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European Securities and Markets Authority
103 rue de Grenelle
75007 Paris
France

**Re: Consultation document on the draft technical advice on criteria for tiering under Article 25(2a) of EMIR2.2.**

Dear ESMA,

CFA Institute appreciates the opportunity to comment on ESMA's consultation paper on the draft technical advice on criteria for tiering under Article 25(2a) of EMIR2.2.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 140,000 members in 150 countries and territories, including 133,000 Chartered Financial Analyst® charterholders, and 147 member societies.

**General comments**

CFA Institute has a long-standing interest in systemic risk issues evidenced by our numerous commentaries on topics such as money market funds[1] and FSOC reforms on SIFIs[2]. In particular, we have commented in May 2015 on the systemic risk that the asset management industry represented. At the time, numerous discussions on the subject were taking place between workgroups and standing committees of the International Organisation of Securities Commissions (IOSCO) and the Financial Stability Board (FSB). As we will discuss in our response, we think it is critical to consider systemic risk in a holistic manner and through the various channels that transmit it across capital markets.

CFA Institute sponsors the Systemic Risk Council (SRC), composed of US and European market leaders, academics, and former policymakers. As sponsor of the SRC, CFA Institute actively monitors and encourages regulatory reform of systemic risk detection and mitigation in capital markets, particularly in the areas of bank capital requirements, money market reform, and funding for financial regulators. CFA Institute also has participated in a G–20 task force charged with making recommendations to harmonize financial regulatory standards worldwide.

Regarding the view of CFA Institute on systemic risk we believe that systemic risk in the financial system can only be shared, distributed, and/or transferred, but never cancelled. In the context of the current consultation, risk taken by investment managers ends up being transferred to Central Counterparties (CCPs) and their clearing members (CMs), which we agree makes CCPs systemic institutions. This is

[1] https://www.cfainstitute.org/-/media/documents/issue-brief/issue-brief-money-market-reform.ashx?la=en&hash=388ABE2B4D71746AAD353819DD494585EC5758B4

[2] https://www.cfainstitute.org/-/media/documents/comment-letter/2015-2019/20150326.ashx

further exacerbated by the concentrated nature of the CCP industry with market shares in excess of 90% not unusual for a single CCP in a given derivative[3].

The process of moving OTC derivatives clearing away from bilateral transactions to a select few for-profit commercial entities no doubt improves the transparency and efficiency of the OTC market but does create concentration and incentive issues that may pose danger to the financial system' stability. Specifically, while the theoretical ideal of a CCP is something like a public utility – providing a vital service at reasonable cost while enabling a reasonable rate of profit to fund the continuing existence of the CCP – the reality is that CCPs are purely for-profit entities that know they are too big to fail.

These, and other, issues were raised in a letter sent to the Financial Stability Board (FSB) by Sir Paul Tucker, Chair of the SRC[4]. In particular, the SRC stressed the urgent need for authorities to agree on what is needed for CCPs to be resolved in an orderly way without taxpayer solvency support. The key issue to understand here is that the CCPs' own recovery plans cannot substitute for resolution as one can imagine numerous scenarious in which the CCPs own recovery plans are overwhelmed.

CFA Institute wishes to draw ESMA's attention to Sir Paul Tucker's letter, and the SRC's work in general, as we believe it is of direct relevance to ongoing work on EMIR. We draw from this work in several of our specific comments below.

**Specific comments**

**Q1: Do you generally agree with the proposed indicators (Indicators 1, 2, 3, 4 and 5) to further assess the nature, size and complexity of the CCP's business? Please elaborate and if you disagree with any specific indicator, please suggest an alternative one to measure the relevant criterion.**

CFA Institute broadly agrees with the proposed indicators 1,2,3,4 and 5 that are designed to assess the nature, size and complexity of the CCP's business. However, we wish to highlight certain issues that we believe ESMA should consider.

First, in determining the financial instruments cleared by the CCP we would like to see the CCP estimate the proportion of derivatives it is clearing that are being used for hedging and speculative purposes respectively. This would provide additional useful information in terms of the purpose of the derivatives in question and the existence of natural counterbalancing positions.

Second, CFA Institute is generally highly supportive of standardisation of contractual terms, disclosures, and operational processes for financial instruments, so we think it would be interesting for ESMA to assess the proportion, by number and by value, of derivatives covered by ISDAs and/or equivalent industry standardised contractual terms.

Third, we believe there is a gap between indicators 3, 4 and 5 for a holistic market risk understanding of the CCP. We again draw ESMA's attention to the letter from Sir Paul Tucker to the FSB, which

[3] For example, LCH has over 98% market share in clearing Euro-denominated interest-rate swaps (http://sdw.ecb.europa.eu/reports.do?node=1000004055)

[4] https://www.systemicriskcouncil.org/2019/03/systemic-risk-council-urges-action-on-resolution-of-central-counterparty-clearing-houses/

higlights the importance of understanding the loss capacity of the CCP from external events such as losses from investment of equity, initial margin moneys or the default fund.

While indicator 5 should provide ESMA a good picture of the operational risk profile of the CCPs, we believe there should be an indicator utilising information typically used to monitor the CCP's exposure to market risk (such as Value-at-Risk, variance, covariance and/or other known measures often part of risk management palettes). Further, in constructing this, and other indicators, we strongly advocate for ESMA to undertake all possible efforts to ensure consistency in definitions across UCITS, AIFMD, PRIIPS and other legislations that seek to measure size and risk of derivatives positions. We believe it should be possible, at least in theory, for the CCP's exposures under EMIR to be equal to the aggregated UCITS and AIFMD exposures (as reported) of the end investors, when considered from a holistic standpoint

Regarding indicator 4, we agree that the liquidity of relevant markets is extremely important to understand in order to ascertain the risks facing the CCP. However, we would like to see some more concrete measures that would satisfy this indicator. For example, in determining the 'nature' of the market we may suggest for ESMA to propose the proportion of algorithmic trading in the relevant market (or variations around this, to include perhaps high frequency trading or block trades, for example).

Finally, regarding indicator 5 we believe better understanding the CCP's management of own-funds, e.g. the default fund, is critical. We would like to draw ESMA's attention to the aforementioned letter by the Chair of the SRC Paul Tucker, which describes our preferred waterfall in the case of a clearing-member default, including the non-discretionary procedures we think should be followed for replenishing the default fund during any recovery process prior to resolution of a CCP.

**Q2: How would you envisage ESMA to consider risks and in particular cyber-risks in relation to the evaluation of systemic importance?**

CFA Institute wishes to make the general point that when considering risks of systemic importance, the issue of resolution needs to be at the forefront. That is, risk assessments in finance tend to assess the likelihood of some unlikely event occurring and the losses that that event would impose. This creates an implicit, possibly unconscious, bias towards finding scenarios or rationales that obviate the need to consider the ultimate resolution of the organisation.

However, for systemic organisations such as CCPs, we believe it is instead necessary to assume that the unlikely event has occurred and that resolution of the CCP is necessary. From this baseline assumption of the worst possible scenario, ESMA should determine how resolution should proceed and whether it would cause systemic issues. This would be the most robust method of determining tiering of CCPs.

**Q3: Do you generally agree with the proposed indicators as specified above (Indicators 6, 7, 8 and 9) to further assess the effect of a failure or disruption of the CCP? Please elaborate and if you disagree with any specific indicator, please suggest an alternative one to measure the relevant criterion**

In general, CFA Institute agrees with the proposed indicators 6, 7, 8 and 9 designed to assess the effect of a failure or disruption of the CCP. However, we wish to make several comments on certain issues.

First, regarding indicator 6, it is critical that ESMA monitors the way in which CCPs invest their equity, initial margin money, or default fund. Given the small amounts of equity CCPs have against which to absorb losses in such investments, we believe this is a very important issue. While beyond the scope

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of this consultation, we woud like to draw attention to the aforementioned letter from the SRC to the FSB, which discusses what the SRC (and CFA Institute independently) believe to to be a prudent approach for the CCPs to manage their own-name portfolios.

Second, indicator 8 proposes ESMA to consider the extent to which distributed ledger technologies (DLTs) are applied in its settlement/ payment process. We caution ESMA to specify these technologies more granularly as there is a significant misuse and abuse of jargon in the DLT/ blockchain space, and fintech more generally. Differences in seemingly minor technical details of blockchain design can have material impacts on the economic and business incentives facing participants, as well as the security and integrity of the systems. It is important for ESMA to ensure it has sufficient expertise, or sufficiently granular disclosure requirements, to avoid being purposefully or inadvertently misled.

**Q5: Do you generally agree with the proposed indicator as specified above (Indicator 12) to further assess alternative clearing services? Please elaborate and if you disagree with any specific indicator, please suggest an alternative one to measure the relevant criterion.**

CFA Institute broadly agrees with the proposed indicator 12 to further assess alternative clearing services. However, we would like ESMA to examine the CCP's interconnectedness with any relevant Trading Venues (TVs). As a dramatic example of the worst case, systemic scenario that can occur when the CCP and TV are vertically integrated or highly interconnected, we wish to draw ESMA's attention to the case of the Hong Kong Futures Exchange clearing house that closed as a result of the 1987 stock market crash, which forced both the futures exchange itself and the Hong Kong stock exchange to close as well.

**Q6: Do you generally agree with the proposed indicators as specified above (Indicators 13 and 14) to further assess relationships, interdependencies, or other interactions? Please elaborate and if you disagree with any specific indicator, please suggest an alternative one to measure the relevant criterion.**

CFA Institute would like ESMA to clarify, or reconsider, whether indicator 13 should be expanded to consider the scope of services that have been outsourced to the CCP from any entity, not just an EU entity. It is not immediately clear to us why, in considering systemic risk (which is global, by definition), ESMA is only concerned with interconnectedness via outsourcing arrangaments for EU entities.

**Concluding Remarks**

We welcome this opportunity to comment on the draft technical advice on criteria for tiering under EMIR2.2. Please do not hesitate to contact us should you wish further elaboration of the points raised.

Yours faithfully,

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