COMMITTEE ON CAPITAL MARKETS REGULATION

FINANCIAL MARKETS LAW COMMITTEE

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AND
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RESOLVING ISSUES OF LEGAL UNCERTAINTY RELATING TO THE RECOGNITION AND SUPERVISION OF CENTRAL COUNTERPARTIES: *ADDENDUM*

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FINANCIAL MARKETS LAW COMMITTEE[1]

This paper has been prepared by Staff of the CCMR and FMLC and adopted by both Committees.[2]

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1 Given the involvement of the UK authorities in discussions concerning the authorisation and recognition of central clearing counterparties, Sonya Branch, Stephen Parker and Sean Martin took no part in the preparation or discussion of this paper and it should not be taken to represent the views of the Bank of England, HM Treasury or the Financial Conduct Authority.

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I. EXECUTIVE SUMMARY AND INTRODUCTION

1 Founded in 2006, the Committee on Capital Markets Regulation (the "CCMR") is an independent and nonpartisan 501(c)(3) research organization financed by contributions from individuals, foundations, and corporations and dedicated, *inter alia*, to ensuring the stability of the U.S. financial system.[3]

2 Founded in 2002, the Financial Markets Law Committee (the "FMLC") is a charity, established for the purposes of education and the advancement of the understanding of financial markets law, whose role is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.[4]

3 In September 2015, the CCMR and the FMLC (together, "Committees") published a comment paper entitled *Resolving issues of legal uncertainty relating to the recognition and supervision of central counterparties* (the "Comment Paper").

4 The Comment Paper examined the legal and regulatory issues in the context of the continuing delay in the adoption by the European Commission of a positive equivalence decision vis-à-vis regulation applicable to central counterparties ("CCPs") in the U.S. and the consequent non-recognition of U.S. CCPs for the purposes of the E.U.'s Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("EMIR") by the European Securities and Markets Authority ("ESMA").

5 The Comment Paper made three key points: (i) regulatory differences should not preclude mutual recognition; frameworks for determining equivalence should accommodate those regulatory differences where possible; (ii) the U.S. Commodity Futures Trading Commission ("CFTC") should outline a clear pathway to substituted compliance for foreign CCPs; and (iii) a template for appropriate levels of host participation in supervisory colleges established by home regulators should be determined as soon as possible.

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3 Information regarding the CCMR, and examples of its work, are available on its website at http://capmktsreg.org/.

4 Information regarding the FMLC, and examples of its work, are available on its website at www.fmlc.org. The FMLC does not comment on the issues set out in this paper from a commercial or policy perspective.

6 The purpose of this addendum is to provide further comments on the problems of legal uncertainty posed by the continued delay in the adoption of a positive equivalence decision by the E.U. and U.S. regulatory authorities in light of recent regulatory developments, particularly, the entry into force of the E.U.'s mandatory clearing obligation for certain interest rate swaps (discussed below). The addendum also discusses ESMA's recent consultation on draft Regulatory Technical Standards amending Article 26 of Commission delegated Regulation No 153/2013 ("Article 26 of RTS 153/2013") with respect to margin period of risk for client accounts.

7 The addendum maintains that mutual recognition remains the most important means for addressing the legal and regulatory issues arising from the supervision of CCPs in a cross-border context.

II. MANDATORY CLEARING OBLIGATION FOR INTEREST RATE SWAPS UNDER E.U. LAW

8 On 1 December 2015, Commission Delegated Regulation (EU) 2015/2205 supplementing Regulation (EU) No 648/2012 with regard to regulatory technical standards on the clearing obligation (the "Regulation") was published in the Official Journal of the European Commission. The Regulation entered into force on 21 December 2015. It provides for a clearing obligation on certain classes of interest rate swaps, as contemplated by Articles 4 and 5 of EMIR.

9 In order to clear interest rate swaps within the scope of the Regulation and by virtue of Article 4(3) of EMIR, "third country" CCPs must be recognised by ESMA under Article 25 of EMIR. This, in turn, requires that the third country in question benefit from a positive equivalence determination by the European Commission. It follows that, without a positive equivalence determination by the European Commission in favour of U.S. CCPs, E.U. clearing members (dealers) and E.U. clients will no longer be able to clear their interest rate swaps with U.S. CCPs after the Regulation comes into effect.

10 The Regulation comes into effect for four counterparty categories on dates between 21 June 2016 and 21 December 2018. For counterparties falling under the first[5] and

[5] The first category comprises clearing members of at least one of the clearinghouses clearing the specified interest rate swaps.

second categories,[6] the clearing obligation comes into effect respectively on 21 June 2016 and 21 December 2016.

11 There is, however, an associated phase-in period, which applies to swaps of a specified minimum maturity by virtue of Article 4(1)(b)(ii) of EMIR. During this period counterparties are subject to an obligation to "frontload" contracts concluded before the start date of the clearing obligation. For the swaps constituting the bulk of the market, the phase-in period will take effect with respect to counterparties in the first category on 21 February 2016 and, for counterparties within the second category, on 21 May 2016.

12 The net effect, then, of the Regulation is that, without a positive equivalence determination by the European Commission and a recognition decision by ESMA in their favour, U.S. CCPs will be excluded from the European market in clearing services from 21 February 2016 in respect of certain classes of interest rate swap.

III. HARMONISING INITIAL MARGIN RULES SHOULD NOT BE A PRECONDITION FOR RECOGNITION

13 A key difference between the E.U. and U.S. rules on initial margin relate to the liquidation period and gross vs. net posting of customer margin with a CCP. Whereas the U.S. rules specify a minimum one-day time horizon, E.U. rules apply a minimum two-day time horizon for the liquidation period.

14 On 26 August 2015, ESMA published a consultation (the "Consultation") relating to the time horizons to be implemented by CCPs in respect of liquidation periods for the purposes of margin calculations.[7] The Consultation sought to investigate the appropriateness of revising the current standard in Article 26 of Commission delegated Regulation No 153/2013 ("Article 26 of RTS 153/2013") with respect to client accounts in order to allow CCPs to apply margin rules to exchange-traded derivatives which track those currently imposed on U.S. CCPs by the CFTC. These

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6 The second category comprises financial counterparties and non-financial counterparties above the clearing thresholds that are alternative investment funds, in each case which hold an aggregate gross notional amount of non-centrally cleared OTC derivative contracts above €8 billion by reference to a prescribed time period which are not in the first category.

7 European Market Infrastructure Regulation—Regulation No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories; ESMA Discussion Paper, Review of Article 26 of RTS No 153/2013 with respect to client accounts, 26 August 2015.

rules would apply a shorter, one-day liquidation period whilst requiring clearing members to pass through to the CCP enough margin to cover the sum of the separate margin requirements for each client's position—a process known as "gross" margining—in a change from the current E.U. rules which permit netting of exposures between clients' positions held in an omnibus account.

15 ESMA published on 14 December 2015, draft regulatory technical standards ("draft RTS") under cover of a consultation paper (No 2015/1867, "Consultation 2") amending Article 26 of RTS 153/2013. The draft RTS seeks to give effect to the changes to Article 26 of RTS 153/2013 proposed in the Consultation. As a result, the draft RTS introduces a one-day liquidation period for exchange-traded derivatives with margins calculated on a gross basis.

16 If adopted by the European Commission, the draft RTS will harmonise the margin levels under the E.U. and U.S. rules. While this development is a welcome step, without a positive equivalence decision, steps towards the harmonisation of margin rules do not resolve the practical, legal and regulatory issues outlined in paragraphs 8 to 13 of the Comment Paper. The Committees believe that mutual recognition remains an important means of addressing the issues.

III. MUTUAL RECOGNITION

17 The Committees have previously emphasised that legal and regulatory certainty in a cross-border context is promoted where there exists a clear legal framework for equivalence determinations. The Comment Paper suggested that such a framework should make room for regulatory differences by tailoring conditions or exceptions to address specific issues.

18 EMIR outlines a framework for the taking of equivalence decisions by the European Commission. The European Commission has, to date, adopted positive equivalence decisions for the regulatory regimes covering CCPs in Canada, Mexico, South Africa, Switzerland, South Korea, Australia, Hong Kong, Japan and Singapore. For U.S. CCPs however, it has not yet done so. In June 2014, the European Commissioner for Internal Markets and Financial Services, Michel Barnier, observed that a positive equivalence decision by the Commission vis-à-vis U.S CCPs was conditional on an "effective equivalence decision" by the CFTC for E.U. CCPs.[8]

19 The Committees note that, should it determine to do so, the European Commission is able to adopt a positive equivalence decision as regards U.S. CCPs even in the absence of reciprocal determination by the CFTC. Article 25(6) of EMIR, which stipulates that the Commission may only take a positive equivalence decision if "the legal framework of the third country provides for an effective equivalent system for the recognition of CCPs" does not go so far as to require that regulatory authorities of the third country in question must have reached a positive determination on recognition. Meanwhile, it is already the case that changes introduced to the Commodity Exchange Act 1936 (see section 5b(h)) by the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 ("the Dodd-Frank Act") authorise the CFTC to exempt a "clearing organization" from registration if it determines that it is subject to comparable and comprehensive supervision by appropriate government authorities in its home country. That is, U.S. law already provides an effective framework for the recognition of E.U. CCPs.

20 The Committees understand that the CFTC's reluctance to recognise E.U. CCPs is, in part, related to concerns that U.S. clients who clear swaps with a foreign CCP will not have the benefit of U.S. bankruptcy laws in the event of the insolvency of the foreign CCP. In briefest summary, the legal point is that, whereas the U.S. Bankruptcy Code entitles the "customers" of a clearing member (a "Futures Commission Merchant" or "FCM") to a rateable distribution of property on the insolvency of the FCM, there is doubt as to whether the definition of "customer" extends to those clients whose derivatives are cleared by the FCM through a non-U.S., exempt CCP.[9] The Committees take the view that a constructive, coherent interpretation of the Bankruptcy Code, the Commodity Exchange Act and the amendments introduced by the Dodd-Frank Act would not deprive U.S. clients of protections under U.S.

8 European Commission Press Release (27 June 2014), available at: http://europa.eu/rapid/press-release_STATEMENT-14-211_en.htm.

9 Subchapter IV of Chapter 7 of the Bankruptcy Code grants priority to the "customer" of an FCM on the insolvency of the latter in the distribution of "customer property". The definition of "customer" depends, in turn, on that of "commodity contract" which refers to contracts cleared through a "clearing organization", defined as a "*registered* derivatives clearing organization". The reference to cleared contracts is an amendment introduced by the Dodd-Frank Act, which also introduces section 5b(h) of the Commodity Exchange Act, authorising exemptions from registration. From the perspective of purposive interpretation, it is strongly arguable that the failure to amend the definition of "clearing organization" in the Bankruptcy Code, when related amendments were introduced by the Dodd-Frank Act, was a drafting oversight and that the definition of "clearing organization" impliedly includes exempt CCPs.

bankruptcy laws where their contracts are cleared through a foreign CCP which has been granted exemption from registration by the CFTC on the basis of comparable regulation in its home jurisdiction.

IV. CONCLUSION

21 The recognition and supervision of CCPs in a transatlantic context continues to give rise to legal and regulatory issues of uncertainty. Mutual recognition by both the E.U. and the U.S. in the context of the cross-border regulation of CCPs would, in the view of the Committees, help address the issues of legal uncertainty, preserve liquidity in derivatives markets and prevent market fragmentation.

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10 Note that the names of members of the Committee on Capital Markets Regulation are given for information purposes only. A list of current members is available on the CCMR's website: http://capmktsreg.org/.

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11 Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

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