ISDA Safe, Efficient Markets

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30 July 2012

Dear Mr. Pearson,

Dear Mr. Buenaventura,

Dear Mrs. Vaillant,

Concerns regarding the application of Article 25(1) EMIR

Prohibition against non-EU CCPs providing clearing services in the EU

Article 25(1) EMIR[1] will prohibit non-EU central counterparties (CCPs) from providing clearing services to clearing members (and trading venues) established in the EU unless and until the CCP is recognised by the European Securities and Markets Authority (ESMA).[2] As with other provisions of EMIR relating to the regulation of CCPs, this provision will apply to all kinds of CCPs including those clearing OTC derivatives, exchange traded derivatives and securities transactions.

[1] Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (EMIR). References to Articles and Recitals are to Articles and Recitals in the text approved by the European Parliament's legislative resolution of 29 March 2012 as revised and published by the Council on 4 July 2012.

[2] Member States will determine the measures that can be taken against a non-EU CCP for contravention of Article 25(1). Article 22(3) EMIR will require Member States to ensure that appropriate administrative measures can be taken against those responsible where the provisions of EMIR have not been complied with and provides that these measures must be effective, proportionate and dissuasive.

There are a number of points in relation to the application of Article 25(1) which are still unclear. It will be essential for firms preparing for implementation of EMIR to understand the likely impact of this provision and we urge the European Commission and ESMA to address these issues and to issue clarifications or provide other solutions to the problems raised.

1. Background and key issues

ESMA will only be able to recognise non-EU CCPs for the purposes of Article 25(1) where certain criteria are fulfilled, including a determination by the European Commission that the non-EU country regulatory regime requires CCPs to comply with equivalent requirements to those contained in EMIR and provides an effective equivalent regime for recognising foreign CCPs (see Article 25(2)–(7)). ESMA will develop draft regulatory technical standards specifying the information to be provided by a non-EU CCP that seeks recognition (Article 25(8)).

A number of non-EU CCPs, including CCPs in Dubai, Hong Kong, Singapore and Switzerland, already admit EU firms as clearing members, either through local branches or as remote members. However, even where non-EU CCPs are willing to apply for recognition from ESMA, there is a risk that they will not be able to obtain recognition before the prohibition comes into effect. We are concerned that Article 25(1) might be regarded as "self-executing" and thus applying from the date 20 days after the publication of EMIR in the Official Journal.

Even if this is not the case, there is also a risk that some non-EU CCPs with existing membership from EU firms might not be regarded as within the scope of the transitional provisions designed to give certain non-EU CCPs time to apply for recognition after the Level 2 measures under EMIR are adopted.

In addition, it is possible that even those non-EU CCPs willing to apply for recognition will not be able to obtain recognition from ESMA if ESMA and the European Commission apply a restrictive approach to the recognition criteria, in particular the requirement in EMIR that non-EU states provide reciprocal access regime for foreign CCPs.

Therefore, there is a risk that Article 25(1) could have the result that non-EU CCPs seek to exclude EU firms from acting as clearing members, whether those firms act as individual clearing members (clearing their own transactions) or general clearing members (clearing their own transactions as well as client business).[3] This could compel firms to use non-EU clearing members to clear their business (which may increase their counterparty risk).[4]

This note reviews these issues and makes proposals for how the Commission and ESMA could implement EMIR in a way that would mitigate the possible adverse impacts on cross-border business. In particular, ESMA could use its powers under its founding regulation to give guidance on certain of the issues highlighted in this note by issuing guidelines,

[3] The definition of clearing member in EMIR is not restricted to general clearing members. See Article 2(14).

[4] Recital 59 makes clear that "in order not to hamper the further development of cross-border investment management business in the Union, a third country CCP providing services to clients established in the Union through a clearing member established in a third country should not have to be recognised by ESMA".

recommendations or opinions to promote consistent supervisory practices, after appropriate consultation.[5]

This note does not review the related issues as to the treatment of derivatives traded on non-EU exchanges in the absence of a determination that the non-EU exchange is "a third-country market considered as equivalent to a regulated market in accordance with Article 19(6) of Directive 2004/39/EC [the Markets in Financial Instruments Directive (MiFID)]" (Article 2(7)). In the absence of such a determination, non-EU exchange traded derivatives would be considered to be "OTC derivatives" for the purposes of EMIR. It appears that the Commission has not published any list of non-EU exchanges considered as equivalent to a regulated market under MiFID (as contemplated by Article 19(6) MiFID). ISDA urges the Commission to progress work on the recognition of third country markets trading derivatives for the purposes of Article 19(6) to avoid the risk that exchange traded derivatives traded on non-EU exchanges are characterised as OTC derivatives under EMIR.

2. **Scope of application: non-EU branches**

Article 25(1) states that a CCP established in a third country may provide clearing services to clearing members or trading venues "established in the Union" only where that CCP is recognised by ESMA.

This provision could affect the ability of non-EU CCPs to provide clearing services to:

i. Firms incorporated in the EU that are remote clearing members of non-EU CCPs, i.e. where they participate from their EU office in the non-EU CCP as a clearing member (e.g. a UK incorporated investment firm that is a remote member of a non-EU exchange and is also a remote member of the related non-EU CCP);

ii. Firms incorporated outside the EU that have a branch in the EU and that are clearing members of the non-EU CCP and participate in the CCP through that EU branch (e.g. a US bank with a branch in the UK, where the UK branch performs clearing services and participates as a clearing member in a non-EU CCP);

iii. Firms incorporated in the EU that have a branch outside the EU that are clearing members of the non-EU CCP but participate in the CCP through that non-EU branch (e.g. a German incorporated bank with a branch in a non-EU country, where the local branch participates in the non-EU CCP as a clearing member);

iv. Firms incorporated outside the EU that have a branch in the EU and that are clearing members of the non-EU CCP from a non-EU office (e.g. a Japanese bank with branches in the EU which participates in Japanese or other non-EU CCPs from its head office or other non-EU branches).

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[5] See Articles 16 and 29 of 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), available at ESMA

It is not clear whether the various references in EMIR to the place of "establishment" of a firm are intended to refer to a place in which the firm maintains a branch or similar establishment or whether they were intended to be limited to the place of incorporation of a legal person. On the basis that they encompass references to branches:

- In cases (i) and (ii) above, the firm is "established" in the EU (and is acting through its establishment within the EU) and therefore it would seem that the non-EU CCP is within the scope of the prohibition if it provides clearing services to the firm in question.

- In cases (iii) and (iv) above, the firm is "established" in the EU (because it is incorporated or has a branch in the EU) and the prohibition would therefore appear to apply to the non-EU CCP, even though the firm in question is also established outside the EU and the non-EU CCP is not providing clearing services to a person acting through an establishment in the EU.

Even if the references are restricted to the place of incorporation, it would seem that the non-EU CCP would still be within the scope of the prohibition in cases (i) and (iii) above if it provided clearing services to the firm in question.

However, recital 59 indicates that it was the intention of the EU legislators that Article 25(1) should only apply where a non-EU CCP provides clearing services "within the Union". In addition, Article 25(3)(a) and the first sentence of Article 25(5) also assume that recognition is only necessary where the non-EU CCP has activities or provides services "in" a Member State or "in the Union". This indicates that the legislative intent was that non-EU CCPs should not be subject to the restrictions in Article 25(1) where they provide services outside the EU.

In addition, recital 59 also indicates that Article 25(1) should not prevent a non-EU CCP providing services to clients established in the EU "through a clearing member established in a third country". This indicates that a CCP can provide clearing services to firm at least when the firm is acting through an establishment outside the EU.

In particular, it would cause considerable difficulty if Article 25(1) purported to prevent a non-EU CCP providing clearing services to a non-EU bank acting through offices outside the EU simply because the non-EU bank also happens to have a branch in the EU

Proposal: The Commission or ESMA should issue guidance making clear that Article 25(1) does not apply where a non-EU CCP provides clearing services to a person acting through a branch or office outside the EU, even if that person is incorporated in the EU, i.e. that Article 25(1) does not apply at least in cases (iii) and (iv) above..

3. Timing of application

EMIR does not provide for any Level 2 measures to develop the obligations under Article 25(1). Therefore, there is a risk that Article 25(1) is regarded as self-executing and as

applying from the date falling 20 days after the publication of EMIR in the Official Journal (Article 91 and Recital 93[6]).

However, Article 25(8) does provide for Level 2 measures to develop the application procedure envisaged by Article 25(2) to (5) Those measures will specify the method by which non-EU CCPs can obtain recognition from ESMA. It would be illogical if the prohibition in Article 25(1) would come into effect before it was even possible for a non-EU CCP to apply for recognition.

Proposal: The Commission or ESMA should issue guidance making clear that Article 25(1) does not apply at least until the Level 2 measures envisaged by Article 25(8) have been adopted and come into effect (as envisaged by Recital 93).

4. Application of transitional provisions

However, even if Article 25(1) does not apply until the regulatory technical standards adopted under Article 25(8) come into effect, this could still result in non-EU CCPs having to suspend existing clearing memberships. The non-EU CCP would not be able to apply for recognition until after those standards came into effect and would be subject to the restrictions in Article 25(1) until a decision is made on its application.

EMIR seeks to address this issue by including a transitional provision that states that CCPs "recognised to provide" clearing services in a Member State prior to the date of adoption of the relevant Level 2 measures (including those under Article 25) have six months after that date to apply for recognition and that, until a decision is made, national law on authorisation and recognition continues to apply (Articles 89(3) and (4)). This is clearly helpful, for example, in relation to those non-EU CCPs that are recognised overseas clearing houses in the UK (assuming that they are willing to apply for recognition).[7] If so, they will be able to wait until the Level 2 measures are adopted and will not have to suspend any clearing memberships of EU firms unless and until their application is rejected.

However, there are other non-EU CCPs with EU members which may have no formal recognition under Member State law.

Proposal: We urge the Commission or ESMA to issue guidance to the effect that the transitional provision is available to all non-EU CCPs that are currently permitted by national law to provide clearing services to EU clearing members, even in the absence of formal recognition arrangements in a Member State.

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[6] Article 91 provides that EMIR "shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union." Recital 93 provides that "any obligation imposed by this Regulation and which is to be further developed by means of acts adopted under Articles 290 and 291 TFEU should be understood as applying only from the date on which those acts take effect."

[7] There are three non-EU recognised overseas clearing houses (RCOHs) in the UK: ICE Clear U.S., Inc., SIX X-Clear and The Chicago Mercantile Exchange (CME) However, it is unclear whether the transitional provision will assist RCOHs if they have clearing members in other Member States where there were no specific recognition requirements.

5. Recognition of non-EU CCPs

Non-EU CCPs that apply for recognition may face a number of obstacles because of the criteria imposed by Article 25, depending on how these are applied. For example:

- ***Scope of authorisation.*** Even if the non-EU country has a legal system which provides for the authorisation and regulation of CCPs, the scope of that regime may be more limited than in the EU. In some cases, even if CCPs comply with equivalent requirements this may not be as a result of "legally binding requirements" (as required by Article 25(6)).

- ***CPPS-IOSCO principles.*** Some of the EU requirements for CCPs may go beyond the requirements in the CPSS-IOSCO principles for financial market infrastructures.[8] For example, EMIR requires that all CCPs have a default fund covering the default of the largest clearing member or the second or third largest clearing member (Article 42(3)). The CPSS-IOSCO principles only require coverage of two clearing members for a CCP that is involved in activities with a more-complex risk profile or that is systemically important in multiple jurisdictions.[9]

- ***Reciprocity requirement.*** The Commission can only make an equivalence determination in relation to a non-EU country if "the legal framework of that third country provides for an effective equivalent system of recognition of CCPs authorised under third country legal regimes" (Article 25(6)). Even if other countries are willing to recognise EU or other foreign CCPs for clearing of OTC derivatives, there may be obstacles to foreign CCPs clearing transactions on local securities or futures exchanges.

- ***Timing.*** There may be timing issues as to when the European Commission can make the necessary determinations with respect to the number of potentially affected jurisdictions, particularly as local laws are changing to accommodate the G20 commitments. In addition, ESMA cannot recognise CCPs unless and until co-operation arrangements are in place with local regulators. Furthermore, ESMA is required to decide on an application for recognition within 180 working days. If there are delays in the Commission making its determination or in the making of co-operation agreements, ESMA may be required to reject applications even if the application does benefit from the transitional arrangements.

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8 Available at BIS.

9 CPSS-IOSCO principle 4 includes a requirement that "a CCP that is involved in activities with a more-complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions."

Proposal to ESMA. ESMA should liaise with the European Commission and affected non-EU CCPs and their regulators to ensure that the recognition requirements do not disrupt existing business. In particular, the European Commission should make clear that non-EU states whose CCPs comply with the CPSS-IOSCO principles will in principle be eligible for recognition.

Yours sincerely,

George Handjinicolaou,

Deputy Chief Executive Officer and Head of Europe, Middle East and Africa

For more information please contact Roger Cogan (rcogan@isda.org).