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2 minute guide
MIFID II, MiFIR, EMIR, interoperability and market access

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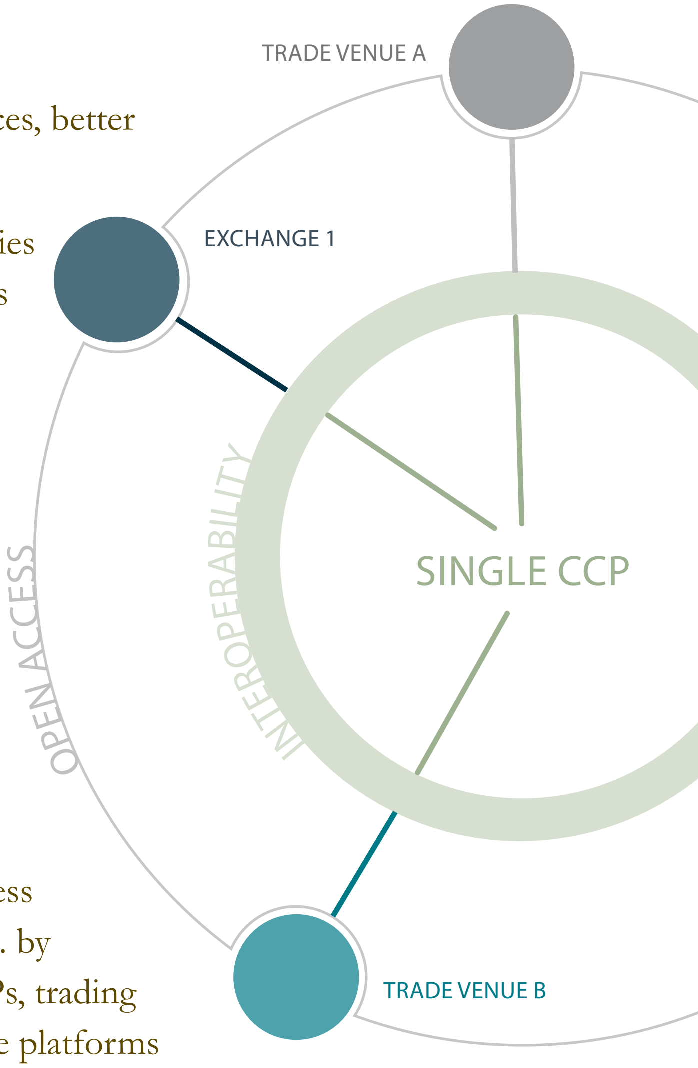
better markets make for better outcomes

- MiFID II, MiFIR and EMIR are key pieces of regulation reshaping the Financial Services landscape across the European Union. They place a broad range of obligations both at a micro-level by detailing how Financial Services firms should operate and report, and extend through to the macro-level by recasting the actual structure of, and conduct within, key financial markets and product categories
- MiFID II (Markets in Financial Instruments Directive) and MiFIR (Markets in Financial Investments Regulation) aim to create a single market for investment services by promoting market access, raising consumer protections and increasing transparency and information flow, all the while looking to lower market risk.
- A key focus area of MIFID II and MiFIR is the promotion of pre- and post-trade transparency, which is the anchor point that links them directly to EMIR (European Market Infrastructure Regulation).
- EMIR regulates over-the-counter (OTC) derivatives, central counterparties and trade repositories. Its purpose is to reduce systemic, counterparty and operational risk, as well as increase transparency in the OTC derivatives market. EMIR is designed to act as a preventative measure to minimise any future financial crisis similar to the systemic fallout that followed the Lehman Brothers bankruptcy.
- EMIR establishes common rules for clearing houses that act as Central Counterparties (CCPs). CCPs effectively guarantee the obligations agreed between two contracting entities when both are participants of the same CCP. EMIR requires that all derivatives be reported, whether OTC or exchange traded, to a trade repository. EMIR covers entities that qualify for derivative contracts in regards to interest rate, equity, foreign exchange, or credit and commodity derivatives. EMIR's required obligations are intended to take effect on a phased basis over the coming years.
- CCPs are viewed by EU regulators and supervisory authorities as a key plank in financial markets infrastructure to reduce risk and opaqueness, and improve overall financial stability, particularly in the near $600 trillion OTC derivatives market. This is line with decisions taken by the G20 in 2009 to reduce future possible market contagion.

what is access and interoperability?

- Open access is a key tenet that underpins the EU's approach to the European single market. Unfettered access to markets is expected to increase competition and thereby bring expected benefits of lower prices, better service levels and more keen cost structures.



» Interoperability is a framework that sets out a series of risk management arrangements between CCPs to enable:

- trades executed across different exchanges or trading venues to be cleared through a single CCP; or
- to have trades cleared through various CCPs at any given exchange or trading venue.

» While access and interoperability are linked, they are not synonyms. In this context:

- Open access means non-discriminatory access to all trading and clearing infrastructures, i.e. by having non-discriminatory access to all CCPs, trading venues should be able to trade on alternative platforms with less complexity and lower fees. Likewise, CCPs with non-discriminatory access to trading venues, parties can reduce or net against their clearing margins through aggregated and enhanced liquidity pools.
- Interoperability means allowing products traded on separate venues to be fully fungible, i.e. clearing houses are obliged to interconnect and share their open interest pool, which in turn lets market participants reduce their costs by netting and/or cross-margining their trades on different venues.

» While MiFIR brings more general access to financial markets, EMIR looks to increase the interoperability (and in turn access) between CCPs, exchanges and trading venues. Open access on its own does not require interoperability but for interoperability to be achieved open access to trading venues or other CCPs is required.

» Interoperability arrangements as set by EMIR currently apply only to cash equities but are to be applied to exchange traded derivatives following a recent announcement by the European Securities and Markets Authority (ESMA).

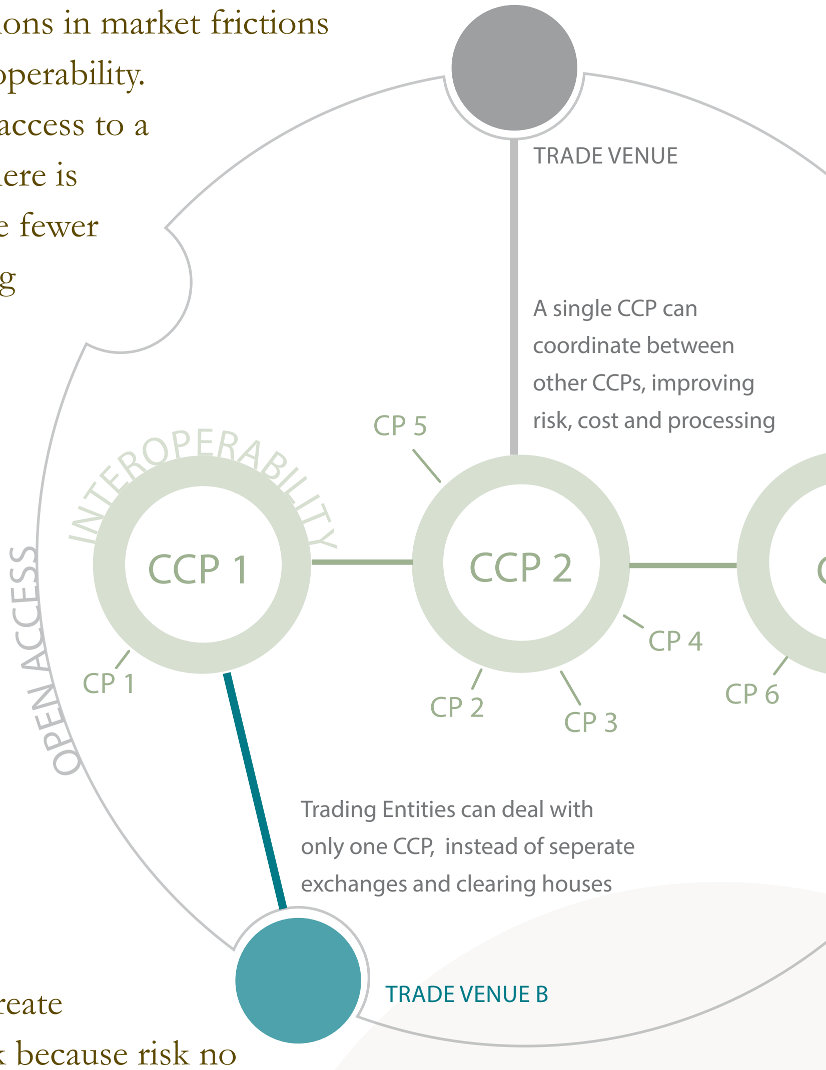
open access and greater interoperability make for more competitive markets

» Competition increases when participants have easier or more cost effective access to markets. It increases choice, drives down prices and forces efficiencies or lower cost structures in the clearing or transmission mechanisms of the market.

» Perhaps the most visible impact that interoperability and access have had is the significant price compression over the past few years. Clearing tariffs have been reduced in cash equity markets by up to 80-90 per cent, while pricing grids applied by CCPs have been simplified enormously.

» More difficult to quantify are the reductions in market frictions brought about by open access and interoperability. Interoperability gives clearing members access to a larger number of CCPs, which means there is scope for multilateral netting. Simply, the fewer the number of CCPs that a single trading party needs to clear through, the greater the scope for netting. This translates into possible:

- lower aggregate credit risk and demand for collateral; and/or
- reductions in the number and value of delivery and payment instructions needed to settle any given set of trades, which reduces liquidity risk and transaction costs, as well as less complex business operations.



» At an aggregate level, open access can create broader, deeper pools of mutualised risk because risk no longer needs to be concentrated in single parties but can be spread across the prevailing network of multilateral CCPs.

» DIM/DFMs are also required to conduct due diligence on the providers of the investment vehicles they use in providing their services to the client. These are typically the products around which they will wrap their services. The Alternative

Investment Market Association was the first to bring in a standard due diligence questionnaire when it became apparent all research teams wanted the information in a consistent format, and is generally the basis for most questionnaires in this instance.

but is it a race to the bottom?

» With clearing tariffs having declined so much as a result of interoperability and access, and volumes not necessarily having increased in the same (or greater) proportion (despite the higher volumes driven by algorithmic trading due to these lower clearing tariff fees), this does raise questions about both the financial soundness (at least in cash equities due to lower profit margins) and the risk mitigation capacities of CCPs.

» If further rounds of price cutting on tariffs charged between CCPs are exhausted (because margins are possibly sub-economic or no single CCP has sufficiently deep pockets to engage in predatory pricing), then competitive pressures might drive CCPs towards a so-called "race to the bottom".

» To defend or grow further their market share, competitive pressures drive CCPs to initiate a variety of non-price responses, e.g.:

- compete by offering less stringent margin requirements or lower default contributions;
- lower access requirements;
- raise the remuneration on assets pledged as collateral; and/or
- lower the quality of collateral accepted.

» The potential effect of these non-tariff, competitive responses is that the actual risk frameworks used by CCPs are weakened to the point where the robustness of the actual central clearing infrastructure is itself at risk. In such circumstances, any significant adverse liquidity or default shock could therefore place undue stress on the system, especially if these non-price competition actions has sufficiently compromised the parameters of any the risk frameworks of the CCPs.

» It is therefore vital that central banks, regulators and supervisory authorities keep these parameters in check through ongoing stress tests, so as not to expose the financial markets infrastructure to undue weakness or vulnerability.

» There is no doubt that more competition in markets should be encouraged - and driven by further interoperability and access - but we should be mindful that excessive competition might result in outcomes that are less than Pareto optimal.

derivatives and interoperability are coming (maybe)

» ESMA issued its final report on interoperability arrangements between CCPs required under EMIR on 2 July 2015. In its report, ESMA recommended an extension of the EMIR provisions related to interoperability arrangements beyond transferable securities and money market instruments, to Exchange-Traded Derivatives (ETDs).

» This was followed up in April 2016 when ESMA announced that ETDs (along with transferable securities and money market instruments) would no longer be exempted from open access provisions between trading venues and CCPs.

» Yet, ESMA's 2015 report concluded that a further extension of interoperability arrangements to OTC derivatives would be assessed at a later stage, given the many more complexities involved with these instruments. This is despite EMIR including the obligation to clear centrally certain classes of OTC derivative contracts through CCPs.

» The deferment on OTC derivatives is not surprising. While interoperability for derivatives products raises similar risks as those for securities products, the scale of these risks, given the larger potential credit exposure on derivative products and the greater risk associated with longer-term exposures in more complex instruments, magnifies their exposure.

» In a recent paper published by the Federal Reserve Bank of Chicago, the authors went further as they argued that beyond the most simple OTC derivatives and clearing arrangements, a whole host of concentration margin problems arise that are so insurmountable, they make interoperability arrangements between CCPs unworkable and therefore challenge the suitability of this regulatory direction. [1]

» Of course, along with all the complexities that make putting the required risk and regulatory safeguards in place around interoperability and OTC derivatives, it should not be forgotten that the Financial Services sector is also currently working towards implementing the MiFID II requirements by 1 January 2018. This is a very significant undertaking and is taking up a large amount of attention and resources of most Financial Services firms. It is unlikely therefore that the industry has sufficient capacity to deal with any further interoperability changes if any further EMIR driven OTC derivatives requirements are raised anytime soon.

1 McPartland, J. And Lewis R., (2016) The Challenges of Derivatives CCP Interoperability Arrangements, Federal Reserve Bank of Chicago

a final word

- Significant progress has been made since the financial crises of 2008 to strengthen and stabilise the Financial Services sector. Regulators have worked on a number of fronts to de-risk financial markets.
- Open access and interoperability, particularly around CCPs, have raised competition levels and brought visible benefits to the cash equity market. There is improved financial stability in this part of the market.
- Yet, caution is advised. A too aggressive drive to apply access and interoperability as required by MiFID II, MiFIR and EMIR without sufficient tools and oversight might not achieve the intended policy goals, particularly in the derivatives market.
- Access and bifurcated trading without proper and detailed interoperability in OTC derivatives could introduce additional systemic risks. Concentration risk can become a paramount concern and depending upon the spread of exposure and level of interconnectedness, the knock on effects of a defaulting CCP can be severe, even threatening the stability of the financial markets infrastructure itself.