



European Market Infrastructure Regulation: the European Commission's Legislative Proposal to Amend Procedures for recognition of Third Country Central Counterparties

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1. INTRODUCTION AND EXECUTIVE SUMMARY

- 1.1. The role of the Financial Markets Law Committee (the “**FMLC**”) 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.
- 1.2. Following the financial crisis of 2009, the G20 agreed at Pittsburgh to address systemic risks posed by the lack of stability and transparency in the global derivatives markets.⁴ Consequently, in 2012, the European Union (“**E.U.**”) adopted Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (the “**European Market Infrastructure Regulation**” or “**EMIR**”) as the centrepiece of its regulatory reform of over-the-counter (“**OTC**”) derivatives markets.⁵
- 1.3. EMIR imposes a variety of obligations, notably the requirement to clear eligible OTC derivative contracts through a central counterparty (“**CCP**”).⁶ It also sets out the regulatory and supervisory framework for the rendering of clearing services in the E.U., including prudential, organisational and business conduct requirements imposed on CCPs established in E.U. Member States (“**E.U. CCPs**”).⁷
- 1.4. Similarly, EMIR establishes a framework for the recognition and supervision of CCPs established in, and regulated by, non-E.U. countries (“**Third Country CCPs**” or “**TC CCPs**”) which wish to provide clearing services to E.U. clearing members and/or E.U. trading venues. Such services are carried out on the basis of equivalence decisions by the European Commission, recognition of each TC CCP by the European Securities and Markets Authority (“**ESMA**”) and cooperation arrangements between the E.U. and such Third Countries.⁸

⁴ See G20 Leaders Statement at the Pittsburgh Summit (24-25 September 2009), available at <http://www.g20.utoronto.ca/2009/2009communique0925.html>.

⁵ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02012R0648-20170103&qid=1492599335405&from=EN>.

⁶ Article 5 of EMIR. “‘Clearing’ means the process of establishing positions, including the calculation of net obligations, and ensuring that financial instruments, cash, or both, are available to secure the exposures arising from those positions” (Article 2(3) of EMIR).

⁷ Titles III, IV and V of EMIR.

⁸ Article 25 of EMIR. More information about these processes is available in paragraph 2.3 below.

- 1.5. Since EMIR and other global regulatory reforms came into force, the use of central clearing and CCPs has increased significantly. As at June 2017, approximately 77% of all OTC interest rate derivative contracts and 51% of all OTC credit derivative contracts were centrally cleared on CCPs.⁹ This trend is likely to continue, given the regulatory emphasis currently given to the benefits of central clearing. Notwithstanding this expansion, the number of CCPs rendering clearing services in the E.U. remains low: currently, 17 E.U. CCPs are authorised and 32 TC CCPs are recognised under EMIR,¹⁰ and the vast majority of CCPs in existence have obtained licensing in the E.U.
- 1.6. The growth in the use of CCPs, combined with its still relatively low number of active CCPs, the high interconnectivity between CCPs and financial market participants located both in the E.U. and overseas and the consequent systemic risk that the failure of a CCP would cause has meant that CCPs have themselves become subject to growing regulatory attention.¹¹ Such attention, together with the fact that a notable proportion of derivatives contracts denominated in currencies of E.U. Member States are cleared by TC CCPs and/or CCPs located in the United Kingdom (“U.K.”)—which will become a Third Country following its withdrawal from the E.U. (“**Brexit**”)¹²—have prompted suggestions that the current EMIR regime on TC CCPs is insufficient and a more active and consistent supervisory process would be beneficial.¹³
- 1.7. As a result—and following an impact assessment report, a number of public consultations, and two peer reviews on the functioning of the supervisory colleges under EMIR conducted by ESMA in 2015 and 2016, the Commission adopted a legislative

⁹ BIS, Statistical release: OTC derivatives statistics at end-June 2017, available at https://www.bis.org/publ/otc_hy1711.pdf.

¹⁰ The full list of authorised and recognised CCPs is available on the ESMA website at: <https://www.esma.europa.eu/policy-rules/post-trading/central-counterparties>. See also Explanatory Memorandum to the Proposal (defined below) and item 2.3 of the Commission Staff Working Document Impact Assessment accompanying the Proposal, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017SC0246&from=EN>.

¹¹ See, for instance, the Proposal for a Regulation of the European Parliament and of the Council on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012, and (EU) 2015/2365 (COM(2016) 856 final).

¹² See Explanatory Memorandum to the Proposal (defined below) and item 2.3 of the [Commission Staff Working Document Impact Assessment accompanying the Proposal](#). Also, the London Clearing House, for example, is reported to currently clear more than 90% of cleared euro-denominated interest rate swaps (see “LCH flags swapping London for New York if euro clearing departs”, Reuters 25 October 2017, available at <https://uk.reuters.com/article/uk-britain-eu-clearing/lch-flags-swapping-london-for-new-york-if-euro-clearing-departs-idUKKBN1CU1YD>).

¹³ See the Commission Communication entitled “Responding to challenges for critical financial market infrastructures and further developing the Capital Markets Union” of 4 May 2017, available at: https://ec.europa.eu/info/sites/info/files/170504-emir-communication_en.pdf.

proposal on 14 June 2017 to amend the processes for authorisation, recognition and supervision of CCPs under EMIR (the "**Proposal**").¹⁴

- 1.8. In this context, the FMLC has established a Working Group to identify and make recommendations to illuminate or resolve, where and if possible, uncertainties, difficulties and concerns around the Proposal's changes to the CCPs regime in the E.U.
- 1.9. The Proposal encompasses changes to both the EMIR regimes on E.U. CCPs and on TC CCPs. This paper will, however, focus on the changes to the TC CCPs' arrangements only, on the basis that: (a) a notable proportion of derivatives contracts denominated in currencies of E.U. Member States are cleared by TC CCPs and/or CCPs established/located in the U.K. ("**U.K. CCPs**"); (b) most of the legal uncertainties identified by the Working Group relate to the TC CCPs regime; and (c) the changes in the Proposal could directly affect the U.K. and/or U.K. CCPs which currently render or wish to render/continue rendering clearing services to E.U. clearing members and trading venues post-Brexit.
- 1.10. Section 2 of this paper therefore provides an overview of the current EMIR regime on TC CCPs and of the changes proposed in the Proposal. Section 3 then identifies issues of legal uncertainty derived from such changes, notably those derived from imprecise definitions of and criteria for the classification of "systemically important" and "substantially systemically important" TC CCPs, unclear rules governing the proposed recognition process (e.g., uncertainties derived from undefined or potentially inadequate timeframes in the recognition process, and the broad discretion granted to the European Commission, ESMA and other competent authorities in detailing or implementing the provisions of the Proposal), complexities derived from the Location Policy, and potential overlaps of the proposed recognition regime with Third Country legal frameworks or other applicable legislation (i.e., issues derived from conflict of laws and/or discrepancies between new infringements and the Comparable Compliance or equivalence provisions).¹⁵

¹⁴ Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs, available at https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-331_en.

¹⁵ See definitions of Location Policy and Comparable Compliance in Section 2.

- 1.11. Section 4 considers the impact such changes may have. It is noted that the volume of clearing services provided to E.U. clearing members and trading venues by TC CCPs (including U.K. CCPs post-Brexit), combined with the relative concentration of the market and the high interconnectivity between CCPs and financial market participants in the E.U. and overseas, may result in certain proposed changes to the TC CCPs regime significantly impacting market participants and the financial stability of the E.U. and other relevant jurisdictions, by causing market disruption, reduced liquidity and increased costs.
- 1.12. Finally, Section 5 sets out possible mitigants and/or solutions to the uncertainties identified. In particular, it suggests that clarifying and/or providing transparency to the decision-making processes in the Proposal would be helpful in avoiding or mitigating some of the impact of the proposed changes.
- 1.13. It is not for the FMLC to comment on matters of policy or the form that future regulatory approaches, if any, should take and this paper should not be understood to constitute comments thereon.

2. BACKGROUND AND OVERVIEW

- 2.1. The E.U. regulation and supervision of E.U. CCPs currently rely mainly on the national competent authority (the “NCA”) of the E.U. Member State where the relevant E.U. CCP is located.
- 2.2. The NCA is responsible for (a) managing and chairing a college functioning on the basis of written agreements between all its members (the “College”) with the purpose of granting, refusing or extending authorisation, reviewing models and parameters and approving interoperability arrangements through joint or majority opinions and (b) producing CCP risk assessments.¹⁶ ESMA is a non-voting member of each College, responsible for coordinating authorities and colleges to ensure consistent practices and the correct application of EMIR, mainly through templates, guidelines, operational issues notes, Q&As and uniform methodology for assessment of compliance.
- 2.3. TC CCPs are permitted to provide clearing services to E.U. clearing members and/or E.U. trading venues, and E.U. entities are able to avail themselves of more favourable

¹⁶ Articles 15, 17, 18, 49 and 54 of EMIR and Article 21 of the Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (the “ESMA Regulations”).

capital treatment regarding their exposures to those TC CCPs where the TC CCP is recognised by ESMA under EMIR, on the basis of:

- a) implementing acts of the European Commission determining that the regulatory and supervisory regime of a Third Country is equivalent to that of the E.U., verified through an outcomes-based process that ensures that such a Third Country imposes equivalent legally binding requirements on TC CCPs in their territory, effectively supervises and enforces its regime, and provides for an effective equivalent system for the recognition of CCPs authorised under other Third Countries' legal regimes;¹⁷
- b) a recognition of each TC CCP by ESMA—in consultation with other relevant authorities, including central bank(s) of issue¹⁸—granted on the basis of: (i) an equivalence decision in respect of the Third Country where it is established, authorised and subject to effective supervision and enforcement ensuring full compliance with the applicable prudential requirements; (ii) an established cooperation arrangement setting out at least the mechanics for exchange of information, prompt notification and coordination of supervisory activities including on-site inspections, and (iii) compliance with regulations on anti-money laundering and anti-financing of terrorism which have been deemed equivalent to that of the E.U. (see Article 25(2) of EMIR);¹⁹ and
- c) continued monitoring and supervision, reliant on cooperation agreements between ESMA and the relevant competent authorities in each relevant Third Country whose legal and supervisory frameworks have been recognised as equivalent²⁰.

¹⁷ Article 25(6) of EMIR. The Staff Working Document on E.U. equivalence decision in financial services policy provides further guidance on what equivalence entails. See European Commission Staff Working Document, *E.U. Equivalence Decision in Financial Services Policy: An Assessment*, 27 February 2017, available at: https://ec.europa.eu/info/sites/info/files/eu-equivalence-decisions-assessment-27022017_en.pdf.

¹⁸ Article 25 of EMIR. recognition is granted by ESMA in consultation with the NSA of the E.U. Member State where the TC CCP intends to provide services or in which currency services are provided, the NSA of the three E.U. Members States that most contribute to the default fund, the competent NSA of the trading venues at the E.U. served or to be served by the TC CCP, NSAs in the E.U. Member States where interoperability arrangements operate, ESCB members and central bank(s) of issue.

¹⁹ Article 25(2) of EMIR.

²⁰ Article 25(7) of EMIR

Proposed changes to the equivalence regime

- 2.4. Under the Proposal, the European Commission will continue to be responsible for equivalence decisions, but will now be able to subject the issue of such decisions to further conditions, if necessary, by way of a delegated act.²¹

Proposed changes to the recognition regime

- 2.5. The Proposal introduces changes to the regulatory and supervisory framework applicable to both E.U. CCPs and TC CCPs.²² In general terms, it gives ESMA the final say on authorisation, recognition or withdrawal decisions—although sometimes subject to the consent of relevant central bank(s) of issue in matters affecting monetary policy (e.g., margin or collateral requirements, liquidity controls, etc) and consultation with other authorities,²³ and creates the CCP Executive Session within ESMA’s Board of Supervisors for that purpose.²⁴
- 2.6. The new CCP Executive Session will comprise: (a) permanent members with voting rights (the head and two independent directors) and without voting rights (European Central Bank and European Commission), (b) members specific to each CCP with voting rights (National Supervisory Authority (“NSA”) of the E.U. Member State where the CCP is established, if applicable) and without voting rights (relevant central banks of issue), and (c) observers (including, if pertinent, representatives of the NSA of the TC CCP offering or intending to offer clearing services into the E.U.). When a decision relates to a TC CCP specifically, only the permanent members (as described in (a) above), the relevant central bank(s) of issue and any relevant observers shall participate.²⁵

²¹ Proposed new Article 25(6) of EMIR, and Article 82 of EMIR.

²² Proposed new Articles 17(3), 20(6), 21(1) and (3), 21a, 21b, 21c, 25(2a), 25(5), 25(6) 25(6a), 25(6b), 25(7), 25b to 25n, and 89(3b) of EMIR.

²³ Article 25(3) of EMIR.

²⁴ For example, the proposed new TC CCPs recognition or withdrawal processes are led by ESMA directly, in consultation of other authorities and subject, in certain cases, to consent by the central banks of issue. In respect of E.U. CCPs, on its turn, the proposed new regime provides that an assessment of an E.U. CCP’s application by a NCA is undertaken in consultation with ESMA, and a NCA must provide ESMA with a fully reasoned draft of its decision to withdraw authorisation of a CCP prior to issuing the decision. Likewise, any review and evaluation of a E.U. CCP by a NCA should be undertaken in cooperation with ESMA, and ESMA is given responsibility for establishing the frequency and depth of any such review. Certain decisions by NCAs are subject to the prior consent of ESMA and relevant central banks of issue (for instance those relating to access to a CCP, the authorisation of a CCP or withdrawal of authorisation of a CCP), and NCAs shall not publish those decisions without amendments proposed by ESMA or relevant central bank(s) of issue, with a resolution mechanism included to resolve disputes between ESMA and a NCA.

²⁵ See Recital 11 of the Proposal, and proposed new Articles 4(3)(a) and 44a(a) of ESMA Regulations.

TC CCPs recognition process

- 2.7. The Proposal introduces a three-tier system for the recognition of TC CCPs based on each applicant's systemic importance to individual affected E.U. Member States and the E.U. as a whole. On the first phase of the proposed new recognition process, a TC CCP would therefore need to be classified as "Tier 1", "Tier 2" or "substantially systemically important" TC CCP (as defined below). Such classification will determine what requirements an applicant will have to meet to be recognised under EMIR and/or whether it will be subject to higher compliance standards once it is recognised.
- 2.8. The degree of a TC CCP's systemic importance is determined on the basis of: (a) the nature, size and complexity of its business; (b) the effect that its failure or a disruption to its functioning would have on critical markets, financial institutions or the broader financial system and on the financial stability of the E.U.; (c) its clearing membership structure; and (d) its relationship, interdependencies, or interactions with other financial market infrastructures (the "**Systemic Importance Criteria**").²⁶ These criteria are to be further specified by a delegated act of the European Commission within six months of the adoption of the Proposal.
- 2.9. TC CCPs that are considered not systemically important or are considered not likely to become systemically important on the basis of the Systemic Importance Criteria (classified as "**Tier 1**" CCPs) would need to comply with the current requirements under EMIR to be recognised.²⁷ ESMA has indicated that TC CCPs which have already been recognised under the current EMIR regime will be considered Tier 1 TC CCPs until it has determined otherwise, which shall occur within 12 months from entry into force of the delegated act detailing the Systemic Importance Criteria.²⁸
- 2.10. TC CCPs that are considered systemically important or are considered likely to become systemically important on the basis of the Systemic Importance Criteria (classified as "**Tier 2**" CCPs) would need to meet both Tier 1 and the following additional requirements (the "**Tier 2 Additional Requirements**") to be recognised:
- a) ongoing compliance (or ongoing Comparable Compliance, as defined in paragraph 2.11 below) with the relevant and necessary prudential requirements

²⁶ Proposed new Article 25(2a).

²⁷ Proposed new Article 25(1).

²⁸ See Explanatory Memorandum accompanying the Proposal, p. 25, and proposed new Articles 25(2a) and 89(3b) of EMIR.

imposed on E.U. CCPs, such as capital requirements, requirements for the internal organisation management, conduct of business, margins, default fund, financial resources, liquidity, investments, stress tests, settlement and interoperability;

- b) compliance with additional requirements imposed by central bank(s) of issue—in particular, where the relevant payments system and/or monetary policies may be impacted by the applicant TC CCP—which such central banks of issue will confirm by issuing a written consent within 180 days from the submission of the complete application (“**Central Bank’s Consent**”);
- c) issuance, by the applicant TC CCP, of an unconditional written consent supported by an independent legal opinion, whereby the applicant grants ESMA access to its premises and agrees to provide any document, record, information and data it holds within 72 hours of receiving ESMA’s request (“**Unconditional Consent**”); and
- d) implemented procedures and measures necessary to enable compliance with the conditions above.²⁹

2.11. The Proposal allows a Tier 2 TC CCP applicant to request ESMA to confirm that the regulatory framework of the Third Country in which it is established and regulated is comparable to the EMIR’s capital and organisational requirements and interoperability arrangements (“**Comparable Compliance**”), by submitting a reasoned request in accordance with the process to be detailed in an European Commission delegated act setting out the minimum elements and the modalities and conditions for carrying out the assessment.³⁰

2.12. If a Tier 2 TC CCP is considered of “substantial systemic importance” by ESMA, it may be denied recognition and need to relocate to the E.U. and apply for an authorisation under Article 14 of EMIR instead (the “**Location Policy**”), even if it complies with the Tier 2 Additional Requirements.³¹ For such purposes, ESMA (in agreement with the central banks of issue) shall recommend that the European Commission issues an implementing act determining that compliance with the Tier 2

²⁹ Proposed new Articles 25(2a) and (2b) of EMIR, and delegated acts to be enacted by European Commission subsequently.

³⁰ Proposed new Articles 25(2b(a)) and 25a of EMIR, and Article 82 of EMIR.

³¹ Proposed new Article 25(2c) of EMIR.

Additional Requirements is insufficient, and that the applicant TC CCP must be authorised and established in an E.U. Member State as a E.U. CCP under EMIR (as opposed to remaining established in the Third Country and being recognised) if it wishes to provide clearing services to E.U. clearing members and/or trading venues.

Monitoring and Supervision of TC CCPs

- 2.13. The Proposal not only gives ESMA a more prominent role in decision-making processes as described above, but also provides for additional supervision and enforcement mechanisms. For example, it grants ESMA powers to (a) monitor continued compliance by TC CCPs, the development of Third Countries' regimes and cooperation agreements to ensure they continue effective in practice, and (b) conduct onsite inspections, request information and impose fines and periodic payments.
- 2.14. Accordingly, the Proposal determines that ESMA establishes (a) procedures for the effective monitoring of regulatory and supervisory developments in each relevant Third Country, and (b) effective cooperation arrangements allowing it to, amongst other things, access information and carry out on-site inspections in TC CCPs.³² ESMA shall also review recognition decisions at least every two years, and may require, *inter alia*, each Tier 2 TC CCP to comply with EMIR prudential requirements applicable to E.U. CCPs and to confirm on a yearly basis that it fulfils all additional supervisory requirements.

3. ISSUES OF LEGAL UNCERTAINTY

The recognition process

Systemic Importance Criteria

- 3.1. As mentioned above, the European Commission will adopt a delegated act detailing the Systemic Importance Criteria broadly set out in the Proposal.³³ As demonstrated in the list below, however, the parameters for such a delegated act in the Proposal confer significant discretion to the European Commission.
- a) The term “systemically important” has not been defined.

³² Proposed new Article 25(6a), (6b) and (7) of EMIR.

³³ See proposed new Articles 25(2a) of EMIR, and paragraph 2.8 above.

- b) There is no guidance on how different elements of the Systemic Importance Criteria shall be weighted and/or interpreted.
- c) The criteria for ascertaining when an applicant is of "such substantial systemic importance" as to justify relocation are not clear.
- d) The criteria for ascertaining when an applicant TC CCP (or service, activity or class of financial instruments, if the case) should be considered "likely to become" systemically important (and therefore be subject to the Tier 2 Additional Requirements)—which is a forward looking analysis difficult to measure—are not clear.

3.2. It is worth noting that the systemic importance test as proposed in the Proposal is not a binary evaluation but one of degree, to which the Proposal gives no parameters, and which will nonetheless determine under what conditions, in what terms and, indeed, whether a recognition decision will be granted.³⁴ Certainty and transparency in respect of the systemic importance assessment of applicant TC CCPs are therefore essential.

Tier 2 Additional Requirements

Compliance with requirements imposed on E.U. CCPs

3.3. The Proposal requires that a Tier 2 TC CCP additionally comply with certain EMIR requirements applicable to E.U. CCPs on an ongoing basis (see paragraph 2.10(a) above), and may request that ESMA issue a Comparable Compliance decision confirming that it meets this requirement by complying with the corresponding requirements of its home country (see paragraph 2.11 above). The need for a Comparable Compliance decision from ESMA in addition to an existing positive European Commission equivalence decision may, however, create uncertainties as ESMA could arrive at a decision which contradicts the Commission's equivalence assessment. If the European Commission has issued an equivalence decision without conditions in respect of the relevant Third Country, there should be no areas in which ESMA should find the requirements of the TC CCP's home country to be not comparable with those requirements applicable to E.U. CCPs. If the European Commission had included conditions in its equivalence decisions, it seems to follow

³⁴ That is, ascertaining systemic importance involves not only determining whether the TC CCP is systemically important to the E.U., but also to what degree (e.g., Tier 1, Tier 2 or of "substantial systemic importance"). See proposed new Article 25(2a) of EMIR.

that ESMA should find the requirements of the TC CCP's home country to be not comparable with those requirements applicable to E.U. CCPs in those areas only.

- 3.4. It would create considerable uncertainties if ESMA were able to find additional areas of non-comparability and in turn require an applicant to make potentially substantial additional operational, governance or risk management changes where the European Commission had already found equivalence. This situation could also create a risk of potential conflicts or incompatibility with the regulatory regime of the home country of the TC CCP, as discussed in paragraph 4.9, below.
- 3.5. Additionally, the Proposal determines that the parameters for a Comparable Compliance decision are set out in a delegated act by the European Commission.³⁵ The Proposal does not however detail the parameters for such delegated act nor includes any consequential amendment to current Article 82 of EMIR (which sets out the extent of the European Commission's delegated powers under EMIR), resulting in uncertainties not only in respect of the criteria for a Comparable Compliance decision, but also of whether delegation is conferred to the European Commission for an indefinite period (Article 82(2)) and/or is revocable (Article 82(4)).

Additional requirements by central banks of issue

- 3.6. An applicant Tier 2 TC CCP will need to comply with "any requirements" of central banks of issue (see paragraph 2.10(b) above). The Proposal does not clarify, however, what these requirements might be, nor the basis on which they will be designed and implemented. This introduces additional legal uncertainty in that central banks have potentially broad and unspecified powers and sole authority to determine whether these conditions are satisfied, which could constitute an effective veto power of relevant central banks over the recognition of a Tier 2 TC CCP. The Commission's proposal, furthermore, lacks any restrictions to ensure that central bank requirements do not cause a TC CCP to breach EMIR or other applicable laws.
- 3.7. Additionally, the Proposal states that ESMA *may* consider that consent by the relevant central banks of issue have been granted upon lapse of the 180 days with no written response received, which makes it uncertain whether ESMA has the discretion to refuse an application on the grounds of non-compliance with central banks' requirements

³⁵ Proposed new Articles 25(2b)(a) and 25a, and current Article 16 and Titles IV and V of EMIR. See also paragraph 2.11 above.

where no central bank's consent was received within 180 days from the submission of the complete application.

Requirement to give Unconditional Consent

- 3.8. An applicant Tier 2 TC CCP must give ESMA an Unconditional Written Consent supported by an independent legal opinion undertaking to provide ESMA with access and information upon request (see paragraph 2.10(c) above), which in itself may conflict with laws in the TC CCP's home country which prevent CCPs from providing certain information to foreign governmental bodies. The Proposal's 72 hours deadline for compliance with a future and unqualified information requirement by ESMA results in uncertainties which could ultimately prevent applicants from meeting the Tier 2 Additional Requirements, as a TC CCP may be justifiably wary of making unqualified undertakings which do not take into account the nature, quantity, justification, proportionality and/or time constraints for obtaining the information requested by ESMA. Likewise, the availability and/or content of the required supporting legal opinion could vary significantly from jurisdiction to jurisdiction and in some cases prevent the success of an application.

Recognition decision

ESMA's consultation obligations

- 3.9. Article 25(3) of EMIR requires ESMA to consult with a number of authorities before determining whether a TC CCP meets the requirements for recognition (see paragraph 2.1 to 2.3 above). However, as exemplified above, the systemic importance assessment introduced by the Proposal adds complexity and subjectivity to the recognition process and creates uncertainties in respect of the manner of carrying out the consultation process. It is unclear whether the nature of the financial instruments cleared by a CCP is relevant for the systemic importance assessment as Euro-denominated repurchase agreements or Euro-benchmarked interest rate derivatives might be much more important for the assessment in comparison with commodity derivatives relating to global commodity markets which are denominated or settled in Euros.

Recognition of individual services, activities or classes of financial instruments

- 3.10. The Proposal does not expressly allow a partial recognition decision—i.e., a recognition decision limited only to services, activities or classes of financial instruments the applicant intends to offer to E.U. clearing members or trading venues (as opposed to

recognition of the TC CCP as a whole).³⁶ Likewise, the Tier 2 Additional Requirements seem to apply to the TC CCP as a whole. Market participants have identified this as potentially unnecessary and disproportionate, as discussed in paragraph 4.7 below.

- 3.11. The Proposal does, however, enable ESMA to limit the scope of a decision to *withdraw* recognition from a particular service, activity or class of financial instruments which no longer meets the criteria for recognition (as opposed to withdrawing recognition of the TC CCP as a whole).
- 3.12. It would, therefore, be beneficial for relevant authorities to provide clarity in respect of (a) whether partial recognition is possible and (b) how the EMIR regime would apply to TC CCPs partially—i.e.: only to certain services, activities or products offered by the TC CCP into the E.U., but not to those that do not pertain to or affect the E.U..

Status of TC CCPs recognised under the prior regime

- 3.13. The Proposal determines that ESMA shall review decisions in respect of TC CCPs recognised under the current regime (i.e., prior to the Proposal coming into effect) within 12 months of adoption of the delegated act setting out the detailed Systemic Importance Criteria and that, in the meantime, such TC CCPs should be considered Tier 1 TC CCPs (see paragraph 2.9 above).
- 3.14. The 12 months' deadline could, further, be unrealistic and create uncertainty over E.U. market participants' ability to access Third Country markets and TC CCPs.³⁷ Such reassessment could impose Tier 2 Additional Requirements on TC CCPs already recognised under the current EMIR regime, which they might not be ready to meet, or could ultimately require TC CCPs to relocate to the E.U. if they wish to continue

³⁶ See proposed new Articles 25(2a), 25(2b) and 25(m) of EMIR. See also FIA paper "Feedback from FIA on European Commission EMIR Review Proposal – Part 2 (authorisation and recognition of CCPs)", p.8 which notes that recognition and supervision by the EU of a TC CCP at the level of a particular service (rather than at entity level) would be a more proportionate approach and would avoid unnecessary oversight by the E.U. of services that are not systemically important in the EU. This could in turn reduce the risk of legal uncertainty arising where a TC CCP is subject to incompatible or overlapping legal or regulatory requirements in the E.U. and its home jurisdiction.

³⁷ For example, reassessment of the current equivalence and recognitions decisions relating to the U.S. could raise concerns about the ongoing access of E.U. based and E.U. affiliated banks and investment firms to U.S. markets. Firms have identified concerns that such potential for reassessment could lead to significant uncertainty and that re-opening of existing decisions could create significant disruption. See FIA paper "Feedback from FIA on European Commission EMIR Review Proposal – Part 2 (authorisation and recognition of CCPs)", p.4, available at https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-331/feedback/F6850_en

providing clearing services to E.U. clearing members or trading venues.³⁸ This could result in regulatory uncertainty as to capital treatment.

Status of U.K. CCPs post-Brexit

- 3.15. It is uncertain whether, upon Brexit, U.K. CCPs currently authorised under EMIR as E.U. CCPs will automatically become recognised as a TC CCP under the new regime, as there is currently no transitional arrangement on the status of authorised U.K. CCPs following Brexit and the E.U. has indicated that there will be no automatic equivalence of the U.K. regime and/or automatic recognition or authorisation of U.K. entities.³⁹ In the absence of grandfathering arrangements, there is the danger of a cliff-edge, where U.K. CCPs would need to cease providing clearing services to E.U. clearing members or trading venues pending a recognition decision post-Brexit.
- 3.16. In contrast, the Bank of England has announced the manner in which its framework for post-Brexit E.U. CCPs will operate and has provided details on the process for re-authorisation of such CCPs.⁴⁰

Processing time

- 3.17. The Proposal does not expressly provide for a clear timeframe and process for (a) the classification of an applicant TC CCP's systemic importance in the preliminary stage of the recognition process and/or (b) for the European Commission to adopt an implementing act declaring that an applicant Tier 2 TC CCP must relocate to the E.U. and seek authorisation as a E.U. CCP under the Location Policy. Similarly, the Proposal does not clearly provide time, remediation periods, an appeals process, or limitations on re-applying should an application for recognition be refused.
- 3.18. These uncertainties are further intensified by the subjective and complex nature of the systemic importance assessment introduced by the Proposal, which may generate

³⁸ It is possible that a reassessment would lead to unfavourable capital treatment for E.U. based firms based on the requirement that TC CCPs must be authorised under EMIR to achieve qualifying E.U. CCP status, which is necessary to ensure that their exposure to TC CCPs receive optimum capital treatment.

³⁹ See ESMA's opinion of 31 May 2017 on [General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union; Staff Working Document on EU equivalence decision in financial services policy](#); item 24 of the preamble to the Proposal; pages 10-11 of the [Commission Staff Working Document Impact Assessment accompanying the Proposal](#). See also FMLC's paper of July 2017 titled '[Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U.—Provision and Application of Third Country Regimes in E.U. Legislation](#)'.

⁴⁰ The Bank of England's approach to the authorisation and supervision of international banks, insurers and central counterparties. <https://www.bankofengland.co.uk/news/2017/december/approach-to-authorisation-and-supervision-of-international-banks-insurers-central-counterparties>

doubts as to what is actually required from applicants and their ability to comply in a timely manner. Transparency in this respect would be beneficial.

Mechanics for relocation of TC CCPs of substantial systemic importance

- 3.19. The Proposal enables the refusal of an application for recognition of a TC CCP of "such substantial systematic importance" even if it meets the Tier 2 Additional Requirements,⁴¹ forcing a Tier 2 TC CCP to partially or fully relocate to the E.U.
- 3.20. To relocate, the Tier 2 TC CCP would have to procure a transfer of open contract positions (and the associated margin) to a new or existing E.U.-based CCP, and may also need to establish a new E.U. CCP.⁴² The relocation of a TC CCP into the E.U. is, however, unprecedented. As such, there is no tried and tested legal relocation mechanism, which raises issues of legal uncertainty in relation to the mechanics of the transfer of positions, margin and default funds, as explained below.

Transfer of positions

- 3.21. Any transfer of positions from one CCP to another—i.e., from the Tier 2 TC CCP to a new or existing E.U. CCP—will generally require the unanimous consent of all members of the TC CCP as this is required to novate all contracts.⁴³ It would be difficult for a CCP to influence such non-consenting clearing members or to unpick a web of positions to accommodate them.
- 3.22. Without the consent of all members, transfers cannot be completed of the entirety of the open interest at the CCP. Given that CCPs could not transfer or retain an unbalanced book at either the transferee or the transferor CCPs (which would result in the relevant CCPs taking counterparty risk, leaving them exposed to a member default and potentially contravening the conditions of their authorisation or recognition), it would be necessary for the open interest of non-consenting members (and allocated open

⁴¹ See proposed new Article 25(2c), and the Location Policy, as defined in paragraph 2.8(2.11) above.

⁴² Although this paper does not detail the process to establish a new E.U. CCP, it is worth noting that such process may take years and requires considerable investment in IT, personnel and systems.

⁴³ Previous E.U.-to-E.U. CCP and U.S.-to-E.U. CCP transfers were only possible with the consent of all members. For example, the transfers from LCH.Clearnet to ICE Clear Europe in 2008 and 2013, from European Commodity Clearing A.G. to ICE Clear Europe in 2013, and from APX Clearing B.V. and APX Commodities Limited to ICE Clear Europe in 2015; and the transfer from New York Portfolio Clearing, LLC to ICE Clear Europe in 2014. Such previous transfers would help inform the process and provide a precedent to some degree, but the process would undoubtedly be more complex and difficult on a cross-border basis, in particular for transfers from a Third Country into the E.U..

interest on the “other side” of such positions) to be closed out prior to the transfer, which could lead to market disruption.

Transfer of margin and default funds

3.23. In any clearing transition, a significant legal and operational issue arises in relation to the transfer of margin and default funds. Default funds are maintained by clearing houses to provide further protections in the event of a clearing member default and all clearing members are required to contribute to it, based on the level of risk they bring. A direct and immediate transfer of an entire default fund from one CCP to another is unrealistic, not least because both CCPs will want to ensure that they have a full default fund at all times, as required by EMIR. Such a transfer has never been attempted before. There have in the past been agreements between CCPs for the transfer of margin. However, the operational limitations in capacity of the current banking system have made it impossible to transfer the entirety of a margin pool at a particular time. This leaves two possible options for transfers, neither of which is risk-free:

- a) Double margin. Both the Third Country and E.U. CCP could call margin separately from the same members for a limited period (i.e., a few days) leading up to and including the date of the transfer. Margin returns from the TC CCP would be processed after the transition. This would ensure that both CCPs have sufficient collateral at all times during the transfer. However, this would result in significant cost of funding to clearing members and is likely to be a relevant factor as regards consent to the relocation.
- b) Margin on trust. The TC CCP (the transferor) would continue to collect margin and hold it on trust for the E.U. CCP (the transferee), with the margin pool then being transferred sequentially to the E.U. CCP over the space of a few days. (This model has been used in the transfers referred to above in footnote 43.) However, a non-E.U.-to-E.U. transfer that is not intragroup is unprecedented and has yet to be attempted. Using this model for a TC CCP relocating to the E.U. would be unprecedented and would therefore potentially raise novel risk issues. Moreover, after Brexit, the recipient E.U. CCP of a mandatory transfer would be unlikely to be located in a country that recognises trusts, giving rise to difficult and potentially fatal issues of legal characterisation.

Intellectual property

- 3.24. To the extent that the TC CCP has intellectual property rights in any data or information relating to the contracts being transferred, it will need to make provision to either transfer or license these rights to the E.U. CCP. This is a potentially complex process, particularly when conducted cross-border, and could involve property rights and human rights infringements when mandated at the behest of a government.

Access to data

- 3.25. Parties will also need to make provision for the E.U. CCP (the transferee) to have access to the clearing data of the TC CCP (the transferor). There is likely to be sensitivity around timing and scope of this access, as well as privacy, bank secrecy, value transfer, costs, tax, confidentiality and data protection issues.

Disciplinary proceedings

- 3.26. Many CCPs have their own disciplinary and complaints processes, some mandated by law. The parties will need to make provision for (a) disciplinary, legal or other proceedings commenced against a person by the TC CCP (the transferor) prior to the transfer; (b) the right of the TC CCP (the transferor) to bring any disciplinary, legal or other proceedings against any person arising from actions or omissions after the transfer; and (c) the right of the E.U. CCP (the transferee) to take action in relation to actions or omissions that took place before the transfer, or in relation to obligations which are not fully or partially performed or completed irrespective of whether the relevant action or omission took place before the transfer. This may be complicated in a cross-border situation, depending on the level of regulatory cooperation on these issues.

Enforcement jurisdiction

- 3.27. The parties will need to decide on an appropriate enforcement jurisdiction to govern transfer-related disputes, which may be more difficult and raise further conflicts of law issues when the transfer is cross-border.

Monitoring and Supervision

Ongoing compliance with the conditions for recognition

- 3.28. The Proposal requires that an applicant Tier 2 TC CCP complies with prudential requirements imposed on E.U. CCPs (or Comparable requirements) on an "ongoing

basis".⁴⁴ The wording suggests that recognition is immediately withdrawn if such continued compliance ceases, but the Proposal also contains a separate process for the withdrawal of recognition which may not be immediate.⁴⁵

- 3.29. It is therefore uncertain whether the Tier 2 Additional Requirements are merely conditions for the issue of a recognition decision (non-compliance with which would trigger the withdrawal of recognition) or also positive obligations subject to continued compliance intended to apply directly to the TC CCP (non-compliance with which would cause immediate withdrawal).⁴⁶ It would be helpful if this point was made clear in the drafting.

Frequency of review

- 3.30. Recital 34 of the Proposal states that ESMA should regularly review recognition decisions and the systemic importance classification of TC CCPs, taking into account changes in the nature, size and complexity of the TC CCPs' business in the E.U. Accordingly, proposed new Article 25(5) enables reviews more frequently than the default mandatory two years periodic review in case of an *increase* in the activities carried out by the recognised TC CCP in the E.U. The proposed new Article 25(5) does not, however, expressly state that more frequent reviews may occur if there is a *reduction* in activities and clarity would be helpful.

Reclassification of recognised TC CCPs

- 3.31. ESMA has the right to withdraw recognition of a TC CCP if the criteria for recognition are no longer met.⁴⁷ It is uncertain, however, whether such review could result in the reclassification of a TC CCP—i.e., the Proposal does not expressly provide for the possibility of re-classification of a recognised TC CCP (a) from Tier 1 to Tier 2 where it becomes systemically important and/or (b) from Tier 2 to Tier 1 where it ceases to be systemically important. Uncertainties in this respect could result in a TC CCPs having to maintain compliance with Tier 2 Additional Requirements which are no longer

⁴⁴ See proposed new Articles 25(2a) and (2b) of EMIR (and delegated acts to be enacted by European Commission subsequently), and paragraph 2.10(a) above. A similar issue arises in proposed new Article 25(6) in respect of equivalence decisions.

⁴⁵ See proposed new Article 25(m) of EMIR.

⁴⁶ See proposed new Articles 25(2b) and 25(m) of EMIR.

⁴⁷ See proposed new Article 25(m) of EMIR.

necessary to ensure the financial stability of the E.U., or having its recognition withdrawn even where it meets the Tier 1 requirements.

Remediation period

- 3.32. The process for the withdrawal of recognition of a Tier 2 TC CCP on the grounds of failure to continue to meet the recognition conditions allows the TC CCP to remediate the non-compliance in up to three months from receipt of a notice whereby ESMA requests that appropriate action is taken.⁴⁸ However, such maximum period may be inappropriate in certain complex cases and undermine the remediation mechanism as a whole. As a result, a provision should be made for ESMA to extend the relevant period in appropriate circumstances, particularly given the potential uncertainty that could result from a failure to remediate an issue such that actions are taken to withdraw recognition from the TC CCP⁴⁹.
- 3.33. Likewise, the reference to ESMA's "request that appropriate action is taken" in proposed new Article 25(m)(2) is vague and may result in further legal uncertainty, to the extent that it is already clear that remediation should require compliance with the Tier 2 Additional Requirements making further ESMA discretion unnecessary.

Framework for withdrawal of recognition

- 3.34. The withdrawal process set out in proposed new Article 25m does not provide a sufficiently detailed or certain framework for the orderly withdrawal of recognition. In particular, the Proposal is not clear on when a decision to withdraw recognition becomes effective and/or does not provide for clear timeframes or prior notification of the TC CCP (except for Tier 2 TC CCPs, in which case a three month remediation period is granted). This does not seem to be consistent with ESMA's obligation to "endeavour to minimise market disruption".⁵⁰ Lack of clarity in this respect may substantially affect not only the TC CCP but also market participants and the financial stability of the E.U. as a whole.
- 3.35. It is also of note that, whilst ESMA is required by proposed Article 25m(2) to provide its reasoning for considering that one of the grounds for a withdrawal of recognition

⁴⁸ See proposed new Article 25(m)(1) of EMIR.

⁴⁹ For example, Article 25m states that ESMA shall endeavour to minimise market disruption when determining the date of entry into effect of the decision to withdraw the recognition.

⁵⁰ See proposed new Articles 25(m)(1)(2) of EMIR.

decision have been fulfilled, ESMA is not required to give its reasoning in any other circumstances where it determines to withdraw a recognition decision. This raises concerns about ESMA's unfettered discretion, as it is not required to provide to the relevant CCP or its relevant Third Country Competent Authority any explanation of its reasoning for the decision to withdraw the recognition of a recognised CCP where it determines that the CCP has obtained recognition by "irregular means", unlike the equivalent authorisation withdrawal process under EMIR Article 20 which provides for the CCP's competent authority to be informed and consulted prior to the decision, subject to certain exceptions.

- 3.36. Additionally, some clarity is needed on how the legislation will treat open interest of a clearing member in a de-recognised TC CCP, i.e., whether it will have to be migrated to an authorised or recognised CCP (and in what timeframe) or must be terminated. In the event that clearing members are required to transfer or close out their existing positions with a Third Country CCP, careful planning will be required as the market has not experienced such a wholesale transfer of open interest previously (see discussion in paragraphs 3.20 to 3.22 above). If existing positions can remain, there will still be some difficulties to overcome, such as risk management of legacy portfolios and compliance with the default management arrangements of de-recognised CCPs, which may require taking on the positions of a defaulting clearing member.

Conflicts between the Proposal and other applicable frameworks

Conflict of laws and Cooperation Arrangements

- 3.37. The Proposal grants to E.U. authorities and to NSA primary supervisory powers over TC CCPs which are assessed to be Tier 2. This has caused much alarm amongst CCPs and other market participants which are concerned that these additional oversight powers will conflict with agreements for equivalence and substituted compliance already in place between the E.U. and Third Country authorities. For example, the E.U.'s assessment of the U.S. for recognition under EMIR was particularly complex and discussions amongst E.U. and U.S. regulators spanned four years.
- 3.38. E.U. and U.S. regulators were unable to agree that the E.U. and U.S. regulatory systems for CCPs guaranteed similar market conduct and prudential outcomes because of technical differences between the two systems. The most frequently publicised grounds for disagreement were the differing margining periods and netting rules applied by the two regulatory regimes. Regulatory standards in the E.U. specified a two-day liquidation period for calculating initial margin on exchange-traded derivatives, whereas

U.S. rules allowed only a one-day period. On the other hand, U.S. rules required the provision of margin on customer positions on a gross basis whereas the E.U. rules would allow margin to be provided on a net basis on omnibus accounts.⁵¹

- 3.39. Market participants followed the process of negotiations with concern. Many E.U. firms rely on clearing services provided by the Chicago Mercantile Exchange (the “CME”) to clear popular “Eurodollar” derivatives, which are purchased as a hedge against movements in U.S. interest rates. Four years after EMIR came into force and with the “cliff edge” deadline for mandatory clearing hanging over E.U. firms, E.U. regulators adopted a positive equivalence determination vis-à-vis the U.S. system. The CME was recognised by ESMA shortly afterwards. As a condition of the decision, the U.S. was required to extend mutual recognition to E.U. CCPs. This was done this in March 2016 by means of the “substituted compliance” mechanism.
- 3.40. Market participants and CCPs are therefore concerned that these new powers bestowed upon NSAs will launch the market into another protracted negotiation amongst regulators on both sides of the Atlantic. Currently, E.U. authorities do not have investigatory and onsite inspection powers over TC CCPs. These are the responsibility of the home regulator, which provides E.U. authorities with relevant information under Memoranda of Understanding or other information sharing mechanisms. A unilateral rethink of the roles of the authorities on each side of an existing agreement could give rise to systemic risk and significant legal uncertainty.

Proposed new infringements and Comparable Compliance

- 3.41. The Proposal introduces a fining regime in the event ESMA finds that a Tier 2 TC CCP has intentionally or negligently committed certain specified infringements.⁵² This regime would apply even if the specific jurisdiction in which the TC CCP is established has different rules or methods which have been deemed equivalent and the TC CCP has been considered Comparably Compliant.⁵³

⁵¹ For further analysis and discussion see Committee on Capital Markets Regulation and FMLC, Resolving Issues of Legal Uncertainty Relating to the Recognition and Supervision of Central Counterparties: a Comment Paper, (1 September 2015), available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc-ccmr_joint_statement_1_september_2015.pdf. The Comment Paper argued that mutual recognition was important to avoid fragmentation of the \$657 trillion global market for swaps and futures.

⁵² See proposed new Article 25g(1) and proposed new Annex III of EMIR.

⁵³ See proposed new Article 25a of EMIR, and paragraph 2.11 above.

- 3.42. The new offences which would most affect TC CCPs operating in accordance with domestic regulatory regimes are set out below, highlighted specifically because these infringements will contradict domestic regimes in jurisdictions from which TC CCPs often operate in the E.U.⁵⁴
- 3.43. Of the offences set out in proposed new Annex III relating to segregation, the following three warrant specific concern:
- 1) A Tier 2 CCP infringes Article 39(1) by not keeping separate records and accounts that enable it, at any time and without delay, to distinguish in accounts with the CCP the assets and positions held for the account of one clearing member from the assets and positions held for the account of any other clearing member and from its own assets.⁵⁵
 - 2) A Tier 2 CCP infringes Article 39(2) by not offering to keep and not keeping where so requested separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the account of its clients.⁵⁶
 - 3) A Tier 2 CCP infringes Article 39(3) by not offering to keep and not keeping where so requested separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients, or by not offering its clearing members the

⁵⁴ For the purposes of this paper, the technical advice drafted by ESMA in relation to three jurisdictions deemed equivalent under EMIR have been analysed: (a) the U.S, which covers the regulatory regimes for both Derivatives Clearing Organisations ("DCOs"), regulated by the Commodity Futures Trading Commission ("CFTC"), and clearing agencies ("CAs"), regulated by the U.S. Securities and Exchange Commission ("SEC")—see ESMA technical advice on the U.S. in relation to its EMIR equivalence decision, available at https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-1157_technical_advice_on_third_country_regulatory_equivalence_under_emir_us.pdf (the "U.S. Technical Advice"); (b) Japan—see the ESMA technical advice on Japan in relation to its EMIR equivalence decision, available at https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-1158_technical_advice_on_third_country_regulatory_equivalence_under_emir_japan.pdf (the "Japan Technical Advice"); and (c) Singapore—see the ESMA technical advice on Singapore in relation to its EMIR equivalence decision, available at https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-1161technical_advice_on_third_country_regulatory_equivalence_under_emir_singapore.pdf (the "Singapore Technical Advice").

⁵⁵ Proposed new Annex III(III)(d) of EMIR.

⁵⁶ Proposed new Annex III(III)(e) of EMIR. Note that the reference to "the account of its clearing members" in the final sentence should refer instead to the "account of its clients".

possibility to open more accounts in their own name for the account of their clients where so requested.⁵⁷

3.44. Article 39(1) to (3) of EMIR states, in turn, that:

1. A CCP shall keep separate records and accounts that shall enable it, at any time and without delay, to distinguish in accounts with the CCP the assets and positions held for the account of one clearing member from the assets and positions held for the account of any other clearing member and from its own assets.
2. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the accounts of its clients ('omnibus client segregation').
3. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients ('individual client segregation'). Upon request, the CCP shall offer clearing members the possibility to open more accounts in their own name or for the account of their clients.

3.45. The difference in wording suggests that a Tier 2 TC CCP which does not follow EMIR-style segregation but instead adopts a segregation regime which is mandatory under its own jurisdiction might be fined by ESMA. For example, the U.S., Japan and Singapore each prescribe a different degree of segregation.⁵⁸

3.46. Similar effects are felt in relation to the new infringements concerning intraday margin calls,⁵⁹ remuneration policy,⁶⁰ capital requirements,⁶¹ margin,⁶² deposits,⁶³ and central

⁵⁷ Proposed new Annex III(III)(f).

⁵⁸ See pp. 108 (DCOs) and 110 (CAs) of the U.S. Technical Advice; and p. 55 of the Japan Technical Advice.

⁵⁹ Proposed new Annex III(III)(j).

⁶⁰ Proposed new Annex III(II)(e).

bank liquidity.⁶⁴ A Tier 2 TC CCP could, therefore—and despite operating according to the requirements of its home regime, which has already been found comparable to the E.U.’s own framework—be compelled to do business at the risk of paying fines subject only to regulatory forbearance, if it wishes to offer its services to E.U. participants. In particular, TC CCPs may be required to make significant changes to their operating models within the confines of their domestic law in order to avoid falling foul of the new regime, or cease offering services into the E.U. Even then, given that the European Commission is able to reassess its equivalence decisions, there would always be some risk of having to make further operational changes in order to continue to be deemed equivalent, notwithstanding the requirements of such TC CCPs’ domestic law.

4. IMPACT

- 4.1. A substantial volume of clearing services are provided to E.U. clearing members and trading venues by TC CCPs. The relative concentration of the clearing market, combined with the high interconnectivity between CCPs and financial market participants located in the E.U. and overseas, may result in any proposed changes to the regime for TC CCPs having significant impact on CCPs, market participants, the financial markets and the financial stability of the E.U. and other relevant jurisdictions, as discussed below.
- 4.2. The actual impact will however depend on both the shape of the final legislation and the way in which market participants react to it, which is likely to have knock-on effects on the way in which other market participants react. It seems that many clearing firms are in any event already establishing new clearing memberships through affiliates in either the E.U. or U.K., depending on where they have centralised their clearing capability to date, to avoid some of the uncertainties caused by the Proposal.

Impact of the Location Policy, withdrawal of recognition or reclassification

- 4.3. The forced relocation of a TC CCP to the E.U., as per the Location Policy, has the potential to cause a split in liquidity, result in increased costs for market participants and

⁶¹ Proposed new Annex III(I)(a). In addition, the definition of "capital" in EMIR is essentially analogous to that of Tier 1 capital under Basel in that it consists of paid-up share capital. However, the definition in the U.S. and other Third Countries is less narrowly-defined.

⁶² Proposed new Annex III(III)(h).

⁶³ Proposed new Annex III(III)(s) and (III)(t).

⁶⁴ Proposed new Annex III(III)(dd).

create regulatory arbitrage between markets.⁶⁵ Likewise, a policy restricting clearing of the derivatives transactions of E.U. market participants to E.U. CCPs would lead to market fragmentation, with a limited E.U. domestic market and an international market accessible by firms outside the E.U., which would in turn also have a significant impact on global market liquidity and particularly on the market available to E.U. market participants, who may find themselves restricted to a smaller range of counterparties and CCPs, leading to increased systemic risks.

- 4.4. In addition, as a result of reduced liquidity there may be pricing differentials between markets, potentially resulting in higher costs for E.U. market participants to hedge their risks.⁶⁶ Cost increases could also result in a reduction in hedging activity which in turn could lead to increased price volatility for fundamental products and commodities with a potential for knock-on effects on prices in the real economy. Fragmentation of liquidity pools could also require CCPs and firms to break apart integrated portfolios which could lead to an increase in margin requirements and systemic risk.
- 4.5. The Location Policy also presents certain technical and legal challenges for CCPs and market participants owing to the absence of a mechanism in the proposed regulation to migrate positions from a TC CCP into a new or existing E.U. CCP. While migrations of open interest have been effected between CCPs, as discussed in paragraphs 3.20 to 3.22, such a cross-border arrangement on a cross-border and on a significant scale would bring unprecedented operational, legal and commercial challenges and could cause disruption, poses potential for systemic risk and represents increased costs for CCPs and market participants. The costs associated with forced relocation would likely extend beyond the financial sector and into other sectors of the regional economy which manage their business risks through derivatives.
- 4.6. Similarly, the lack of a transparent framework and clear processes (including set deadlines, definitions, and criteria and parameters for decision making) for classification as “systemically important”, partial or total recognition, review of recognition, reclassification, and/or the partial or total withdrawal of recognition combined with the lack of a clear and appropriate period of notice of such decisions (and, remediation, when appropriate) may significantly impact the relevant CCP and market participants.

⁶⁵ See FIA paper “Feedback from FIA on European Commission EMIR Review Proposal – Part 2 (authorisation and recognition of CCPs)”, p.13, available at https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-331/feedback/F6850_en .

⁶⁶ See LCH paper – “London Stock Exchange Group response to the European Commission proposal for a regulation amending EMIR (Part II – Supervision of EU and Third Country CCPs)”, pp.17-18

The lack of transparency and predictability in respect to their status may cause market disruption, fragmentation (and illiquidity) and potentially create systemic risk in the E.U. and/or global financial markets.⁶⁷ Such loosely prescribed processes may also result in arbitrary or conflicting decisions. In the case of withdrawal decisions, in particular, lack of foreseeability and a clear framework for an orderly withdrawal may cause market disruption (see paragraphs 4.3 and 4.4 *ff* above).

- 4.7. Clarity in the recognition, reclassification and withdrawal processes are particularly important because the QCCP status, and therefore, preferential capital treatment, is dependent on recognition⁶⁸. The impact of a withdrawal of recognition under the Proposal would therefore be significant. Furthermore, if a CCP were to lose its recognition entirely, E.U. clearing members and clients would not be able to clear through it at all, whereas if a TC CCP is only systemically important in respect of a single service, they would not need to lose access to liquidity and competition in relation to the other products and services assuming that partial recognition could be implemented, or (as applicable) recognition could be withdrawn in respect of a single service, as anticipated by Article 25m(1). Therefore, applying the Tier 2 Additional Requirements to the TC CCP as a whole, instead of to a single service, both to recognition and withdrawal processes, might be potentially unnecessary and disproportionate (please see also paragraph 4.10 below).
- 4.8. Moreover, even if the legislation is amended to clarify the period for recognition or withdrawal, clearing members may wish to establish arrangements with alternative CCPs in advance given the time typically required for this, especially where other market participants are also looking to establish new connections. The clearing firm will need to take account of numerous issues including legal, operational, IT, credit, risk, client relationship management. The CCPs themselves will wish to restrict the rate at which they accept new members to allow for risk assessment and the necessary customer due diligence.

⁶⁷ See FMLC Paper “Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from E.U.–the Provision and Application of Third Country Regimes in E.U. Legislation”, July 2017, p.33. TC CCPs may find that an undefined and unlimited power of withdrawal affects their regulatory status in other jurisdictions outside the E.U.

⁶⁸ Under the E.U. Capital Requirements Regulation (“**CRR**”) the capital requirements for derivatives trades cleared through QCCPs are significantly less onerous than for trades cleared through non-QCCPs.

Impact of Tier 2 Additional Requirements and Comparable Compliance

- 4.9. As discussed in paragraph 3.3 above, the Tier 2 Additional Requirements may force changes in a TC CCP's operating structures which would not only have a potential significant time and cost implication for the CCP in question but would also be likely to impact on clearing members and their clients, for example, requiring changes to account structures, calculation of margin and default fund contributions and the process for management of a default of a member, amongst others. The time and cost of implementing such changes may be significant and, in certain cases, may not be compatible with the Third Country regime applicable to the relevant TC CCP, which in turn could affect their regulatory status in other non-E.U. jurisdictions, or even constitute infringements (as discussed in paragraph 3.41 and *ff.*) as a result of conflicts of laws.

Impact of new supervisory powers on TC CCPs

- 4.10. As mentioned in section 3, above, the introduction of the new supervisory powers which have been given to E.U. authorities over Tier 2 TC CCPs could give rise to conflicts between regulatory and supervisory authorities in the E.U. and in the relevant Third Country, especially where the Third Country has already been granted a positive equivalence determination. The case study of the U.S assessment described above illustrates that, although the European Commission's approach to equivalence is broadly outcomes based, it may refuse or delay a positive decision on the basis of regulatory differences. The new infringements mentioned in paragraphs 3.42 to 3.47 would create practical issues for TC CCPs from such equivalent jurisdictions as the U.S., Japan and Singapore, whereby the CCPs may be required to make significant changes to their operating models within the confines of their domestic law in order to avoid falling foul of the new E.U. fining regime. This could prevent a Tier 2 TC CCP from being authorised and therefore active in multiple jurisdictions, which in turn could result in market fragmentation and a reduction in liquidity.
- 4.11. As discussed above, ESMA may determine that the regulatory regime of the relevant Third Country is comparable to that of the E.U., even when the regimes are not identical. ESMA is required to monitor the regulatory developments in these Third Countries. It is unclear whether a TC CCP, following the rules in its home country which have perhaps developed since the European Commission issued its comparability decision, can be found to have infringed any of the capital, organisational or operational requirements set out in Annex III of the Proposal. If yes, such a finding would trigger fines to be paid by the CCP. This calls into question the validity of decisions for

comparable compliance and of the international MoUs which support them, as well as the previous equivalence regimes and MoUs that have been established under those regimes.

Impact of proposed extra-territorial monitoring and supervisory powers

- 4.12. The extra-territorial supervisory and monitoring powers granted to ESMA raise concerns in relation to recognition of relevant local protections around confidentiality and legal privilege. Similarly, the ability of E.U. authorities to take direct supervisory authority over TC CCPs, in addition to departing from established principles of regulatory deference currently in place, could in turn create a risk of uncertainty or conflicts with local regulatory authorities and requirements or could also in theory give rise to systemic risk in the Third Country or other jurisdictions.

5. POTENTIAL SOLUTIONS AND MITIGANTS

Regulatory deference

- 5.1. A possible solution to any uncertainty that may arise from potential conflicts of regulation would be for the E.U.'s proposed framework for TC CCPs to be amended to provide increased scope for regulatory deference vis-a-vis domestic authorities.⁶⁹ The FMLC accepts, however, that the guiding objective of the proposed framework is to increase, not decrease, oversight of TC CCPs by E.U. authorities and that, in light of this, the scope for increased regulatory deference may be politically and practically limited.

Clarification of the criteria to be considered in the recognition process

- 5.2. In light of the policy and the significant uncertainty amongst market participants concerning the specific criteria which ESMA will use in making its recognition decision, the FMLC considers it vital that any future iteration of the Proposal clarify the "systemic importance" criteria and the parameters for the delegated act, not only by defining systemic importance (and the gradations thereof), but also the factors that ESMA should take into account when determining whether a TC CCP, or a particular service, activity or class of financial instruments, is or is "likely to become" systemically important. Similarly, the FMLC recommends clarification of the criteria for ascertaining when a Tier 2 TC CCP is considered of "such substantial systemic

⁶⁹ For example, the U.S. does not apply any registration, regulation or oversight to E.U. CCPs offering U.S. customers clearing services for non-US ETD contracts.

importance” that it would be required to relocate to the E.U. In view of the substantial impact of such categorisation on any TC CCP (and potentially on the market for its cleared products given its “systemic importance”), it would be helpful if the criteria were detailed at an earlier stage—for example at the point of entry into force of the Proposal as regulation.

- 5.3. Clarity as to the nature, extent and type of requirements which central banks may impose on TC CCPs applying for recognition would also help resolve market uncertainty. An alternative mechanism for participation of the central banks of issue in the decision making process, for example, through the CCP Executive Session but with ESMA having the final determination as to applicable conditions and their satisfaction by the applicant Tier 2 TC CCP could mitigate uncertainties in respect of the broad and unspecified powers to impose additional requirements for recognition granted to central banks of issue by the Proposal.

Processing (and other) timeframes

- 5.4. One way to provide CCPs and other market participants with greater certainty in relation to the recognition process would be to make clear the processing time during CCP assessment, including any firm periods during which the CCP is required to respond to demands for additional information. Clarity as to one or all of the following periods would be helpful:

- By amendment to Article 25(2b)(b) a requirement might be imposed for ESMA to assume compliance by an applicant Tier 2 CCP in the event a central bank of issue does not provide a written response to ESMA within the 180-day deadline either confirming or denying compliance.
- A requirement for TC CCPs to provide information to ESMA as soon as is reasonably practicable. A minimum period might be imposed during which an applicant TC CCP must provide additional information requested by ESMA under Article 25(4).
- A specified initial application review period could be imposed by the end of which the applicant receives confirmation as to the decision or recommendation of ESMA (as applicable) in the recognition process (under draft Articles 25(2a) and (2c)). This would enable the CCP to consider any impact upon its business and take appropriate action—for example, by withdrawing its application for recognition and establishing itself in the E.U.

- Finally, in the case recognition is withdrawn, a clear minimum period between the issue of a withdrawal of recognition decision by ESMA and date it takes effect would mitigate legal uncertainties and reduce the risk of such decisions affecting not only the TC CCP, but also market participants.

5.5. EMIR does not provide for an appeals process or remediation periods or any limitation on re-applying should an application for recognition be refused, nor does it specify procedural timeframes. Given, however, the uncertainties relating to the complexity and subjectivity added to the recognition process by the Proposal (especially for Tier 2 TC CCPs) and ESMA's broad discretion to determine what constitutes systemic importance, consideration could usefully be given to the introduction of a process for challenging ESMA's determination and/or timeframes and limitations for new applications following a refusal.

Reflect comparable compliance in the new infringement regime

5.6. In order to address the potential for CCPs to be fined or otherwise sanctioned for compliance with rules that have been already assessed by ESMA to be comparable in accordance with proposed Article 25a, the FMLC proposes that Article 25n should be clarified as to whether an infringement involving comparable compliance under Article 25a would give rise to the application of sanctions or whether this should be a case of exemption of fines or sanctions. The term "infringements (...) Annex III" appears several places in the legislation to describe other sanctions and steps being taken, where similar considerations/insertions should be made so as to clarify whether the ESMA's decisions to be taken would reach also the case where the relevant infringements involve comparable compliance.

Partial recognition

5.7. The FMLC considers partial recognition—by which a more granular approach is taken to recognition, allowing a decision in respect of specific services, activities and/or class of financial instruments of a particular TC CCP—might be one way by which to prevent upheaval in the market. This would resolve the current mismatch between the possibility of a partial withdrawal decision under proposed new Article 25(m) of EMIR and the omission in this respect for recognition decisions under proposed new Article 25(2b) of EMIR. Likewise, allowing ESMA to make determinations on a more granular basis would enable ESMA to deny recognition in respect of certain services, activities and/or classes of financial instruments not meeting the EMIR requirements

without denying market participants in the E.U. access to that TC CCP as a whole. This is in line with the approach taken in the U.S.

- 5.8. Partial recognition might reduce the risk that conflicts of laws or overlapping, duplicative or potentially incompatible regulatory requirements could lead a CCP to determine that either (a) it cannot provide services to E.U. participants or (b) it is required to assume significant additional and unnecessary regulatory burdens for parts of its business not “systemically important” in the E.U.

Transitional period

- 5.9. In order to enable CCPs, their members and clients to transition to the relevant new supervisory arrangements in a timely and orderly manner, it may be beneficial to agree a transitional period. In particular, in the event of relocation, transitional provisions would provide market participants with sufficient time to implement all the operational, capital and legal changes prior to such relocation.
- 5.10. A sufficient and proportionate transitional period would help also in the context of the review of recognition decisions granted under the current EMIR regime (i.e., before the Proposal enters into force as regulation) in the event such an existing equivalence or recognition decision is to be withdrawn or is subject to the new requirements. This would enable the TC CCPs to action the anticipated associated rulebook, procedural and legal changes in the Third Country jurisdiction.

Consultations

- 5.11. Finally, a more transparent consultation process between ESMA and relevant authorities might make the recognition assessment seem less impenetrable or inscrutable. This would also give firms some advance warning that they need to start clearing through another CCP.
- 5.12. A public consultation might be equally helpful prior to making a relocation decision, giving stakeholders (CCPs, clearing members, and E.U. market participants) an opportunity to provide feedback and enable ESMA to issue a fully informed and adequate decision and a reasonable timeframe for relocation. Consideration could helpfully be given to the introduction of such a requirement.

6. CONCLUSION

6.1 The objective of this paper has been to identify and, where appropriate, suggest potential solutions to issues of legal uncertainty which may arise in the context of the Legislative Proposal adopted by the European Commission on 14 June 2017 to amend the processes for authorisation, recognition and supervision of CCPs under EMIR.

6.2 The FMLC has drawn attention, in particular, to issue pertaining to:

- the recognition process, which could give rise to uncertainties owing to the lack of clarity in the parameters and conditions for ascertaining the Systemic Importance Criteria and the Tier 2 Additional requirements, as well as in relation to the complexity and subjectivity of the recognition decision;
- the relocation of TC CCPs of substantial systemic importance. Here, issues potentially create uncertainty surrounding the transfer of positions, margins and default funds, intellectual property and data, and create technical and legal challenges for CCPs and market participants owing to the absence of a mechanism in the proposed regulation to migrate positions from a TC CCP into a new or existing E.U. CCP;
- the monitoring and supervision processes;
- the reclassification of recognised TC CCPs, as ESMA has the right to withdraw recognition of a TC CCP if the criteria for recognition are no longer met;
- the framework for withdrawal of recognition, as it does not provide a sufficiently detailed or certain framework for the orderly withdrawal of recognition);
- potential conflicts of law and cooperation arrangements within the proposed expanded territorial scope of ESMA's investigatory powers and new infringements and comparable compliance (-i.e., the fining regime);
- the status of the U.K. CCPs post-Brexit, which is uncertain, as if no transitional agreement is settled between the U.K. and the E.U., there will be no automatic equivalence of the U.K regime and/or an automatic recognition or authorisation of U.K entities post-Brexit.

6.3 Uncertainty arising from these issues would significantly impact the relevant CCP and market participants. To address this uncertainty, therefore, the FMLC recommends the following:

- Consideration of an approach of regulatory deference, where appropriate, to address the potential incompatibility of requirements applicable to TC CCPs.
- Clarification of the parameters of the European Commission delegated act so as to clearly define, at an early stage, the terms and factors to be taken into account whilst classifying a TC CCP as either the “systemic importance” or as of “substantial systemic importance” whereby the Location Policy would apply;
- The consideration in the Proposal of a partial recognition—by which a more granular approach is taken to recognition, allowing a decision in respect of specific services, activities and/or class of financial instruments of a particular TC CCP;
- Clarification of the application of the Proposal in cases that clearing members are required to transfer or close out their existing positions at a TC CCP;
- Clarification of the processing times for CCP assessment, including any firm periods during which the CCP is required to respond to demands for additional information;
- Clarification of whether TCC CCPs complying with rules which have been determined by ESMA to be comparable under Article 25a can also be held responsible under the new infringements set out in paragraphs 3.42 to 3.47, above;
- A period of transition in the event an existing equivalence or recognition decision is to be withdrawn or subject to new requirements, to provide market participants with sufficient time to implement all the operational, capital and legal changes.
- A transparent consultation process between ESMA and relevant authorities, prior to making a relocation decision, as it would give stakeholders an opportunity to provide feedback and enable ESMA to issue a fully informed and adequate decision and a reasonable timeframe within which to relocate.

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