EU Reaches Agreement on MiFID II

After several years of work, officials from the European Parliament and the European Council have finalized the revised directive on markets in financial instruments (MiFID II) and a regulation on markets in financial instruments (MiFIR).

The final texts include several measures that will impact derivatives markets, including position limits for commodity derivatives, an obligation to trade clearable derivatives on regulated platforms such as exchanges, multilateral trading facilities and organized trading facilities, and a requirement to provide non-discriminatory access to trading venues and clearinghouses.

The texts also mandate risk control requirements for algorithmic and high-frequency trading, including algo testing and trading halts but not minimum order resting times, and establish a framework for granting access to EU markets for firms from outside the EU based on an “equivalence assessment” of third country jurisdictions.

The next step in the process will be the publication of the official texts, which is expected in May or June, and the drafting of “Level 2” implementing standards by the European Securities and Markets Authority (see the more detailed discussion of MiFID II in a separate article elsewhere in this issue).

European Commission Adopts Cross-Border Standards for EMIR

On Jan. 13, the European Commission adopted regulatory technical standards on the cross-border application of the European Markets and Infrastructure Regulation. The standards specify the contracts that are considered to have a “direct, substantial and foreseeable effect” within the European Union and specify situations where it is necessary to “prevent the evasion of rules or obligations” under EMIR such as mandatory clearing requirements.

The standards were drafted by the European Securities and Markets Authority and adopted by the Commission without modification. The European Parliament and the Council will now have up to three months (extendable by another one or three months) to object to the regulatory technical standards.

EU Court Strikes Down U.K. Challenge to ESMA Authority

On Jan. 22, Europe’s highest court, the European Court of Justice, dismissed an action filed by the U.K. government challenging a law that gives the European Securities and Markets Authority the power to impose an EU-wide ban on short-selling.

The decision was a set-back to the U.K. efforts to limit EU regulation of financial services and is expected to strengthen the authority of EU institutions at the expense of national authorities. The case arose when the EU adopted a regulation in 2012 aimed at harmonizing short-selling.

The U.K. challenged the regulation, contending that the discretion it granted to ESMA went beyond what is permissible or legitimate under the EU treaties. In its decision, the ECJ found that the conditions and criteria in the short-selling regulation appropriately limited ESMA’s powers.

IOSCO Publishes Customer Protection Recommendations

The International Organization of Securities Commissions on Jan. 29 published a report entitled *Recommendations Regarding the Protection of Customer Assets*. The recommendations are intended to help regulators enhance the supervision of intermediaries holding client assets and are based on responses from the international body’s consultation published in February 2013.

The report outlines the responsibility of intermediaries in complying with customer protection, including the development of risk management systems and internal controls to monitor compliance. This also includes management of client funds with third parties. The recommendations state that an intermediary should reconcile the client’s accounts and records with the third party.

FIA submitted a comment letter to IOSCO in March 2013 in response to the consultation. In that letter, FIA strongly endorsed the effort and offered several recommendations regarding the implementation of IOSCO’s recommendations.

Korean Authorities Respond to Broker Default

On Jan. 17 the Korean authorities announced “a plan to improve security of derivatives transactions” to prevent trading errors from causing catastrophic losses. The plan, which is expected to be implemented during the first half of 2014, was developed after a local broker, Hanmag Securities, went bankrupt in December after placing a large number of erroneous orders for Kospi 200 stock index options.

The plan was announced jointly by the Financial Services Commission and the Financial Supervisory Service as well as the Korea Exchange and the Korean Financial Investment Association. The three main elements of the plan are to encourage securities firms to strengthen internal

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Clearing Firm Concentration Worries ECB

A leading European central banker has signaled official concern with the concentration of risk among a small number of global clearing firms. Speaking in Washington on Jan. 23, Benoît Coeuré, a member of the European Central Bank's executive board, warned that the move toward central clearing has "unintended consequences" that pose risks for financial stability.

He observed that one of these consequences is that a small number of large financial institutions are the dominant providers of clearing services, and added that their membership in multiple clearinghouses creates "interdependencies" that increase the risk of contagion in a crisis. He suggested that policymakers should encourage higher risk management standards at clearinghouses and appropriate capital requirements for clearing firms, although this should avoid discouraging participation in clearing.

In addition, clearinghouse members need the ability to conduct effective due diligence "to understand the risks they are facing," he said. He also mentioned that international regulators are working toward standards for CCP recovery and resolution regimes and said he hoped this would be published in mid-2014.

Coeuré made the comments at a conference hosted by the U.S. Treasury Department and organized by the Office of Financial Research and the Financial Stability Oversight Council.

FSB Targets Aggregation of Swap Trading Data

Recognizing that the plethora of trade repositories for over-the-counter derivatives is creating data standardization issues, international regulators have begun looking for mechanisms that could be used to aggregate the data so that it can be used to identify systemic risk.

On Feb. 4, the Financial Stability Board, an international organization set up to coordinate financial sector regulation and promote the implementation of the G20 agenda, issued a consultation paper that analyzes several options for aggregating OTC derivatives trade repositories data.

The paper examines three models for an aggregation mechanism: a physically centralized model; a logically centralized model; and the collection and aggregation by authorities themselves of raw data from trade repositories. It discusses the key requirements and challenges, focusing on legal considerations and data and technology considerations, and proposes criteria for assessing different aggregation models.

The FSB said it aims to publish a final version of the report in May 2014.

Basel Amends Leverage Ratio

The Basel Committee on Banking Supervision on Jan. 12 announced an agreement on amendments to modify the leverage ratio framework, a key component of the Basel III capital standards.

Of particular interest to FIA members is the treatment of client cleared derivatives in the leverage ratio framework. Under the amended approach, exposures to clearinghouses associated with client-cleared derivative transactions can be excluded from leverage ratio calculations, provided that the clearing firm does not guarantee the performance of the clearinghouse to its clients.

Additionally, the amended framework specifies that the cash portion of variation margin may be used to reduce the leverage ratio's exposure measure provided that certain conditions are met. The Basel Committee stated that it will monitor the impact of leverage ratio disclosures and will complete the final "calibration" of the leverage ratio by 2017.

Bank of England Releases Report on Cyber Security Test

The Bank of England released a report on Feb. 5 outlining findings and recommendations from the "Waking Shark II" cyber security test conducted last November. The test, which involved 220 participants from the financial sector including exchanges and clearinghouses, simulated the disruption that a cyber attack could cause to markets and market infrastructure. A key finding was that a single coordinating body is needed to manage communications during an incident. The Bank of England also noted participant interest in making the next exercise more challenging.

LME Announces Next Steps in Warehouse Reform Program

The London Metal Exchange on Feb. 5 announced another round of reforms to its warehouse program. The changes are intended to reduce the queues at certain warehouses and are slated to be implemented by April 1. The changes include hiring a consulting firm to conduct a logistical review of LME's warehousing network, establishing a new physical market committee, and commissioning a legal review of its warehousing agreement.