AmCham EU

AmCham EU's response to the Call for evidence on the EU's regulatory framework for financial services

CONSULTATION RESPONSE

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AmCham EU speaks for American companies committed to Europe on trade, investment and competitiveness issues. It aims to ensure a growth-orientated business and investment climate in Europe. AmCham EU facilitates the resolution of transatlantic issues that impact business and plays a role in creating better understanding of EU and US positions on business matters. Aggregate US investment in Europe totalled €2 trillion in 2014 and directly supports more than 4.3 million jobs in Europe.

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SPEAKING FOR AMERICAN BUSINESS IN EUROPE

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The American Chamber of Commerce to the European Union (AmCham EU) has been a longstanding supporter of efforts to complete the single market for financial services, and warmly welcomes the Commission's Action Plan on Building a Capital Markets Union (CMU). We strongly believe that a well-functioning and appropriately regulated transatlantic capital market is key to driving long-term economic growth and competitiveness in Europe and the US. Europe's openness to global business and investment will continue to be a key factor in its economic success.

Following the financial crisis, we understand the need to restore financial stability and public confidence in the financial system did not allow for a full impact assessment before important new rules were determined. However, the significant volume of legislative change may have led to some inconsistencies, gaps and unintended consequences that could negatively impact economic growth and market resilience. We therefore very much welcome the Commission's intention to review the cumulative impact of recently introduced financial services legislation, and the opportunity to provide our feedback and suggested policy remedies on several such regulations. While it may be difficult to fully assess the cumulative impact of regulation on the industry given that a number of legislative proposals are yet to enter into force, the current cumulative impacts of legislation on markets and market participants are already apparent. We therefore support the establishment of an ongoing impact assessment of the legislative changes made as this could reveal any conflicts with the objectives of CMU and allow the Commission to amend legislation to ensure it is fully aligned.

In the context of the Commission's call for evidence on the EU regulatory framework for financial services, we wish to draw your attention to the following issues:

- **Market liquidity**: we are concerned that the cumulative weight of interest rate dynamics, market structure and participant changes, and behavioural changes on both buy- and sell-sides, along with regulation, may be having a dampening effect on market liquidity. It is important that incremental safety and soundness policy that might further impact market liquidity is rationally and precisely calibrated. It should comply with past requirements to avoid duplicative burdens, and be well coordinated across regulatory bodies and jurisdictions to avoid further deteriorations in market liquidity. Examples are listed below:
    - If **transparency requirements under the Markets in Financial Instruments Directive and Regulation (MiFID/R)**, are not appropriately calibrated, it could incorrectly identify bonds as liquid when in reality they are not. This could reduce their ability to mitigate risks, and reduce liquidity in the market and/or raise transaction costs and reduce funding for smaller issuers. In addition to liquidity calibration, the timing of transparency is also a crucial element to consider so that transparency does not negatively affect liquidity. Legislators should ensure the right balance is struck between transparency and liquidity. In the US, the Trade Reporting and Compliance Engine (TRACE) reporting requirements introduced under the Financial Industry Regulatory Authority (FINRA) rules (which requires reporting within fifteen minutes) have contributed to a noticeable reduction in liquidity. Rapid

price disclosure required by TRACE have reduced dealers' willingness to intermediate larger trades. Such trades typically take more time to risk manage than smaller ones, thus limiting investor flexibility and further reducing market depth and breadth.

  - Liquidity in Credit Default Swap (CDS) markets (as reflected via the iTraxx SovX Western Europe index) appears to have significantly diminished in the period following the announcement of the political agreement on the **European Short Selling Regulation** (SSR) in 2012. This introduced a ban on uncovered sovereign CDS - and even more acutely when the regulation became effective. We believe that a mitigation of the adverse effects of the ban could be achieved through an appropriate recalibration of the **definition of market making activities** (Article 2(k) of the SSR) such that: a) the market making exemption only requires a firm to be a member of a single trading venue, rather than be a member of a trading venue where each instrument in which the firm makes markets is listed; b) the exemption is available for market making in any 'financial instrument' (per MiFID definition), rather than only in relation to market making in financial instruments positions which must be taken into account when calculating a net short position in shares or sovereign debt; and 3) non-EU market making firms are permitted to make use of the exemption automatically (given that the Commission has not made any equivalency determinations in this respect).

- **Systemic resilience**: the shift to mandatory clearing of standardised over-the-counter (OTC) derivatives, as introduced by the European Market Infrastructure Regulation (EMIR), has led to the concentration of risk in Central Counter Parties (CCPs). We strongly recommend a harmonised EU-wide regime for the recovery and resolution of financial market infrastructures. CCPs should adopt a robust recovery and continuity framework which ensures continuity of clearing services as opposed to winding down the services. To this extent it is important to have recovery tools to re-establish a matched book for a CCP, following the default of one or more of its clearing members. CCP resilience should be enhanced by ensuring that CCPs have skin-in-the game sufficient to align incentives between the CCP and the clearing members. The availability of adequate funding and liquidity resources is critical to the resilience and successful resolution of a CCP, for which different options could be explored. CCPs risk management methodologies and frameworks should be regularly tested and assessed using regulatory driven standardised and transparent stress-test criteria to assure market participants they are adequate. We recommend CCPs have adequate risk governance practices and clearing member consultation processes. CCPs should consider all relevant stakeholders' interests, including those of its direct and indirect participants in making major decisions.

- **Product identifiers**: in response to the financial crisis, numerous reporting requirements have been put in place to increase transparency in the market. For example, details on OTC derivatives must be reported to trade repositories. Similarly, the need to improve transparency for securities financing transactions (SFT) has led to the development of a new EU reporting framework for SFTs. Ensuring the quality of reported data is crucial, to allow authorities to gain a comprehensive view of the market activities. However, the lack of a globally consistent and common approach to identifying financial instruments/products is a significant barrier to achieving increased transparency. We therefore urge the regulatory community to continue focusing their attention on the development of such identifiers, as well as on the global consistency of data fields.

- **Equivalence determination**: equivalence and substituted compliance are critical components to a sound cross border regulatory framework. Such mechanisms should be based on a flexible, outcomes-based approach to assessing comparability among regimes, rather than rigid, line-by-line analysis. Assessments of foreign regimes should take into account differences in legal frameworks, local market practices and characteristics, and importantly, timetables for implementation of reform in different jurisdictions. Policymakers should consider the cross-border implications at the onset of policy development to foster consistency with international standards and/or other jurisdictions and to mitigate barriers to equivalence/substituted compliance at a later date. This is in keeping with principles recommended by the International Organization of Securities Commissions (IOSCO) and supported by the Cross Border Regulation Forum (CBRF) and the Financial Markets Law Committee (FMLC). In particular, we point out that, given the international nature of the derivatives markets, ensuring that under **EMIR**, non-EU CCPs will continue to be able to provide their services in the EU will be key to safeguarding the continued smooth functioning of the international derivatives markets. Another example is the equivalence provisions in MiFID II and MiFIR for third country access to the EU which are subject to a precondition for a reciprocal recognition framework for third country authorised investment firms in Article 47 (1) MiFIR. This requirement will hamper equivalence determinations, making it much more difficult to arrive at an equivalence decision for cross-border services and consequently will act as barriers to access for third country institutions in Europe and to third country products for European investors.

- **Audit Quality and Engagement Quality Control Reviews**: as a response to the financial crisis, Regulation 537/2014 introduces a legal requirement for an Engagement Quality Control Review (EQCR) to be carried out as part of the statutory audit of, inter alia, every credit institution in the EU. That review must be performed by an EU-registered statutory auditor. In the largest Member States where there is no shortage of industry expertise within the local audit profession, the EQCRs have been performed by locally approved statutory auditors. However, in the smaller Member States it has been common practice for EQCRs in certain complex or high-risk industries (e.g., banking) to be performed by a statutory auditor from another Member State. The requirement for every EQCR performed in the EU to be conducted by a statutory auditor locally approved in the Member State as of 17 June 2016 is a retrograde step and a counter-intuitive response to the financial crisis. As the principal objective of Regulation 537/2014 is to improve audit quality, we would recommend that any EU statutory auditor should be eligible to perform the EQCR of any public interest entity (PIE) in the EU.

- **EMIR Article 9 - Dual-sided reporting**: Unlike the US Dodd Frank Act and the laws of most other developed markets, EMIR mandates both counterparties to report daily the details of the transaction to a trade repository (TR), resulting in unnecessary operational complications for both firms and non-financial end users of financial markets (NFCs). The dual sided reporting (DSR) process is not only costly in systems and resources, but it is also duplicative and does not add to the quality of the data available to regulators. Although Article 9 allows for a counterparty to delegate reporting, this is not a workable option for firms or NFCs given the legal risks involved and the costs associated with checking and confirming the data reported in the TR was done accurately. As a result of the new regime, NFCs are facing disproportionate cost burdens. Nearly 134 000 new reporting counterparties will be required to report, of which approximately 104 750 (76%) are NFCs that predominantly use derivatives to hedge or mitigate commercial risks (NFC-s).[1] These NFC-s represent only 2% of the total notional amount of derivatives reported under EMIR. These reporting obligations represent a disproportionate burden on all NFCs and in particular, on NFC-s who do not contribute to systemic risk. It has been suggested that DSR can facilitate dispute resolution; however, we do not believe this to be the case and, in practice, DSR duplicates TR data and existing EMIR rules for portfolio reconciliation and dispute resolution without any improvement to data quality. Moreover, superior alternatives to DSR exist, such as use of trade confirmations that actually verify the key economic terms of the trade: ISDA data suggests such trade confirmation rates are vastly higher than DSR matching rates.[2] Considerable cost savings to all market participants, and in particular commercial end users, would be made with a move to a single-sided reporting (SSR) regime; indeed, in an analogous situation with Securities Financing Transaction Reporting (SFTR) regulation, Article 29 requires an annual European Securities and Markets Authority (ESMA) cost-benefit analysis to take into account the benefits of SSR. We would therefor urge that reporting requirements under EMIR be redesigned such that NFC-s be subject to at most SSR (where they are not exempt from reporting entirely), and that the entity required to report transaction data to the TR is determined via an appropriate hierarchy laid out in technical standards.

- **EMIR Article 9 - Intragroup reporting**: the intragroup reporting regime unfairly punishes NFCs from a cost perspective and could discourage them from mitigating risk, further increasing internal risk and stifling corporate growth. As EMIR's dual reporting imposes a reporting obligation on each NFC affiliate, each EU affiliate must separately report the intragroup transaction to a TR, and the NFC that then hedges that risk externally with a third party must also report that same transaction – resulting in four reports to a TR for the same transaction. Delegation is not an option, as these are transactions that are within a NFC corporate group and counterparties are unable or unwilling to report them. We would advise that Europe follows the example of other jurisdictions who have exempted intragroup reporting in recognition that intragroup transactions are of little empirical value to the public and to regulators.

- **EMIR - Recalibration of threshold calculation**: we are aware that ESMA has recently contemplated recalibrating the threshold calculation for determining when NFCs exceed the clearing thresholds by suggesting that 'hedging transactions' be included in such calculation. Such a 'hedging penalty' would result in 'real economy' companies losing clearing and margin exemptions, which would needlessly divert capital and liquidity away from economic growth, resulting in a direct negative impact on growth in the EU and reduced participation in markets. We therefore strongly oppose changes to include hedging transactions in the NFC threshold calculations.

- **MiFID II Article 2 & 9 - Own account exemption/direct electronic access**: article 2(1)(d)(ii) has introduced much uncertainty over whether corporate end-users of financial

[1] European Securities and Markets Authority (ESMA), 'EMIR Review Report no. 1: Review on the use of OTC derivatives by non-financial counterparties', 13 August 2015, available at https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-1251_-_emir_review_report_no.1_on_non_financial_firms.pdf

[2] International Swaps and Derivatives Association (ISDA), 'ISDA response to the European Commission EMIR Review Consultation', p. 45, 13 August 2015, available at http://www2.isda.org/attachment/Nzc5Mg==/EMIR%20REVIEW%20RESPONSE%20FINAL%20%5b190815%5d.pdf

markets who perform their hedging activity (FX and derivatives) directly on electronic trading venues can avail themselves of their 'dealing on own account' exemption. Article 2(1)(d) has been interpreted by some as requiring corporate end-users that use common electronic trading platforms to become licensed investment firms (and therefore lose the benefit of the dealing on own account exemption), solely because they may be considered *'members of or participants in a regulated market or an MTF or have direct electronic access to a trading venue'*. Such an interpretation and resulting registration requirement would have an anomalous effect in which corporate end users that are predominantly hedging their commercial risks would be treated the same as financial firms engaged in dealing and/or algorithmic trading. This would also require NFCs to assess whether electronic submission of orders to a trading venue constitutes 'direct electronic access'. Such an assessment will need to be undertaken multiple times by each end-user and ongoing monitoring will be needed of the status of any multilateral system - resulting in costs in time and resources and driving end-users away from the platforms to use more costly, less efficient and less competitive means to hedge their risks. We would advise the Commission to clarify that corporate end-users that qualify for the 'dealing on own account' exemption are not considered 'members or participants' and are not considered to have 'direct electronic access' to a trading venue when they request pricing from and execute transactions on multilateral trading facilities (MTFs) with licensed financial firms (whether as systematic internalisers or otherwise) that make markets and provide liquidity on MTFs or other trading venues.

- **Equity trading obligations in MiFID**: unless non-EU venues are not deemed equivalent, the application of trading obligations to non-EU listed shares where the EU is not the primary market will force firms to trade on EU markets with no meaningful liquidity. As a remedy, we would suggest to adopt an EU Short Selling Regulation-style exemption where the trading obligation is suspended in those instances where the EU is not the primary market.

- **Investor Disclosure Inconsistencies**: Articles 13 and 14 of the SFT regulation will require regulated funds (Collective Investments in Transferable Securities, UCITs, and alternative investment funds, AIFs) to make specific disclosures about their SFT activities in prospectuses (or other pre-investment documents) and in periodic investment reports. UCITS and AIFs are already required to make extensive disclosures about SFT activities (e.g. under ESMA's Guidelines for Competent Authorities and UCITS Management Companies[3] (the 'Guidelines'). The SFT regulation introduces some very specific requirements that are not explicitly required by the Guidelines, which will require the wholesale re-issue of prospectus documents and production of revised periodic reports by fund managers funds - a cost estimated in excess of € 320 million[4], for no obvious benefit to investors. All disclosure requirements on regulated funds relating to their SFT activities should be made consistent.

AmCham EU once again wishes to thank the Commission for providing us with the opportunity to comment and provide evidence on the cumulative impact of recently adopted financial services legislation. As a cross-sectorial business organisation representing over 160 American companies with parentage in Europe, we also support the submissions to the Call for evidence made by our members

[3] European Securities and Markets Authority (ESMA), 'Guidelines for competent authorities and UCITS management companies', 18 December 2012, available at https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf

[4] Assuming just 25% of UCITS funds (8000) engage in SFT activity. Costs per new prospectus for index funds are estimated at €40 000. Active fund prospectus costs are higher.

and the industry associations Association for Financial Markets in Europe (AFME), the International Swaps and Derivatives Association (ISDA) and the International Capital Market Association (ICMA).

We look forward to a continued close dialogue on these important issues and remain at the Commission's disposal to provide any further supporting evidence.

Yours sincerely,

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