COMMITTEE ON CAPITAL MARKETS REGULATION

FINANCIAL MARKETS LAW COMMITTEE

THE COMMITTEE ON CAPITAL MARKETS REGULATION
AND
THE FINANCIAL MARKETS LAW COMMITTEE

COMMENT PAPER

Resolving Issues of Legal Uncertainty Relating to the Recognition and Supervision of Central Counterparties

SEPTEMBER 2015

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COMMITTEE ON CAPITAL MARKETS REGULATION

FINANCIAL MARKETS LAW COMMITTEE[1]

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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

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 not-for-profit organisation, 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 the aftermath of the global financial crisis, G20 member countries agreed to a series of reforms to the international financial regulatory framework. Among these commitments was the introduction of a comprehensive regulatory framework for over the counter derivatives ("OTC derivatives"), including the introduction of mandatory central clearing for standardised products. The financial crisis revealed that the OTC derivative markets were susceptible to the build-up of systemic risk—owing in part to interconnected counterparty credit exposures and a lack of transparency—which contributed to the crisis. This resulted in a regulatory push for central clearing, in the expectation that clearing would reduce counterparty credit risk and improve transparency.

4 Legislative measures introduced to implement this commitment include the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the 2012 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 ("EMIR"). Since 2008, as a result of these measures and related initiatives, the role of central clearing has grown. For example, according to the Bank for International Settlements, in credit default swap markets the share of outstanding

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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.

contracts cleared through central counterparties rose from under 10% in 2010 to 29% in the second half of 2014.[5]

5 Whilst multiple legal initiatives designed to protect and regulate CCPs have been introduced over the past five years, legislators and regulators—facing unprecedented complexity and grappling with market practice in extraordinary detail—have struggled to create a harmonised international regulatory framework. Despite their very considerable achievements and a commendable focus on international coordination, inconsistencies and conflicts have inevitably emerged between respective national and regional rules. Where these are found, they give rise to significant uncertainty for market participants, increasing compliance costs and hampering cross-border market activity.

6 The CCMR and the FMLC (together "the Committees") have each previously published material drawing attention to shortcomings in the coordination of international financial regulation governing the clearing of derivatives.[6] In particular, these publications have addressed issues relating to cross-border activity by CCPs and the need for improved standards of mutual recognition. In May 2014, commenting on the Financial Stability Board's Seventh Progress Report on Implementation of OTC Derivative Market Reforms, the FMLC noted that legislative harmonisation in the field of OTC derivative market reforms had not been—and was not likely to be—achieved and the Committee recommended, on this account, action to foster greater clarity in respect of criteria for equivalence and comparability determinations. The CCMR, on the other hand, noted in August 2014 that, to avoid market disruption,

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5 Bank for International Settlements, *OTC derivatives statistics at end-December 2014*, April 2015, available at: http://www.bis.org/publ/otc_hy1504.pdf.

6 **FMLC**: "Coordination in the Reform of International Financial Regulation", February 2015, *ibid.*; "Discussion of legal uncertainties arising from the draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012", August 2014, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_report_on_legal_uncertainties_arising_from_the_draft_regulatory_technical_standards_on_risk-mitigation_techniques_for_otc-derivative_contracts_not_cleared_by_a_ccp_under_article_11(5)_of_emir.pdf; Letter to Financial Stability Board on Seventh Progress Report on Implementation of OTC Derivative Market Reforms, 16 May 2014, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/issue_182_-_response_to_fsb_seventh_progress_report_1.pdf.

CCMR: Letter to Michel Barnier and Timothy Massad "European Commission and CFTC Should Recognize Derivatives Clearinghouses", 21 August 2014, available at: http://capmktsreg.org/app/uploads/2014/09/CCMR_CCP_recognition_letter_08_21_2014.pdf; Letter to Elizabeth Murphy on on the Proposed Rule and Final Guidance, addressing the application of the provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act to cross-border swaps, available at: http://capmktsreg.org/news/committee-submits-comment-letter-to-sec-and-cftc-on-cross-border-swaps/; Letter to Rodrigo Buenaventura, Gary Gensler and Patrick Pearson "European Union and United States Need to Resolve Differences Between Their Clearinghouse Requirements", available at: http://capmktsreg.org/news/ccmr-releases-letter-on-resolution-of-differences-between-e-u-and-u-s-clearinghouse-requirements/.

"the European Commission and the Commodity Futures Trading Commission ("CFTC") must recognize each other's regulatory regime for derivatives clearinghouses as equivalent."[7]

7 This comment paper focuses on 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 CCPs in the U.S. and the consequent non-recognition of U.S. CCPs for the purposes of EMIR by the European Securities and Markets Authority ("ESMA"). In a recent report, ESMA noted that the equivalence decision process is taking much more time than expected: three years after the entry into force of EMIR the majority of the third country CCPs are still operating in the E.U. under a transitional regime. This, says the report, puts European clearing members and their subsidiaries at risk and creates the potential for regulatory arbitrage between European and third country CCPs.[8]

8 The absence of a positive equivalence determination vis-à-vis the U.S. has also given rise to material uncertainty of at least two kinds: practical uncertainty about when and whether certain legislative requirements for regulatory capital will apply; and legal uncertainty as to the application of contractual and statutory provisions for a stay of termination rights during bank resolution.

9 As far as regulatory capital is concerned, the E.U. Regulation No 575/2013 on prudential requirements for credit institutions and investment firms (the "CRR") imposes capital requirements for E.U. banking groups' exposures to CCPs, together with a transitional period for the recognition and authorisation of non-European CCPs which expired on 15 June 2014. In the absence of recognition having been granted by this date, the CRR provides that European clearing members need to hold very significantly more regulatory capital to continue to clear on U.S. CCPs than would be the case if recognition were granted. Were these capital requirements to come into force (as the CRR provides) without an equivalence determination in favour of U.S. CCPs, it is likely that there would be an immediate and significant shift in the practices of E.U. clearing members and their clients, with some possible

7 Financial Markets Law Committee, Letter to Financial Stability Board, 16 May 2014, *ibid.;* Committee on Capital Markets Regulation, Letter to Michel Barnier and Timothy Massad, 21 August 2014, *ibid.*

8 In the context of an ongoing review of EMIR by the European Commission, ESMA has recently (13 August 2015) responded to a consultation by the Commission on the different aspects of EMIR ("EMIR Review Report no.4"). This observation can be found at paragraph 105. EMIR Review Report no.4, available at: http://www.esma.europa.eu/system/files/esma-2015-1254_-_emir_review_report_no.4_on_other_issues.pdf.

attendant market disruption. The rule in CRR has been held in abeyance, however, for over a year by three implementing acts of the European Commission which extend the transitional period afforded by that regulation.[9] This practice of deferring the application of regulatory capital requirements by means of *ad hoc* measures adopted days before the expiry of a transition period has led to considerable market uncertainty.

10 As regards resolution stays, E.U. Directive 2014/59 establishing a framework for the recovery and resolution of credit institutions and investment firms (the "RRD") provides for resolution authorities to be invested with a power temporarily to suspend termination rights but not where those rights are held by "central counterparties" (Article 71(1), (2) and (3)). Such statutory resolution stays are becoming more prevalent across the globe but they raise significant conflicts of law questions wherever there is a risk that a stay in the resolution forum will not be recognised by the governing law of the contract. Regulators have, therefore, promoted initiatives to secure widespread contractual recognition of resolution stays.

11 In the E.U., some jurisdictions have implemented the resolution stay provisions of the RRD in such a way as to distinguish between those third country CCPs which are recognised by ESMA and those which are not.[10] In such cases, third country CCPs which are not recognised are not excluded from the operation of a resolution stay. The third country legal systems which govern the CCPs' operations are, however, highly unlikely to recognise any resolution stay which applies to local CCPs. This potentially gives rise to the conflicts of law problems mentioned above. Legal uncertainty of this kind is particularly acute in the case of U.S. CCPs, given the very high volume of business which they currently undertake for E.U. clearing members and clients.

12 This situation also brings into sharp focus legal uncertainty about the intended ambit of the relevant exclusion for "central counterparties" from the stay provisions in the

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[9] The deadline was extended to 15 December 2014, subsequently to 15 June 2015 and, most recently, to 15 December 2015 by Commission Implementing Regulations 591/2014, 1317/2014 and 2015/880 respectively.

[10] In the UK, for example, under section 70C of the Banking Act 2009, the Bank of England may suspend the rights of any party who is not an "excluded person". Section 70D defines "excluded person" so as to include a recognised central counterparty, EEA central counterparty or third country central counterparty but a "third country central counterparty" must (by virtue of section 285 of the Financial Services and Markets Act 2000) be a recognised CCP under Article 25 of EMIR.

RRD, where the term is not defined.[11] And it creates uncertainty—in light of proposed regulatory requirements requiring authorised firms to negotiate clauses recognising resolution stays with third country CCPs which have not been recognised under EMIR[12]—as to the interpretation of such clauses in cases where ESMA subsequently recognises the CCP during the life of the contract, as seems likely with U.S. CCPs. In any event, the FMLC understands that some E.U. banks have expressed very serious misgivings about the likelihood of their being able to negotiate the requisite contractual clauses with U.S. CCPs, given the systemic risk implications of suspending CCP termination rights.

13 In light of these legal and market uncertainties, the issue of CCP recognition is an important one. This paper addresses three issues which arise in the context of equivalence assessments in the transatlantic context. The first issue addressed in the sections below is the well-publicised disagreement between regulatory authorities concerning the equivalence of E.U. and U.S. margin requirements; the second issue is the lack in the U.S. of an effective, clear and ascertainable legal pathway to substituted compliance for E.U. CCPs; and the third issue is uncertainty as to whether traditional models of joint supervision can be appropriately adapted to the transatlantic context.

14 The Committees have jointly produced this Comment Paper. Their aim in doing so is to highlight the damaging impact that ongoing uncertainty in these areas is causing for the wholesale financial markets and to call for a resolution of the issues.

Executive Summary

15 The Committees take the view that a balanced solution exists to the current impasse between the European Commission and CFTC regarding the mutual recognition of U.S. and E.U. CCPs. This solution would promote legal certainty and avoid the

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11 A recital unconnected to the stay provisions refers to "central counterparties as defined by [EMIR]". "Central counterparty" is not a defined term in EMIR but "CCP" is defined and used (e.g. in Article 25) in such a way as to make it clear that it applies all CCPs not just recognised CCPs.

12 In the UK, for example, the Prudential Regulation Authority has proposed (in a May 2015 Consultation Paper: CP19/15) a rule which would prohibit firms from creating new obligations or materially amending an existing obligation under a financial contract (as defined) without counterparty agreement recognising a resolution stay. The proposed rule would rely on the definition of "excluded person", *supra* n.10, which distinguishes between recognised and non-recognised third country CCPs.

fragmentation of the $657 trillion global market for swaps and futures[13]—90% of which takes place in the U.S. or E.U.[14]

16 The Committees have three main points to make. First, the Committees observe that, although the E.U. and U.S. initial margin requirements for futures are different, they are both designed to achieve the same objective—the adequate protection of futures counterparties from any potential changes in the market value of a futures contract. The Committees are confident that the post-financial crisis reforms to the derivatives markets in the E.U. and U.S. accomplish their goal of materially reducing systemic risk. Neither the E.U. nor U.S. regulators have demonstrated that either regime's initial margin requirements fail to do so. From the perspective of a concern with systemic risk reduction,[15] E.U. and U.S. CCP margin requirements result in broadly equivalent margin levels.[16] Therefore, the existing differences between these regimes should not preclude mutual recognition. Second, the CFTC should outline a clear pathway to substituted compliance for foreign CCPs. Only the European Commission currently has a robust legal framework for equivalence decisions (i.e., in EMIR). Thereafter, equivalence determinations by the European Commission and the CFTC should accommodate regulatory differences by tailoring conditions or exceptions, where necessary, to address specific issues. Third, a template for appropriate levels of host participation in supervisory colleges established by home regulators should be determined as soon as possible. The Committees recommend that the home country (i.e. the CCP's country of domicile or main establishment) should be the lead supervisor in such colleges, in keeping with established practice, but that the regulators of the host country should be accorded a significant and well-defined role in the college. Adopting appropriate structures for the joint supervision of CCPs by U.S. and E.U. regulators would avoid overlapping supervisory efforts and potential conflicts which are engendered by the current regime of parallel authorisation/registration and supervision.

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13 As of December 2014. See: http://www.bis.org/statistics/dt1920a.pdf; and http://www.bis.org/statistics/r_qa1506_hanx23a.pdf.

14 *Ibid.*

15 Under EMIR an equivalence determination is to be made, broadly, on the basis of risk mitigation and management requirements, including: robust governance arrangements, fair conduct of business rules (including counterparty protection) and sound prudential requirements. Commercial considerations do not form part of an equivalence determination.

16 This point is subject to further analysis below.

II. DIFFERENCES BETWEEN INITIAL MARGIN RULES SHOULD NOT PRECLUDE MUTUAL RECOGNITION

17 Initial margin is collateral that derivatives counterparties must post with a clearing member or CCP to guard against the potential exposure that could arise from changes in the market value of a derivative between the time a counterparty defaults and the time it takes to terminate, value and close out that counterparty's derivatives portfolio—a time period which may vary by product and regulatory regime. It is important to note that concerns about differences between E.U. and U.S. rules have focused on initial margin for futures (listed derivatives, including oil, gold, Eurodollars and E-Mini S&P 500 contracts) not for swaps (OTC derivatives, including interest rate swaps, foreign exchange and credit swaps). EMIR, however, requires the European Commission to make an equivalence determination on the basis of the prudential requirements which are applied to CCPs by foreign ("third country") legal regimes in respect of exposures generally, i.e. both futures and swaps.[17]

Assessing the Significance of Differences between U.S. and E.U. Rules

18 Of the several parameters used to determine initial margin requirements, there are two key differences between the U.S. rules and E.U. rules which have reportedly become the focus of discussions between regulators—liquidation (or holding) period and gross vs. net posting of customer margin with a CCP.[18]

19 The liquidation period is the time that regulators determine it would take to terminate, value and close out a futures position.[19] The U.S. rules specify a minimum one-day

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17 E.U. Regulation 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN.

18 Among the other parameters determining margin requirements are the portfolio margining methodology and procyclicality requirements. As regards portfolio margining, Article 27 of Commission Delegated Regulation (EU) No 153/2013 establishing regulatory technical standards on requirements for central counterparties (the "RTS Regulation") allows CCPs to reduce required margin where the price risk of one instrument is reliably correlated to the price risk of another instrument. As regards procyclicality requirements, Article 41 EMIR provides that a CCP shall monitor and, if necessary, revise the level of its margins to reflect current market conditions taking into account any potentially procyclical effects of such revisions. ESMA has produced Regulatory Technical Standards ("RTS") requiring CCPs introduce one of three possible options as a counter-cyclical component in their margin calibration methodology: i) a margin buffer of 25% which can be scaled down in times of rising margin requirements; ii) the assignment of a minimum 25% weight to stress observations, which buffer may be exhausted during stress periods; and iii) a floor for margin requirements consistent with a ten-year look-back period for estimated volatility. In the context of an ongoing review of EMIR by the European Commission, ESMA has recently (13 August 2015) published a report on the efficiency of these procyclicality requirements ("EMIR Review Report no.2") elaborating possible changes that can be introduced to both EMIR Level 1 and the RTS to increase the requirements' effectiveness. The report calls for international convergence in the area of procyclicality treatment in order to avoid regulatory arbitrage and accommodate the mitigation of systemic risks and recommends the global development of best practice standards. ESMA Review Report no.2, available at: http://www.esma.europa.eu/system/files/esma-2015-1252_-_emir_review_report_no.2_on_procyclicality.pdf.

19 Letter from the Committee on Capital Markets Regulation to the CFTC on Margin Requirements for Uncleared Swaps. November 2014, available at: http://capmktsreg.org/news/ccmr-submits-comment-letter-margin-requirements-non-cleared-swaps/.

time horizon while E.U. rules apply a minimum two-day time horizon for the liquidation period.[20] Holding all other parameters constant, a longer liquidation time will result in higher margin requirements. Specifically, initial margin increases as the square root of the liquidation time. Thus, a two-day liquidation period will result in a margin requirement that is 1.4 times larger than a one-day liquidation period. The E.U. rules are *prima facie* more stringent than the U.S. rules insofar as they require the futures customers to post more initial margin with clearing members than the U.S. rules require.

20 The U.S. rules, however, require clearing members to post the "gross" amount of customer margin with a CCP, while the E.U. rules permit clearing members to post the "net" amount of customer margin with a CCP in respect of "omnibus" segregated client accounts ("OSAs").[21] Gross posting of customer margin means that a clearing member must post with the CCP the full amount of margin posted by all customers. This is the approach taken to all customer accounts maintained by a registered Futures Commission Merchant ("FCM") in the U.S. but in the E.U. it is only applied in respect of individually segregated client accounts ("ISAs"). Net posting of customer margin allows a clearing member to reduce the amount of customer margin that it posts with a CCP by netting one customer's exposures against another customer's offsetting exposures. For example, suppose one customer is long S&P500 futures and another customer is short S&P500 futures. The E.U. rules for OSAs would allow the clearing member to net customers, thereby reducing the amount of initial margin that the clearing member posts with the CCP. The U.S. rules are *prima*

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20 In Article 26 of the RTS Regulation, *supra* n.18.

21 Article 39 of EMIR sets out a minimum of three account types that CCPs and clearing members should cater for: house accounts, individually segregated client accounts and omnibus segregated client accounts. In the context of an ongoing review of EMIR by the European Commission, a recent report by ESMA (13 August 2015) on segregation and portability requirements under EMIR ("EMIR Review Report no.3") has recorded that the split between house and client positions and within client positions implies some "denetting" effect with the result that the scheme gives rise to an increase in margins called by CCPs from clearing members and by clearing members from their clients, with resulting cost implications (at paragraph 46). In the report, ESMA suggests that some consideration should be given to introducing Level 2 measures providing for OSAs which attract margin on a gross basis, in keeping with the U.S. model. The report then goes on to say that different liquidation periods might be considered for accounts margined on a gross basis (at paragraph 59), again in keeping with the U.S. model of shorter liquidation periods. The report cautions, however, that no quantitative data have been analysed on the effects of reducing the liquidation period on the one hand and the transition from a net to a gross account structure on the other hand. EMIR Review Report no.3, available at: http://www.esma.europa.eu/system/files/esma-2015-1253_-_emir_review_report_no.3_on_segregation_and_portability.pdf.

facie more stringent than the E.U. rules insofar as they consistently require U.S. clearing members to post initial margin with CCPs on a "gross" basis.[22]

21 It is important to note that the total amount of initial margin posted with a CCP includes two components—"customer" margin and "house" margin. Customer margin is collateral received by clearing members for client transactions and then posted by clearing members with the CCP. House margin is collateral posted by a clearing member to secure its own positions in the futures market.

22 The effects of the E.U. and U.S. rules are different with respect to house margin and customer margin. This is because the E.U. rules that allow netting across customers, clearly do not apply to house margin, as these trades are on the clearing member's own behalf. Given the longer E.U. liquidation period and holding other parameters constant, the E.U. rules require at least 1.4 times more "house" margin than the U.S. rules. Other differences between U.S. and E.U. rules may, however, offset this effect. In particular, E.U. rules allow affiliates of a clearing member to post as customers, so margin posted by affiliates of clearing members can be netted against the positions of other customers. Since house margin makes up a relatively small portion of the total margin posted with a CCP,[23] differences in methodology would not appear to be particularly significant overall.

23 Although a recent CFTC analysis argues strongly that the U.S. rules result in more initial margin collateral being posted with a CCP than the E.U. rules,[24] the E.U. rules described in this comment paper would result in the collection of at least 1.4 times more customer collateral by E.U. clearing members than the U.S. rules require.[25] The

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22 ESMA is currently considering, in respect of OSAs which attract margin on a gross basis, whether CCPs should be allowed to apply a one-day liquidation period for financial instruments in the case of futures. See ESMA, *Review of Article 26 of RTS No 153/2013 with respect to client accounts*, 26 August 2015 ("Review of Article 26"), available at: http://www.esma.europa.eu/system/files/2015-1295_dp_on_review_of_article_26_of_rts_153-2013.pdf. See also *supra* n. 21.

23 Approximately 14% of margin posted with U.S. CCPs is house margin, by CFTC estimates. (See Chairman Massad, "Remarks before the E.U. Parliament", May 6, 2015, available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opamassad-20.pdf). ESMA has said recently, in EMIR Review Report no.3, *supra* n.21, that no clear view as to the take-up of the different types of account—house vs. client—has yet emerged in the E.U. (at paragraph 45).

24 See Chairman Massad, "Remarks before the E.U. Parliament", *ibid*. ESMA has also referred to a calculation which seems to conclude that margin requirements calculated on one-day gross OSAs typically result in higher levels of margin held at the CCP than those calculated on two-day net OSAs. See Review of Article 26 *supra* n.22.

25 The figure may be higher according to factors not considered here. Some reports indicate that the E.U. rules may result in the collection of several times more margin by clearing members than the U.S. rules. This paper is principally concerned with margin held and collected by a CCP.

initial margin posted with an E.U. clearing member must be segregated, with the object that E.U. customers are not exposed to the risk of shortfall on a clearing member's insolvency. Therefore, regardless of whether initial margin is held at a clearing member or at the CCP itself, the initial margin is still designed to provide protection to futures counterparties from market risk.

24 While there are differences between the U.S. and E.U. initial margin requirements, the analysis above has demonstrated that, in the case of key differences on liquidation periods and gross/net margining, the differences offset one another to a significant degree.[26]

25 Neither the U.S. nor the E.U. regulators have demonstrated that either regime would fail to accomplish its goal of addressing the risk posed by the default of futures counterparties.

26 Both Committees therefore strongly recommend mutual recognition on a broad equivalence basis as a means of reducing regulatory conflict.

III. A FRAMEWORK FOR EQUIVALENCE DETERMINATIONS SHOULD ACCOMMODATE REGULATORY DIFFERENCES WHERE POSSIBLE

27 The Committees believe that legal and regulatory certainty can be improved in a cross-border context—and potential regulatory conflict avoided—by acts of mutual recognition. Accordingly, the Committees urge national and regional authorities to establish a clear legal framework for equivalence determinations coupled with an approach which accommodates regulatory differences where possible by tailoring conditions or exceptions to address specific issues. In the context of cross-border derivatives clearing, this process would facilitate the mutual recognition of U.S. and E.U. CCPs and reduce the current uncertainty.

28 EMIR establishes legal rules for the taking of equivalence decisions by the European Commission on a jurisdiction-by-jurisdiction basis (Article 25(6)). By reason of a positive equivalence determination in favour of a third country, ESMA may recognise a CCP established in that country (Article 25(2)), provided it is authorised and

[26] ESMA has impliedly noted this offsetting effect in EMIR Review Report no.3, *supra* n.21, where it recommends that consideration be given to reducing the liquidation period on the one hand and moving from a net to a gross account structure on the other hand. This, says the report, would incentivise the take up of more secured account structures (at paragraph 59). See also *supra n.* 22.

supervised effectively in its home jurisdiction. Once a CCP is recognised by ESMA it may provide clearing services in the E.U. without further need for registration or authorisation.

29 In contrast, in remarks made in June of this year, Chairman Massad indicated that the CFTC would continue to require CCPs to register before providing clearing services in the U.S. in respect of futures listed in the U.S. and swaps cleared for U.S. clients.[27]

30 The Committees believe the CFTC should outline a clear pathway to substituted compliance for E.U. CCPs—one anchored in a rule or rules which permit equivalence determinations to be made, in the first instance, on a jurisdiction-by-jurisdiction basis and which permit individual CCPs to be recognised (without the need for further registration) on the basis of effective supervision and control in an equivalent jurisdiction. Within that general framework, the CFTC can, where necessary, tailor conditions or exceptions to address specific issues. This would allow U.S. dealers and U.S. clients to use foreign CCPs that are subject to rules that the CFTC deems equivalent to the U.S. rules and *vice versa*.[28]

31 In 2013, ESMA released a report adopting this approach to the U.S. regime.[29] In that report, ESMA recommended a positive equivalence determination notwithstanding certain regulatory differences in clearing obligations, rules on timely confirmation of trades and portfolio reconciliation.[30] In June 2014, however, the European Commission stated that it would only be able to recognise the U.S. CCP regime if the CFTC were to approve substituted compliance for E.U. CCPs.

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27 Chairman Massad, "Remarks before the FIA International Derivatives Conference", 9 June 2015, available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-25.

28 In this regard, the CCMR previously recommended in 2013 and 2014 that the CFTC should establish a general substituted compliance process for foreign CCPs including E.U. CCPs.
See: http://capmktsreg.org/app/uploads/2014/09/CCMR_CCP_recognition_letter_08_21_2014.pdf; and http://capmktsreg.org/news/ccmr-releases-letter-on-resolution-of-differences-between-e-u-and-u-s-clearinghouse-requirements/.

29 European Securities and Markets Authority "Technical advice on third country regulatory equivalence under EMIR-US" Final Report, September 1, 2013, available at: http://www.esma.europa.eu/system/files/2013-1157_technical_advice_on_third_country_regulatory_equivalence_under_emir_us.pdf.

30 *Inter alia*, differences identified by ESMA relate to the scope of products subject to the clearing obligations and the scope of entities subject to timely confirmation rules in the E.U. and the U.S. In the case of clearing obligations, ESMA said that its recommendation was based on a "common understanding that the strictest rule would apply in such case."

32 Two potential examples illustrate how conditions or exceptions can address specific issues within the general recognition framework. Both examples relate to concerns which the CFTC reportedly has with E.U. rules for CCPs.

33 First, the CFTC is reportedly concerned that the E.U. rules for collateral protection and segregation for futures and swaps are not equivalent to the U.S. rules. For example, the E.U. rules permit E.U. CCPs to offer two forms of collateral protection: one of which—applying to ISAs—is stricter than the U.S. rules and the second of which—applying to OSAs—is less protective than the U.S. rules.[31] In this instance, the CFTC can remedy any perceived deficiencies in the E.U. segregation and collateral protection rules by requiring E.U. CCPs who apply for recognition to provide U.S. clients with the stricter form of EMIR-compliant customer protection, consistent with the customer protection rules required by the Dodd-Frank Act.[32] In this regard, it is worthy of note that ESMA has recently recommended making the use of ISAs—and thus the stricter form of collateral protection—compulsory in certain cases in the E.U.[33]

34 The CFTC is also reportedly concerned that if U.S. clients clear swaps with a foreign CCP then foreign bankruptcy laws, which do not provide recovery and protections consistent with U.S. bankruptcy laws, would be applied to these U.S. clients. One way in which the CFTC could address this matter for swaps is in the same way it did for U.S. clients clearing futures with a foreign CCP. To the extent that U.S. clients clear futures with a foreign CCP through an FCM, those U.S. clients qualify for the application of U.S. bankruptcy laws in the case of their FCM's insolvency.[34] The CFTC could exercise its rulemaking authority under Section 20 of the Commodity Exchange Act ("CEA") to clarify that U.S. bankruptcy laws will apply in a similar manner to U.S. clients clearing swaps with a foreign CCP through a registered U.S.

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31 EMIR requires that CCPs offer clients the choice between omnibus and individual segregation of positions and collateral (Article 39(2), (3) and (5) of EMIR), *supra* n.21. Omnibus accounts typically involve cross-netting and other mutualisation risks between clients and so provide for less strict protection than individually segregated client accounts. Both accounts ring-fence the house funds and the client funds separately but the individual client funds are also safe from the risk associated with cross-mutualisation in omnibus accounts.

32 Given the regulatory scope of the EMIR conduct of business rules, it is at least arguable that the requirement for mandatory client choice in Article 39(5) is intended to apply to the provision of by CCPs of clearing services within the E.U. and not to the provision by E.U. CCPs of clearing services in third countries. If this is correct, E.U. CCPs should not be required to offer client choice in the U.S. where the CFTC's conduct of business rules apply.

33 "[F]or example when a client's cleared position at a given CCP exceeds a pre-determined size or for entities of the same group as the clearing member". See EMIR Review Report no.3, *supra* n.21 (paragraph 55). It is unclear whether ESMA takes the view that legislative changes are needed to achieve this result.

34 Commodity Broker Liquidation, 11 U.S. Code Chapter 7, Subchapter IV.

FCM.[35] The FMLC would note as a general principle, however, that differences in creditor treatment between jurisdictions can represent an obstacle to the efficient cross-border resolution of a global financial institution.

35 Accommodations of this kind can facilitate mutual recognition in the form of approvals for substituted compliance or equivalence determinations by providing comfort to national regulators that the strictest rule will apply in each case.

IV. A NEW MODEL FOR GLOBAL COLLEGES OF CCP SUPERVISORS IS REQUIRED

36 At present and absent mutual recognition by the U.S. and E.U., financial markets participants are subject to a system of dual authorisation/registration and parallel supervision by national authorities in both regions. This is a situation which gives rise to the risk of conflicting supervisory decisions or directions and potentially creates significant regulatory uncertainty. It also results in unnecessary and overlapping supervisory efforts which are burdensome for both regulatory authorities and participants alike. The present situation is the one which legislative provision for mutual recognition was designed to avoid.

37 One method of supervisory cooperation which has been successfully adopted in the sovereign context is peer review. Here, the "home" jurisdiction is assessed for its legal and regulatory efficacy by an organisation representing other affected jurisdictions in a process which bears some resemblance to a kind of "audit" of the regime in question. Peer review, however, where it has been implemented among regulatory authorities outside the sovereign context, has proved troublesome to apply to international supervisory outcomes.[36]

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[35] This clarification would be consistent with Sections 4d(f)(5) and 5b(h) of the CEA, which appear to contemplate this result.

[36] In an essay in Wymeersch, Hopt, and Ferrarini (eds.), *Financial Regulation and Supervision: A post-crisis and analysis* (Oxford, 2012), Niamh Moloney writes that

> Peer review mechanisms have proved troublesome, partly given concerns among IOSCO members as to potential damage to bilateral relationships.

And also:

> Early experience with IOSCO, however, underlines the difficulties with peer review… the CESR experience, as revealed by its public documents at least, has been mixed. The FATF's Mutual Evaluation Process is regarded as successful. But… even here, the review process has been described as "resource intensive and sometimes painful".

38 In light of the shortcomings of the supervisory approaches just mentioned, international regulators have advocated the establishment of colleges of supervisors.[37] EMIR adopts this approach to supervisory cooperation between Member States but makes no provision for participation by non-E.U. supervisors.[38] The key objectives to be pursued by the college under EMIR are exclusively European: i.e. the preservation of the functioning of the internal market and the avoidance of discrimination against Member States.[39] Participating regulatory authorities are to be guided in their mutual cooperation, by a concern for "the potential impact of their decisions on the stability of the financial system in all other Member States".[40] The model of supervisory cooperation set out in EMIR is therefore ill-adapted to participation by authorities in third countries.

39 CCPs represent a large concentration of risk. Given this, a host regulator will reasonably expect to have a significant degree of influence in a college established by the CCP's home regulator before it will feel comfortable abandoning its own registration or authorisation requirement. This reality should be acknowledged in the transatlantic context and a template for appropriate levels of host participation in supervisory colleges should be set out as soon as possible. The Committees recommend that the lead supervisor for CCPs operating in multiple jurisdictions should be determined by the domicile or main establishment of the CCP and also that host supervisors should be accorded a significant role, commensurate with the risk to their domestic markets, which is clearly demarcated. The Committees would be willing to contribute to the process of settling a robust template or memorandum of understanding for participation by host regulators in supervisory colleges in any way which might assist in resolving the current impasse and the legal and regulatory uncertainty which it entails.

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37 In June 2014 the Bank for International Settlements published *Principles for Effective Supervisory Colleges*.

38 The parameters for the authorisation and supervision of CCPs are set out in Articles 18 to 24.

39 See Recital 52 of EMIR.

40 Under Articles 23 and 24 of EMIR.

V. CONCLUSION

40 In conclusion, the Committees believe that if the European Commission and the CFTC follow the approach described above then the issue of mutual CCP recognition can finally be resolved and the legal and regulatory framework for CCPs can be made as robust as possible. This in turn will help address legal and regulatory uncertainty and work to preserve liquidity in derivatives markets and prevent market fragmentation.

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41 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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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.