criteria for hedging exemption for NFC derivative transactions. This would also present an opportunity to level the playing field with FCs and take on board our long standing request to exclude physically settled FX Forwards and Swaps from the clearing thresholds calculation, based on the same rationale under which they are excluded from variation margin requirements today.

This seems particularly relevant to those FCs that perform extensive hedging (effected via Spot FX, as well as physically settled FFX and FX Swaps) as part of their strategy but make limited use of broader OTC derivative instruments. These entities may exceed the clearing threshold only in the Foreign Exchange category and yet, as a result of this, are nonetheless forced to put in place costly and burdensome arrangements for the clearing of consistently low volumes of clearable IRS and CDS.

It would make sense to recognise the special nature of physically settled FX Forwards and physically settled FX Swaps , as very often they are the only asset class to breach the Clearing Threshold and as a result require the clearing of small positions in other asset classes which in themselves are far below their relevant asset class threshold. This scenario is exacerbated by the fact that FX positions appear large in absolute notional terms given the calculation methodology (add-up notionals and no netting by off-setting transactions).

Excluding physically settled FX Forwards and Swaps from clearing thresholds, as proposed above, would also more closely align the approach taken under the EMIR clearing obligation with the approach that has relatively recently been ratified in respect of the EMIR margin requirements. (Please also see our comments / proposal below to remove these instruments from the scope of the AANA calculations underpinning entity-level scoping applicable to the margin requirements, which would ensure full consistency across both EMIR Clearing and Margining.) A recital in the EMIR 3.0 text could require ESMA to revise the relevant RTS to this effect.

Extension of margining exemption for single stock and equity index options:

The review of the EMIR framework is an appropriate time to introduce the permanent exemption of single stock and equity index options from margining requirements as per the temporary exemption found today in Art. 1(5) of the Margin RTS. This is important given that the international context remains the same with exemptions from variation and initial margin exchange for these contracts continuing to prevail. Key financial centres either do not bring these instruments into scope of margining requirements (US and Singapore), or have provided temporary exemptions like we have in Europe today: Hong Kong, Switzerland and the UK.

Exemption of these instruments does not create additional risk in the financial system given that they account for a very small proportion of the overall OTC market, and the fact that they are predominantly used for hedging and risk mitigation purposes. Given this, it makes little sense to burden market participants in Europe with additional funding costs and operational complexity when trying to access these instruments.

A recital can be introduced in EMIR 3 that recognises that in some major jurisdictions single-stock equity options and index options are not subject to equivalent margin requirements and that to avoid market fragmentation and to ensure a global level playing field it is appropriate to permanently exempt these contracts from the margin requirements.

Collateral

Eligible Collateral

We support the expansion of the list of eligible collateral for Initial Margin to include money market funds and exchange traded funds. This would also contribute to enhancing the attractiveness of EU CCPs. Similarly, MMFs should also be allowed as eligible investments by CCPs. MMFs have key features that should qualify them as eligible instruments. MMFs are highly regulated, well-diversified, short term vehicles that invest in short term money markets (they are also presumed as eligible cash equivalent vehicles for their investors). They also represent the safest products in the asset management space. They are highly liquid and stable investment vehicles in normal markets. Their liquidity depends on the underlying money markets own liquidity, as they are not guaranteed products, but investment funds that pass market opportunities and risks onto their investors.

Other highly liquid instruments like European sovereigns could be included as they could meet the intraday call constraints of CCPs.

Implementation period for the VM

We would like the confirmation of the 4-month transition period for the implementation of VM documentation from eligibility (when an NFC is upgraded to NFC+ or FC status) as it is currently only mentioned in the paragraph 8 of the explanatory memorandum.

Initial Margin for cleared and non-cleared derivatives

We reiterate key requests which remain unaddressed:

- the removal of physically settled (i) FX forwards and (ii) FX swaps from the AANA calculation since they are exempted from posting IM/VM

- the alignment of the criteria for the NFC+ IM obligation (including the thresholds) with those applying for the NFC+ clearing obligation: we favor a "product per product" approach:

- the IM requirement to apply only on the category of derivatives for which the threshold is breached and avoid having the requirement to post/collect IM for all categories of derivatives, similar to the approach applied to NFCs.

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

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