ISDA's response to the Commission's proposed regulation as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs (the "EC Proposal")

Management Summary

ISDA and its members welcome the European Union's review of CCP supervision arrangements. We agree with the proposal's objective of ensuring that EU supervisors are able to exercise appropriate and proportionate oversight of CCPs that provide clearing services in the EU. We also support the review of the supervision arrangements for third country CCPs which are systematically important for the European Union.

ISDA members note the inclusion of a location policy within the proposed regulation and Vice President Dombrovskis's statement on 13 June 2017 that it is meant to be a "last resort" to be used "only when a CCP is of substantial systemic importance and enhanced supervision by ESMA is not sufficient to safeguard financial stability".

Our membership has serious concerns about the risks presented by a location policy such as the geographical fragmentation of markets and distortions in competition, as well as material adverse impacts on the reduction of systemic risk, added costs, and reduced market liquidity and efficiency. Further, a location policy could have a significant impact on the structure and functioning of capital markets in the EU and consequently the financing of the EU economy and on EU end users. It could also have negative repercussions among policymakers in other jurisdictions because of its extraterritorial implications.

While we recognize and share the proposal's objective of ensuring that EU supervisors are able to exercise appropriate and proportionate oversight of CCPs that provide clearing services in the EU, ISDA is unable to support an approach that gives rise to the serious risks referred to above.

As such, our members welcome the EC's proposal to make enhanced supervisory cooperation the preferred option and we encourage the EC to continue to build on regimes that rely on regulatory coordination, cooperation and deference, such as those already practised today between the Commodity Futures Trading Commission (CFTC) and the Bank of England (BoE) in their supervision of SwapClear, which have served the derivatives markets well since the financial crisis.

ISDA's membership includes CCP clearing members, financial and non-financial clients of clearing members and CCPs. We have consulted and received input from all its membership in developing this response. In line with ISDA's mission, and notwithstanding the impact location policy could have on other globally systemic important CCPs, our response covers the impact of the proposed regulation on CCPs clearing derivatives. Many but not all of the points made will equally apply to CCPs clearing other types of products.

This response continues the points made in the letter to Vice-President Dombrovskis, dated 8th June 2017[1].

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[1] https://www2.isda.org/attachment/OTQ2Ng==/ISDA%20FINAL%20response%20to%20EC%20Communication%208%20June%202017.pdf

ISDA believes the clear aim should be to develop a consistent and global 'shared supervision' model which allows efficient functioning of the markets and is consistent with the deferential and international comity-based approach the European Union has taken to implementing G20 derivatives reforms.

<u>ISDA strongly recommends coordinated management of systemic risk through supervisory cooperation</u>

ISDA advocates supervisory cooperation: Derivatives markets are global, and firms acting in this global market have to manage all the risks that come with operating internationally. This is equally true for the way firms interact with global CCPs. To manage risk across jurisdictions, relevant supervisors have to cooperate closely, ensuring their arrangements take into account risks in other relevant jurisdictions to ensure they are managed consistently.

Supervisory cooperation should be proportionate and efficient: The framework for cooperation should avoid duplication, and should allow supervisors to rely on and/or defer to each other's regulatory and supervisory frameworks as much as possible. In this regard, we welcome the concepts of comparable compliance for tier-2 CCPs in a manner consistent with the principles of international comity and cooperation.

The interests of supervisors should be aligned through rules agreed ex-ante and based on global standards: ISDA appreciates that the interests of authorities in different jurisdictions may not always be fully aligned, particularly during a CCP's recovery or if home authorities are considering resolution. Even within the EU, structures that give all authorities in all relevant member states appropriate oversight have to be further developed. Cooperation with third country CCP supervisors and other relevant authorities should be organised in a manner similar to intra-EU cooperation through enhanced supervisory cooperation, based on globally agreed principles and standards.

The Financial Stability Boards (FSB's) "*Guidance on Continuity of Access to Financial Market Infrastructures (FMIs) for a Firm in Resolution*" will for instance be helpful in guiding authorities from different jurisdictions through the recovery, resolution or default of a clearing participant.

There is already a precedent in supervisory cooperation for a large CCP: The US Commodity Futures Trading Commission (CFTC) has registered SwapClear as a Derivatives Clearing Organisation and co-supervises SwapClear together with the UK Bank of England (BoE), approving models, rulebook changes and performing inspections. This arrangement is similar to the powers currently proposed for ESMA. We note that the CFTC only applies its rules to the OTC Swap clearing business of SwapClear, and only directly in respect of that business line's clearing for US clients. The CFTC's rules do not apply to LCH Ltd's other clearing services or directly to SwapClear's services for non-US clients. The CFTC also grants substituted compliance where EU rules are comparable and comprehensive and no-action relief in certain instances where the EU legal or regulatory framework is inconsistent with US Commodity Exchange Act and CFTC rules.

Supervisors have a role to play in ensuring CCP margin and haircut models are robust: We understand that some EU member states and supervisors would like to prevent a CCP from making sudden changes in collateral haircuts or concentration limits, as experienced by clearing members in the euro sovereign repo market in 2011. The 2012 EMIR Regulation, which came into effect in March 2013, has significantly enhanced communication and cooperation between regulators, addressing the primary concern from 2011. CCP haircut models have also improved and are now less procyclical. In addition, special enhanced cooperation was established in 2015 between the BoE and the ECB to address ECB's specific systemic risk concerns. This cooperation could be further strengthened post-Brexit under the Commission's proposed enhanced supervision framework for third country CCPs. While we share the concern to avoid disruptive measures, clearing members and clients have significant reservations about any arbitrary, ad-hoc or subjective actions taken by supervisory authorities that would stand in the way of prudent risk management by CCPs and would generate unhelpful incentives for supervisors and CCPs. ISDA believes relevant supervisors should agree ex-ante on models to protect against systemic risk in their jurisdictions, for instance by ensuring these models address pro-cyclicality and possible changes in the market and wider economy.

<u>ISDA recommends changes to the proposed rules for supervision and powers for third countries</u>

The criteria for designating a tier-2 CCP should be clearly defined, and designed with the impact on the EU27 in mind: A CCP can be large in size and interconnected, but its systemic importance to the EU may be diminished if the exposures of EU27 members are limited. We note that the CFTC approach to registration focuses on OTC derivatives activities that relate directly to US markets and US market participants, while providing opportunities for tailored exemptions from registration in other instances. A similar framework may be worthy of consideration in this instance.

To the extent that the tier-2 framework is applied, it should be at the level of the clearing service and not the CCP: Given that many CCPs have several clearing services, the decision should be taken at the level of the clearing service, not at CCP level, as the risk management framework of most CCPs is linked to a clearing service and/or to a default fund for a clearing service.

A CCP needs to be given time to comply with EMIR: Once a CCP has been designated as tier-2, adequate phase-in time should be granted in the proposed rules to allow for ESMA's 'comparable compliance' assessment and for the CCP to adapt its risk management framework and rulebooks as necessary to the EMIR standards. The CCP must have adequate time to obtain approvals for such changes through its internal governance structure and then obtain supervisory approval. We recommend that CCPs be given at least one year for this process.

The recognition status of a CCP determined to be a tier-2 CCP needs to be clarified: The proposed rules are silent on whether an already recognised CCP will keep its recognition status during the transition to a tier-2 CCP. It is vital to clarify this to avoid cliff-edge effects.

EU policy makers have indicated that powers over third country CCPs are modelled on US rules. However, we believe that the powers go above and beyond the US rules. Any action that may lead to regulatory retaliation should be avoided: The US does require non-US CCPs to register with CFTC or obtain exemption from such registration. Any such exemption would be based on requirements tailored to the specific CCP and its operations. Moreover, both registration and exemption are based on the products to be cleared for US persons and therefore do not necessarily apply to an entire CCP. We also note that the US has not designated any third country CCPs as systemically important.

Powers of the central bank should be restricted to the powers specifically envisaged by this regulation: Changes in the ECB statutes[2] should not result in the ECB itself being able to mandate

[2] https://www.ecb.europa.eu/press/pr/date/2017/html/ecb.pr170623.en.html

clearing within the EU27, but should only allow the ECB to execute the powers specifically set forth in the final EMIR legislation. We recognise that there may be monetary policy and liquidity risk concerns specific to central banks which may not be adequately reflected in the existing arrangements. The EC's proposal is intended to address this. However greater clarity is required around the mandate attributed to central banks of issue so as to avoid any undue uncertainty resulting from an ambiguous mandate.

<u>A location policy for derivatives as proposed would increase risk and cost, in particular for clearing members and their clients in the EU27 and create an un-level playing field in the markets.</u>

Such a location policy will lead to more correlated, less robust CCPs: Only EU27 counterparties would be directly impacted by the non-recognition approach envisaged by the EC's proposal. We would expect a CCP clearing a limited set of transactions to have fewer, more correlated clearing members than a CCP with a global membership profile. Should one of the members at such a CCP with fewer, potentially concentrated and highly correlated members default, the loss not covered by margin will be mutualised between fewer clearing members. Additionally, there would be fewer firms to bid in an auction and support porting of clients of the defaulted clearing member, increasing the risk of auction failure and liquidation of positions. Fewer clearing members also impacts resources including the availability of traders to assist in the hedging process.

Increased liquidity risk for firms intermediating between CCPs: Non-EU domiciled firms offering liquidity in the smaller EU27 market could hedge their market exposures in the larger global liquidity pool. This will lead to such firms incurring largely directional positions across CCPs in the EU27, increasing risk and costs associated with margining a directional portfolio. During sudden and large intraday market moves, associated intraday margin calls will cause huge liquidity strains on the members and their clients, as CCPs usually call for intraday margin, but for risk and liquidity management reasons do not pay out intraday margin.

There will be less choice for EU27 participants: A lack of CCP choice would stifle competition and innovation during business as usual and could be even more problematic in times of market stress as it would limit alternatives to a distressed CCP. It should be noted that while the majority of interest rate swaps may well be cleared at a single CCP, there is choice of clearing location and competition. As such, competition leads to continuous innovation and development in the provision of the service to the market participants.

A migration of positions to an EU27 CCP would pose unprecedented operational risk and execution cost: Unless legacy transactions are grandfathered, all affected clearing participants will have to close out their transactions on the global legacy CCP, and execute new transactions to re-establish these transactions on the EU27 CCP. This will cause unprecedented operational risk and unnecessary market transaction costs. On the other hand, grandfathering of existing contracts will limit member's ability to mitigate future exposures, resulting in increased risk to clients and clearing members alike.

It is likely that a difference in price for the same product cleared on the EU27 and third country CCP (basis) will develop and/or continue: A basis develops if different types of firms clear across various CCPs. In today's marketplace there is a different price for the same type of swap contract cleared at LCH versus CME, LCH versus Eurex and LCH versus Japan Securities Clearing Corporation (JSCC). Should an EU27 investor find itself at the wrong side of the basis because it has to clear on a EU27 CCP, the transaction would be more expensive. Clients not mandated to clear under EMIR would be incentivised to avoid this cost by contracting with firms outside the EU27. Additionally, EU27 banks could be priced out of the market, resulting in an un-level playing field in servicing their clients' needs.

We expect wider bid/ask spreads in a smaller, fragmented market: A smaller market would attract fewer market makers, possibly leading to wider bid/ask spreads and more volatility. Lower liquidity and increased volatility will impact clients significantly. This effect would be amplified during any migration period, as many firms would have to look for bids in the same direction.

Fragmenting markets would result in higher margin and capital requirements, stymying the efficiency of Europe's capital markets. Fragmenting the Euro interest rate swap market would reduce opportunities for multilateral netting, which will increase costs for derivatives end users. According to a quantitative impact study (QIS) based on data submitted by 12 large banks, the fragmentation of the euro swap market would result in a 16%-24% initial margin increase for house accounts, with some larger members reporting more significant increases of around 50%.

Our survey also indicates a 65% increase in CET1 capital requirements stemming from increases in risk weighted assets (RWAs), and leverage requirements associated with cleared portfolios.

As initial margin is risk based, an expected increase in margin requirements in the system indicates an overall increase of risk in the system. The additional cost associated with increased margin requirements is likely to be borne by derivatives end-users and clients, which will ultimately negatively impact individual savings accounts, pension plans and commercial businesses.

A location policy would be even more problematic if it were implemented at CCP level, as opposed to product/currency level: It is unclear from the text whether a location policy would be mandated by CCP, or by product/currency: Article 25 2c of the EC Proposal talks about a decision at the CCP level. It is unclear whether article 25m of the EC Proposal on "Withdrawal of recognition" would then be used to calibrate the scope of such a policy. As discussed above, the risk and cost of a location policy for euro interest rate swaps is concerning. Should such a policy affect other currencies and products that are also cleared at this CCP, whether systemically important or not, the effect will be multiplied for EU27 clearing members and their clients.

These outcomes run counter to G20 policies to avoid fragmentation of markets, protectionism and regulatory arbitrage.

Location policies have been considered in jurisdictions other than the EU and have either been abandoned as a policy option (in Canada and Australia) or drastically scaled down (Japan).

Detailed ISDA comments to the Proposed EU CCP Supervision Regulation (EMIR 2)

ISDA agrees with the starting point for this regulation:

- The requirement for EU supervisors to have access, as necessary, to CCPs that provide clearing services to firms in the EU.
- With the backdrop of Brexit and the importance of UK CCPs to the financial system of the European Union we also support the requirement for a supervisory model that addresses the supervisory concerns associated with large third country CCPs that are systemically important to the EU financial markets and economies.

ISDA believes the clear aim of the regulation should be to develop a consistent, global shared supervision model which allows efficient functioning of the markets. Whilst ISDA members understand that the proposed regulation foresees a location policy only as a last resort measure, we remain strongly opposed to a location policy and the forced fragmentation of markets, and express concern about the uncertainty that even the possibility of a location policy poses. The far superior option is supervisory cooperation, as already practiced between the CFTC and the BoE in the supervision of SwapClear.

Coordinated management of systemic risk through supervisory cooperation

Derivative markets are global in nature as a result of both the products and the market participants that transact in them. While there are some small domestic derivative CCPs whose activity is mainly conducted in local currency, the market is mainly served by a small number of large CCPs with a global reach. Globally integrated derivatives markets provide for risk reduction and lower cost through netting and trade compression, diversification of participants and economies of scale. This model is market driven and provides for efficiency while preserving choice to clearing participants.

Similar to global trade, breaking up this model into separate CCPs and therefore liquidity pools via a location policy would reduce efficiency whilst at the same time increasing risk and cost in the global system. We will discuss this in detail below.

ISDA strongly believes that globally integrated markets will not be served with fragmentation, but instead through required common standards and close supervisory cooperation.

The regulation makes regular reference to the scope of regulatory arbitrage created by different levels of supervision. ISDA members are keen to make the point that they are risk-averse when selecting a CCP, with the overriding requirement of the CCP to be safe, not risking their participants' position, margin, default fund, assessment or loss allocations with aggressive risk management frameworks. While there are other aspects of a CCP service that may make it more, or less, attractive to members, a failure to meet stringent risk standards makes these other features irrelevant.

A successful supervisory cooperation model needs to have the following characteristics:

Comprehensive:	The cooperation framework needs to take into account all systemic risks to the home jurisdiction (being the jurisdiction of the CCP) and the host jurisdiction (being the jurisdiction other than its own, into which the CCP

provides services) making sure they are managed satisfactory for both sides.

Proportionate and efficient: The framework should avoid duplication and complexity. We welcome the principle of equivalent rules (for tier-1 CCPs) and comparable compliance (for tier-2 CCPs). Such regimes should be flexible and outcomes focused, based on adoption of international standards, rather than line-by-line assessments.
Supervisors might also want to agree to standardised reporting for CCPs that satisfy both home and host supervisors.

Effective and aligned: ISDA members appreciate that designing governance models for CCPs with stakeholders in several jurisdictions is not trivial. Interests of home and host jurisdictions should be aligned as far as possible ex-ante, by agreeing the risk management framework, models and rulebooks among CCPs and relevant supervisors based on global standards.
Licensing of third country CCPs by some jurisdictions has proven to be an effective mechanism for ensuring CCPs comply with the specific rules of all the jurisdictions in which they operate and, in practice, has led to significant service improvements and enhancements which have benefitted the global markets as a whole.

We note that there is already a working example of dual supervision: SwapClear clears the large majority of USD interest rate swaps outside of the United States. The CFTC has registered and supervises SwapClear as a Derivatives Clearing Organisation, approving models and rulebook changes and performing inspections. This arrangement is similar to the powers currently proposed for ESMA. For further discussion please see below.

There will be cases where the interests of both jurisdictions are not aligned, for instance in recovery or resolution situations. We welcome the work that the Commission has done with the proposed framework of regulation for the recovery and resolution of central counterparties. This proposed EU regulation is an example of the many stakeholders whose interests have to be taken into account even in a setting within the Union, a model that can be used in a similar fashion if the CCP is located in a third country. We also would like to point to global standards that such cooperation could be based on, for instance the establishment of Crisis Management Groups (CMG) as proposed by FSB "*Guidance on Central Counterparty Resolution and Resolution Planning*" to make sure European authorities have appropriate involvement in the resolution of a third-country CCP. In addition, special enhanced cooperation was established in 2015 between the Bank of England and the ECB to address ECB's specific systemic risk concerns.

Potential conflicts exist in the management of the default of a multi - jurisdictional CCP member, for instance if the CCP wants to close out a clearing member which is under resolution in the other jurisdiction. Such situations and procedures for addressing them can be identified and agreed upon in advance, ideally based on globally agreed principles and guidance. For instance, the FSB "*Guidance on Continuity of Access to Financial Market Infrastructures (FMIs) for a Firm in Resolution*" sets out global standards and processes to be followed by regulators and market participants to ensure that a clearing member that goes into resolution retains access to a CCP, regardless of jurisdiction. Likewise, establishment of CMGs for CCPs that are systemically important in more than one jurisdiction, as mandated by the FSB "*Guidance on CCP Resolution and Resolution Planning*" mentioned above, facilitates coordination of resolution planning and resolvability assessments, as well as processes for cooperation and information sharing during a crisis[3]. Applying common standards will always support alignment of actions.

During the 2011 Eurozone crisis haircuts for some European sovereign issuers increased markedly in line with the CCP models and market data. These increased haircuts were thought to have caused increased attention of the market to the credit risk of these countries. It is understandable that policymakers want to avoid a repeat of such a situation. We would like to point out that the governance, regulation and supervision of systemic risk in the Eurozone has changed, for instance by introduction of the single supervisory mechanism, EMIR improving CCP risk management and supervisory cooperation, and the swap line between ECB and the BoE. CCP haircut models have also been changed based on lessons from this crisis and are now less pro-cyclical now.

Agreement of swap lines between central banks is another measure that can be taken ex-ante and that would improve CCP resilience and reduce systemic risk. Existing successful arrangement between the ECB and the BoE could be used as a blueprint.

We understand that some EU member states and supervisors would like to prevent the changes in collateral haircuts or concentration limits that were experienced in the euro sovereign repo market in 2011 from happening again. While we share the concern to avoid disruptive measures, clearing members have significant reservations about any arbitrary, ad-hoc or subjective approach that would stand in the way of prudent risk management by CCPs and would generate unhelpful incentives for supervisors and CCPs. ISDA believes relevant supervisors should agree ex-ante on models to protect against systemic risk in their jurisdictions, for instance by ensuring these models address pro-cyclicality and possible changes in the market and wider economy. Moreover, the 2012 EMIR Regulation, which came into effect in March 2013, has significantly enhanced communication and cooperation between regulators, addressing the primary concern from 2011.

[3] http://www.fsb.org/wp-content/uploads/P050717-1.pdf

Location Policy leads to market fragmentation, increased risk and higher cost

Whilst ISDA members recognise that the proposed regulation foresees a location policy only as a last resort measure, we remain strongly opposed to any location policy that results in the forced fragmentation of markets, and express concern about the uncertainty that the possibility of such a location policy poses.

The regulation envisages denying recognition to CCPs located outside the Union that are deemed of substantial systemic importance to EU financial stability, a policy which would only impact EU market participants subject to EMIR. It is unlikely that all liquidity for IRS clearing services, let alone euro IRS will move to the EU27. Separating and clearing these transactions on-shore within the EU27 in either a new or already existing CCP could increase risk (for both the system and individual participants) and cost. Such increased risk and cost will outweigh any potential benefits.

<u>Risk</u>

A location policy would lead to more correlation risk and less robust CCPs:

If EU27 firms are counterparty to only a small part of the euro interest rate swaps portfolio, any CCP that clears these transactions on-shore, driven by a location policy, will be equally small in scale, at least in respect of this asset class.

Such a CCP will have fewer clearing members mutualising the risk for interest rate swaps. Therefore, should a default happen, the share of the cost that is not covered by margin will be split among fewer members, leading to a larger risk and liquidity burden and higher risk of the shock spreading through the system in a stressed situation. There would also be fewer members who can spare traders to participate in the default management groups of the CCP that supports the default management process and fewer firms with the capacity to bid in a default auction, thus increasing the risk of a failed auction, driving a much broader systemic risk.

As a location policy will affect only EU27 firms, the credit risk of the clearing members at the on-shore CCPs would likely be more correlated than at a global CCP.

Splitting a liquidity pool in any portion will reduce the size and resilience of the involved CCPs.

Increased risk for the overall system

As discussed in detail below, separating a portfolio from a global CCP is estimated to increase margin by 16%-24% for house accounts. Margin models at CCPs are highly risk sensitive, and increased initial margin (IM) levels therefore point to increased risk in the overall system. Given the strict regulation for portfolio netting laid down by EMIR, the netting benefits in a CCP are based on economic links between risk factors and observed data.

Interconnectivity and increased intraday liquidity risk

CCPs are designed as fire-stops to insulate clearing members and their clients from each other's credit risk. By fragmenting the liquidity pools, non-EU domiciled firms offering liquidity in the EU27 market would likely hedge their market exposures in the larger global liquidity pool. This will be a cost in normal times, potentially leading to a basis, but increase systemic risk in times of crisis as large variation margin calls in stressed times will stress liquidity of these banks. For a member with offsetting risk across CCPs, a large market move would trigger a significant intraday cash inflow at one CCP and a corresponding cash outflow at the other CCP. With only one CCP clearing all transactions, these amounts would net down to a single payment or receipt. But with more fragmented clearing, the member would need to fully fund the intraday call from the CCP that it owes and could not rely upon the receipt coming from the other CCP to help fund the payment. For a range of risk management reasons, typical practice for CCPs is to call to cover margin shortfalls intraday but not to pay out gains. This will increase intraday funding needs, possibly by a number of multiples. In a stressed environment, intraday funding is likely to be difficult to source in general. Moreover, the funding stress would spread to the broader financial system beyond the CCP.

We note that the FSB study "Analysis of Central Clearing Interdependencies"[4] found that the largest 20 out of 307 clearing members included in their analysis account for approximately 75 per cent of total financial resources. These would the same group of members providing liquidity to the EU27 interest rate clearing market.

Choice of CCPs

Establishing a location policy would mean that EU27 firms will have a restricted choice of CCPs where they can clear contracts subject to the location policy. This restricted choice will stifle competition and innovation in normal times, and reduce alternatives to clear in stressed times. This can lead to increased clearing fees, increasing the cost of clearing for banks and end-users who have to use such a CCP.

We note that ESMA in their "*Final Report: Draft technical standards on the Clearing Obligation – Credit Derivatives*" from October 2015 have adapted the timing of the clearing obligation for CDS to make sure two CCPs would be authorised to clear CDS in the EU.

ISDA have always argued that clearing participants should have a choice where to clear OTC derivatives. This is for reasons of competition, innovation and having a fall-back in a crisis. Such choice should however be market driven, not based on mandate. So far most products are cleared in one dominant CCP, however there are options to each of these dominant CCPs:

Product / Asset Class	**Dominant CCPs**	**Alternatives**
IRS	SwapClear	CME, Eurex, regional CCPs
CDS	ICE (US and EU)	CDSClear
FX	ForexClear	CME, Eurex, HKEx

The table shows that for each dominant CCP there is one or more alternative CCPs to help ensure competition, innovation and redundancy. A location policy for interest rate swaps will actually mean less choice, as EU27 firms likely will not be able to use SwapClear anymore.

[4] http://www.fsb.org/wp-content/uploads/P050717-2.pdf

Migration risk and the cost of finding a new counterparties

Unless the location policy allows “grandfathering” of existing positions, a large number of transactions and a huge quantum of risk will have to be transferred between CCPs. Due to the large number of transactions it is near impossible for affected clearing members and their clients, including investment managers, to migrate transactions one-by-one. The CCP has to have a matched book, so for each contract to be transferred, a counterparty has to be found who is willing to take the other side of that transaction – one for both the source and target CCP.

Other than large clearing members, who have clearing memberships at many CCPs, clients usually clear at few CCPs per asset class and will have to bear additional cost establishing a new relationship with the on-shore CCP, and possibly also a new clearing broker offering access to this CCP. Smaller clients could struggle finding a broker at all. During migration they will also have to follow the lead of their clearing member with regard to when and how to migrate.

Such an exercise would create incredible operational challenges and legal complexities. No regulator in any jurisdiction has to date attempted to implement a location policy (or any other type of policy) involving movement of such a vast amount of derivatives-related risk from one CCP to another, let alone from a CCP in one jurisdiction to another (About 150 trillion notional volume of euro-denominated swaps has been cleared at LCH Swapclear so far in 2017 until end of August, a quarter of which is for EU counterparties). This would likely result in significant disruptions and increased systemic risk.

Legal complexities would include the membership agreements with a new CCP if required, updating of documentation with all affected clients who would need to access another CCP, negotiation of transactions to close the risk at one CCP and negotiations to do so at another CCP, especially if this is done in bulk. Moving transactions from one CCP to another would be entering operationally and legally unchartered waters.

<u>Cost</u>

Fragmenting a market leads to inefficiencies and higher cost for all parties involved. This is the result of margin inefficiencies and also due to an expectation of more friction and higher trading costs.

Increased cost to end-users: Basis and wider bid/ask spreads

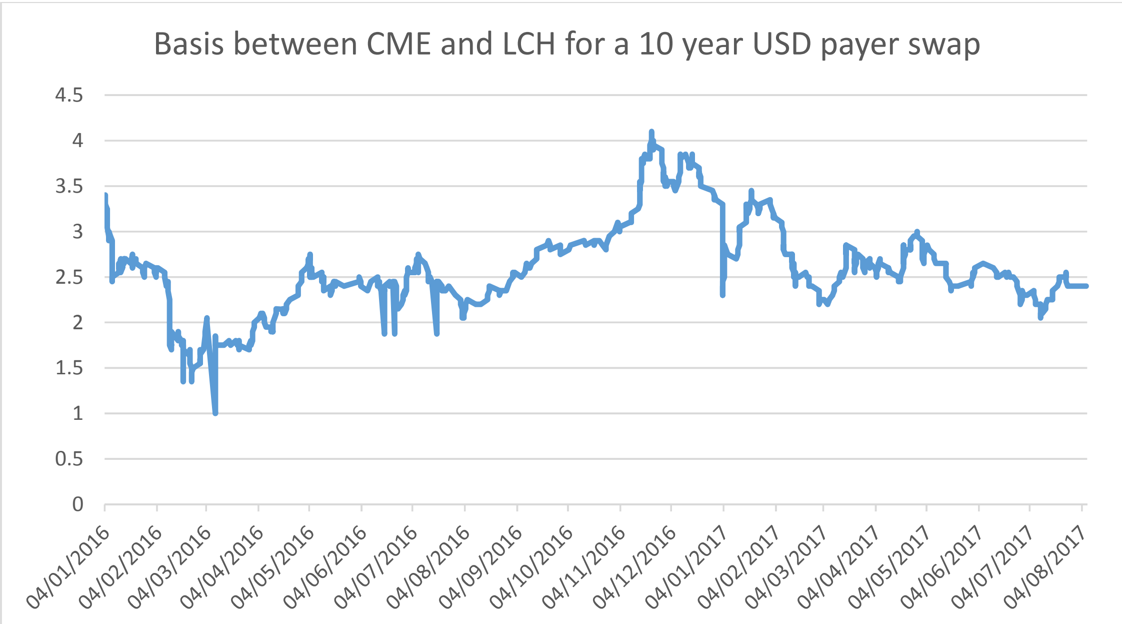
Two effects can impact transaction costs for forced users of a CCP:

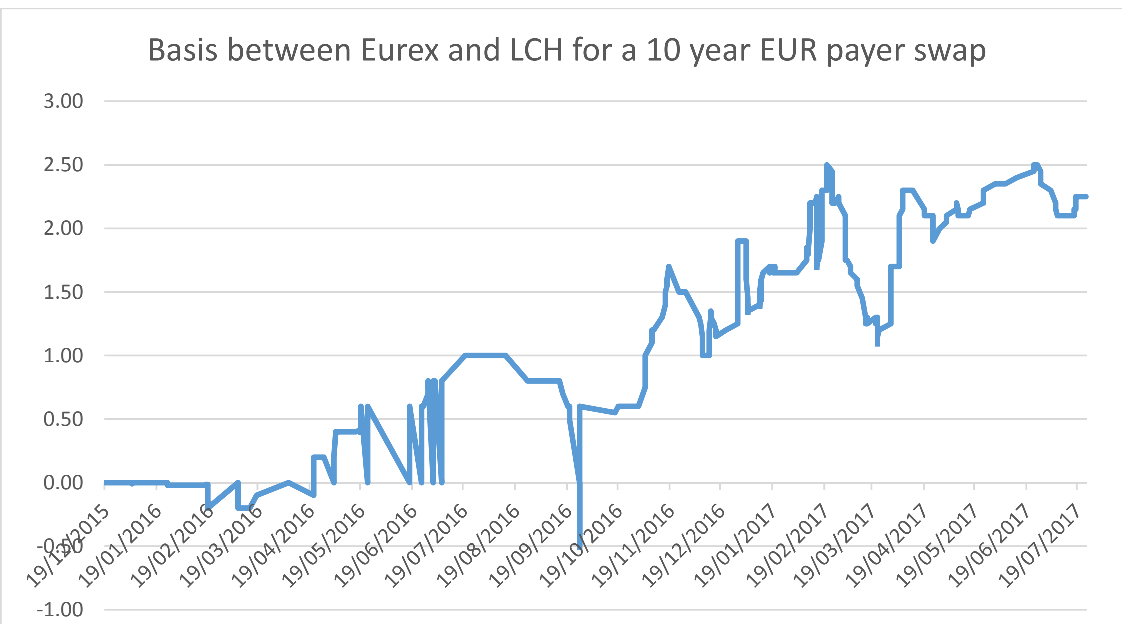
1. A basis between transactions at that CCP and the CCP with the majority of liquidity can emerge, affecting cost for participants on the “wrong side” of the basis, and
2. the bid-offer spread can widen, partially because market makers will factor volatility in the basis between CCPs in the price, and also because of less competition in the smaller market.

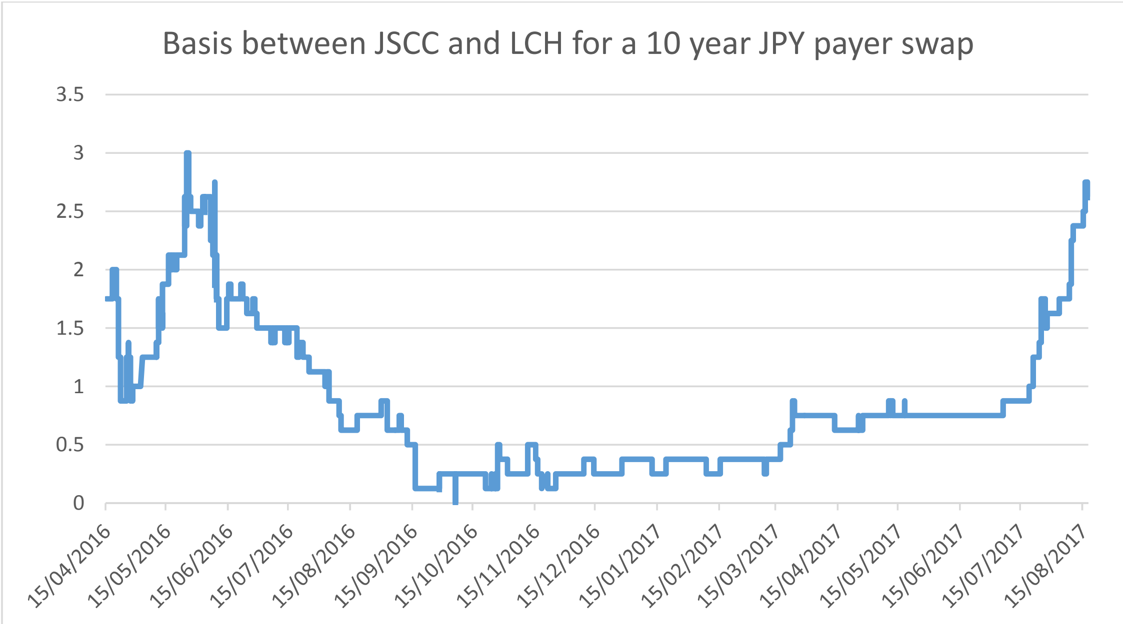
Basis between CCPs

Clearing mandates do not universally cover all participants in the derivatives market due to exceptions from the mandate, for instance for corporates who use derivatives for hedging, or pension funds. This leads to an imbalance in a CCP, as the majority of participants are financial entities with similar hedging needs – paying fixed and receiving floating. This overall directionality of clients will cause the portfolios of dealers to be equally directional. Dealers will price the higher margin for this directional portfolio into the client transactions, making these transactions more expensive than the same transaction at the CCP with the bulk of liquidity.

These bases have developed for interest rate swaps between LCH and JSCC, CME and Eurex:







Market data provided by courtesy of Tradition.

We note that, already in today's market, there is a price basis between LCH and Eurex in relation to IRS clearing. To date we note that a price basis has not developed in CDS markets where more than one CCP offers the clearing for the same product. This is due to the structural differences in the markets for CDS versus IRS in that a) CDS markets are significantly smaller than IRS markets, particularly in Japan where there has been such small volumes of on-shore clearing that local firms are reporting difficulties in hedging CVA risks and b) the nature of the CCPs are very different, notably in Europe, with all client clearing concentrated in ICE Clear with the LCH.Clearnet SA service exclusively servicing major global dealers to date.

The Japanese IRS market offers a good parallel: Historically 25% of transactions were cleared on-shore, 75% were cleared off-shore. This is very similar to the expected make-up of the clearing market after a location policy. Recently the proportion of off-shore transactions has decreased, without reducing the basis however. The basis between JSCC and LCH can be volatile (see above).

We cannot know in advance whether a basis will develop between the on-shore and off-shore euro IRS clearing services. Given that there is a basis in similar constellations, including CCPs without a location policy, a basis is at least very likely and a risk not to be ignored.

Should a European asset manager require a typical hedge of a EUR 100 million receive fixed/ pay variable euro IRS swap with 10 years maturity with a PV01 of EUR 97,500 (based on market data as of 11 August 2017), a basis of 1bp would lead to additional cost of EUR 97,500 = EUR 97,500 *1bp = EUR 97,500. This additional cost – a multiple of the income of an average pension saver - would ultimately be borne by EU27 investors as the asset manager is required to clear. Even a corporate with a hedging exemption would be affected: the corporate would either contract with an EU27 firm, which will be under the same pricing constraints as they have to re-hedge at the on-shore CCP, or – if they are large enough – would decide to buy the hedge from a third country firm to achieve better pricing. EU27 banks could possibly be at least partially if not fully priced out of the euro interest rate swap market, and at the least play on an unlevel playing field.

Wider bid/ask spreads

A smaller, fragmented and closed market will attract fewer market makers, leading to less competition, less liquidity and potentially higher volatility, especially during the migration period. All these factors will increase cost for client end users of such CCP. Should a volatile basis emerge, dealers will also have to take this volatility of the basis into consideration when pricing transactions.

Higher fees

The on-shore CCP that will clear the transactions subject to the location policy will clear fewer interest rate swaps than the off-shore CCP. Large parts of the cost of a CCP are however fixed: designing a comprehensive risk management framework is largely independent of the volumes cleared. It is therefore expected that clearing fees will increase for on-shore clearing members and clients, as the fixed cost of running a CCP has to be paid for by fewer transactions.

Increased margin and capital – ISDA QIS

ISDA surveyed 12 large international clearing member banks on a best efforts basis in order to estimate the potential margin and capital impacts resulting from a euro swap location policy. Such a requirement would result in an overall IM increase in the range of 16% to 24% for clearing members' house accounts, depending on the proportion of swaps falling under the policy[5]. Some clearing members have reported more significant impacts – with increases of up to 50%.

The ISDA survey also points to a 65% increase in CET1 capital requirements associated with increased RWAs and leverage requirements. On the RWA side, the impact is attributed to higher trade exposures, margin requirements, and default fund contributions resulting from the loss of multilateral netting benefits by splitting cleared euro swap portfolios.

The key driver of increased leverage ratio exposure is the loss of ability to compress cleared trades.

The analysis is based on current market structures, and while some impacts could potentially be mitigated by factoring in other netting efficiencies that can be gained at other CCPs it is unclear whether large efficiencies can be achieved when cross margining euro swaps with other products such as repos or futures.

Overall, it is the view of ISDA members that a location policy at a minimum poses the risk of considerable cost increases to EU27 clients and dealers, a risk which in ISDA's opinion is not in proportion to the perceived benefits of direct supervision.

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[5] Estimates are based on two scenarios: (i) all existing euro swaps are migrated to a Eurozone CCP; and (ii) all existing trades where one counterparty is an EU entity are migrated to a Eurozone CCP.

Triggering of article 25 new section 2c (requirement to relocate to the union)

Article 25 2c gives ESMA the right to recommend the European Commission to declare that a CCP should not be recognised under EMIR where it is deemed of substantial systematic importance to the financial stability of the Union or Member States. As proposed, it is unclear whether this proposal and eventual delegated act of the Commission would constitute a blanket prohibition for the CCP to provide clearing services in the Union on a cross-border basis or whether it could be more granular and targeted in the same way as ESMA may, under this proposal, withdraw a CCP recognition decision to a particular service, activity or class of financial instruments.

Should this last resort option ever be used as a general prohibition to provide clearing services in the Union, EU27 firms will be affected not only for their euro denominated portfolio, but for all currencies that are cleared at this CCP, including other unrelated clearing services. In the example of LCH this would affect clearing services for repos, foreign exchange and equities.

As outlined above, a location policy will increase cost for European clearing members and their clients, and risk to both the system and clearing participants, even if only evoked for one currency. Imposing a location policy for more currencies and asset classes will only increase fragmentation and the unintended consequences linked to such fragmentation.

The consequences of a systemic CCP losing equivalence carries high risks and potential costs for EU27 firms. The consequences for clearing members and financial markets are significant. It would therefore be essential to explain the drivers behind this decision in the regulation. Before following ESMA's recommendation, it will be critical that the Commission performs a detailed cost/benefit analysis.

This cost/benefit analysis needs also to include an analysis of the time and cost of the migration between CCPs. Also, given the wide-ranging consequences of such a decision, the Commission should design the migration process to minimise impact on all market participants – some cost and risk cannot be mitigated though as described above. This process needs also allow generous time for EU27 clearing members to on-board to other CCPs. ISDA also proposes to grandfather existing transactions, as these have been executed based on the regulatory requirements before a de-recognition and have been priced for clearing at the off-shore CCP. Grandfathering would also reduce the operational and legal burden of migrating thousands of legacy transactions (see above under operational risk), but would introduce additional risk as firms are not able to add new transactions to manage the risk of grandfathered positions.

We are also mindful that the process of de-recognition will have interdependencies with the Brexit process and urge all involved parties to make sure these two issues are worked through in a consistent manner.

Proposed rules for CCP supervision

Tier-2 CCPs

Article 25 2a describes the criteria for determining whether a CCP will be systemically important for the Union. We welcome that the triggers for tier-2 CCPs have not been set as hard triggers.

Given that many CCPs have several clearing services, the decision should be taken by clearing service, not at CCP level, as for most CCPs the risk management framework is linked to the clearing service and/or default fund for that particular clearing service.

We propose some changes to the high-level criteria in article 25 (2a):

a) Nature, size and complexity of the CCP's business or exposure to counterparties should not affect the Union as long as this business is to a large extent conducted outside of the union, or in non-Union currencies. We propose to change the criterion to "*the nature, size and complexity of the CCP's business with Union participants, including the value in aggregate terms and in each Union currency of transactions by Union participants cleared by the CCP, or the aggregate exposure of the CCP engaged in clearing activities to its counterparties in the Union*".
   For size criteria we advise against any notional based criteria. With the increased use of portfolio compression notional is not a good indicator of risk. Better measures would be the sum of IM and default funds.
b) For the second criteria in article 25 2a (b) we suggest not to analyse the impact of failure of a CCP would be on the Union, but what the impact recovery and resolution actions in relation to this CCP will be on the Union.
c) The membership structure should be only relevant as long as a material part of these members are in the Union: "*the CCP's clearing membership structure if a material part of these members are from the Union*;"
d) Similar to the observations above, CCP relationships, interdependencies and other interactions are only relevant if the involved entities are located in the Union.

Under the proposed new article 25 (2a) the Commission is given 6 months to adopt a delegated act specifying the criteria for assessing the nature, size and complexity of the CCP's business, including the aggregate value and exposures of the CCP in Union currencies to determine whether a CCP might be a tier-2 CCP. We wonder if this time is long enough to cater for the European rulemaking process, for instance if the Parliament or Council request changes.

Under the transitional provisions proposed, new article 89 (3b) requires that within 12 months of the above delegated act entering into force, ESMA is to review all third country CCPs already recognised, applying the revised tests under (new) article 25. This timeline is not realistic, especially given that determining US CCPs to be tier-2 might require re-opening of the equivalence agreement between the EC and CFTC, which would very likely take more than 12 months based on previous experience.

The proposed regulation is quiet about the recognition status of CCPs determined to be tier-2 CCPs, especially as most large third country CCPs are already recognized. ISDA proposes that the regulation explicitly clarify that a CCP would be treated as a recognized CCP for the period during which ESMA conduct its analysis as to whether that CCP should be covered under tier-2, and that the CCP would still be recognized after it has been determined to be a tier-2 CCP. Paragraph 2b (a) suggests that a CCP determined to be a tier-2 CCP has to comply immediately with the requirements set out in article 16 and in Titles IV and V. Given that such a CCP might have to adapt its risk management framework and/or rulebook and go through its internal governance process as well as potential approval by the local regulator, there should be an appropriate time for the CCP to make these changes. ISDA proposes this to be one year. Over this period the CCP should be treated as recognized.

ESMA Powers for third country CCPs

EU policy makers have indicated that powers over third country CCPs are modelled on the US CCP supervision framework. However, we believe that the powers in the EC Proposal go above and beyond the US framework. Non-US CCPs do have to register with CFTC or obtain exemption from such registration. Any such exemption would be based on requirements tailored to the specific CCP and its operations. Moreover, both registration and exemption are based on the products to be cleared for US persons and therefore do not necessarily apply to an entire CCP. This framework allows the CFTC to tailor its supervision of non-US CCPs in a way that is proportional to the CCP's US-related activities. It also allows the CFTC to both defer to comparable requirements of the CCP's home regulators and maintain the authority to impose additional requirements with respect to the CCP's US-related activities if it deems necessary. To address potential conflicts with home regulators, the CFTC enters into memoranda of understanding or similar arrangements with the relevant home regulators for non-US CCPs registered with it.

We also note that ISDA and its members have advocated for the CFTC's exemption process to apply to CCPs that clear OTC derivatives for US clients, as we do not believe that any additional risks associated with clearing for clients necessitate actual registration. Exemption from CFTC registration is typically based on compliance with the globally-agreed CPMI-IOSCO *Principles for Financial Market Infrastructures* (PFMIs). In line with the foregoing, we globally support processes whereby regulators in third countries defer to home regulators and tailor their supervision to the activities of the third-country CCP in their respective jurisdictions. The CFTC generally takes this approach for exchange-traded derivatives. Global work of CPMI-IOSCO, memorialized in the PFMIs, contemplates the systemic nature of CCPs and therefore implementation of the PFMIs in a particular jurisdiction should be the basis for determining whether deferential supervision is appropriate, regardless of whether a CCP is determined to be systemically important in a particular jurisdiction. We fear that a less deferential approach would likely result in regulatory retaliation, which should be avoided.

We also note that the US has not designated any third country CCPs as systemically important. Moreover, the US Financial Stability Oversight Council's (FSOC) public statements regarding the CCPs it designated as systemically important under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) focus explicitly on US financial markets.[6]

Under the US framework, the Board of Governors of the Federal Reserve System (FRB) has backup authority over US CCPs that FSOC designates as systemically important. In general, the FRB has the power to take action if it determines that requirements imposed by the primary regulator (*e.g.,* the CFTC for CCPs registered with the CFTC as "derivatives clearing organizations") for a systemically important CCP are insufficient to prevent or mitigate significant liquidity, credit, operational or other risks to the US financial markets, or to the financial stability of the US. Any such determination would be subject to notice and FSOC review. The FRB also has rights to information from the CCP's primary regulator and may participate in examinations of the designated CCP, generally in coordination with the CCP's primary regulator.

The role of the FRB under Title VIII of the Dodd-Frank Act is more deferential and subject to closer coordination with the relevant CCP's primary regulator than the role contemplated by the EC Proposal for the ECB. In general, we believe that the role of central banks should be reviewed

[6] https://www.treasury.gov/initiatives/fsoc/Documents/2012%20Appendix%20A%20Designation%20of%20Systemically%20Important%20Market%20Utilities.pdf.

globally to establish consistent standards. Such standards should be based on ensuring central banks have authority and oversight that is proportional with their exposure to specific CCPs and any relevant liquidity risks, and is tailored to address the role that the central bank plays with regard to monetary policy and, to the extent applicable, protecting financial stability in the relevant jurisdiction.

Appendix 1 attached hereto provides a more detailed overview of CCP supervision in the US and notes several specific instances in which we believe the EC Proposal goes beyond the US framework.

Role of Central Bank of Issue (CBI)

In June, the ECB made a recommendation to the European Parliament and the EU Member States to amend the ECB Statute. Whilst these amendments are said to be the implementation of the powers that ECB are being given by this proposed regulation, these changes that would allow ECB to mandate a location policy on its own. ECB should not have powers above those given to it by this regulation.

We also believe that these powers should be specified in more detail.

G20 Commitments

The EU has faithfully implemented the 2009 G20 commitments on derivatives reform, including committing to avoid 'fragmentation of markets, protectionism, and regulatory arbitrage'.

This approach is reflected in the EU's successful advocacy in favour of the principles of deference and international comity in international forums (e.g. IOSCO and the FSB) charged with monitoring the implementation of the Pittsburgh G20 commitments, principles made explicit in successive FSB progress reports on implementation of OTC derivatives reforms, for example.

An EU CCP location policy would run contrary to the deference principle and would fragment markets. As senior regulators in the US and other G20 authorities understand, fragmentation is harmful to the wider economy and society, and not just a problem for financial markets.

Multilateral netting at a global CCP supports safety and soundness of the global derivatives markets.

Detailed comments in relation to ESMA's powers

Please find below two detailed comments to new ESMA's powers.

Article 21a (7) speaks of a financial market participant but from context it seems that the paragraph is in relation to CCPs

Article 25e (2) – We doubt whether the power to seal business premises during on-site inspections is realistic. Sealing a CCP's premises can stop the CCP from operating according to regulation and its rules.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 875 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Appendix 1: Overview of CCP supervision in the United States

I. General

a. Registration as a "Derivatives Clearing Organization" (DCO) with the Commodity Futures Trading Commission (CFTC) (Section 5b of the Commodity Exchange Act (CEA), 7 U.S.C. 7a-1).

i. Based on using the "mails or any means or instrumentality of interstate commerce" interstate commerce, which is very broad, but, as a result of exemption process, effect is that required to clear *swaps* for *customers* (Section 5b(a) of the CEA, 7 U.S.C. 7a-1(a)).

ii. Registration is with respect to specified products (which may not include all products cleared by the relevant CCP).

iii. The CFTC may exempt, conditionally or unconditionally, a DCO from registration for the clearing of *swaps* if the CFTC determines that the DCO is subject to *comparable, comprehensive supervision and regulation* by the U.S. Securities and Exchange Commission (SEC) or the appropriate government authorities in the home country of the organization. Such conditions may include, but are not limited to, requiring that the DCO be available for inspection by the CFTC and making available all information requested by the CFTC (Section 5b(h) of the CEA, 7 U.S.C. 7a-1(h)). The CEA is not as prescriptive with respect to exemptions for the clearing of futures.

b. CFTC Part 39 Regulations

i. Subpart A – General Provisions Applicable to Derivatives Clearing Organizations

1. Procedures for registration (CFTC Reg. 39.3): Generally must submit Form DCO, which, among other things, sets forth the information that the CFTC requires to determine whether the CCP complies with the core principles for DCOs set forth in Section 5b(c)(2) of the CEA, 7 U.S.C. 7a-1(c)(2), and Subpart B of the CFTC's Part 39 Regulations (described below).

2. Procedures for implementing DCO rules and clearing new products (CFTC Reg.39.4): Implements Section 5b(c)(2) of the CEA, 7 U.S.C. 7a-1(c)(2).

ii. Subpart B – Compliance with Core Principles

1. *Financial resources* (CFTC Reg. 39.11)
2. *Participant and product eligibility* (CFTC Reg. 39.12)
3. *Risk management* (CFTC Reg. 39.13)
4. *Settlement procedures* (CFTC Reg. 39.14)
5. *Treatment of funds* (CFTC Reg. 39.15)
6. *Default rules and procedures* (CFTC Reg. 39.16)
7. *Rule enforcement* (CFTC Reg. 39.17)
8. *System safeguards* (CFTC Reg. 39.18)
9. *Reporting* (CFTC Reg. 39.19): Requires information specified as well as any other information that the CFTC deems necessary to conduct its oversight of a DCO. Specific requirements include:

a. *On a daily basis*: initial margin requirements and initial margin on deposit; daily variation margin by clearing member, separated by house and by each customer of the clearing member; all other daily cash flows; end of day positions for each clearing member, separated by house and by each customer of the clearing member; securities positions held in a customer account that are subject to a cross-margining agreement.

b. *On a quarterly basis*: report of financial resources.
c. *On an annual basis*: report of chief compliance officer, audited financial statements (of DCO or if not available for DCO, for DCO's parent company).
d. *Separate event-specific reporting if*: decrease in financial resources that exceeds specified threshold; decrease in ownership equity that exceeds specified threshold; deficit in six-month liquid asset requirement; current liabilities exceed current assets; DCO requests that clearing member reduce its positions; determination to transfer or liquidate positions of a clearing member; default of clearing member; change in ownership or corporate or organizational structure; change in key personnel; change in credit facility funding arrangement; DCO imposes sanctions against clearing member; occurrence of other specified events related to financial condition; material inadequacies in financial statements; occurrence of other specified exceptional events; occurrence of specified planned changed.

10. *Recordkeeping* (CFTC Reg. 39.20)
11. *Public information* (CFTC Reg. 39.21)
12. *Information sharing* (CFTC Reg. 39.22): Requires DCO to enter into, and abide by the terms of, appropriate and applicable domestic and international information-sharing agreements, and to use relevant information obtained from such agreements in carrying out its risk management program.
13. *Antitrust considerations* (CFTC Reg. 39.23)
14. *Legal risk considerations* (CFTC Reg. 39.27): Among other things, requires DCO to identify and address any material conflict of law issues; be able to demonstrate the enforceability of its choice of law in relevant jurisdictions; and be able to demonstrate that its rules, procedures and contracts are enforceable in all relevant jurisdictions.

c. The CFTC maintains a list of registered and exempt DCOs on its website. A copy of the registration letter or exemption letter, as applicable, are available for each DCO.
d. Registration of Non-US DCOs
   i. Pursuant to the terms of registration letters, the CFTC (i) limits the specific products and US-related activities of the non-US DCO to which its regulations will apply and (ii) in some instances, tailors certain of its regulations (*e.g.,* financial reporting requirements) for the relevant non-US DCO.
   ii. Comparability Determination and No-Action Relief (CFTC Letter No. 16-26) for Registered DCOs subject to the European Markets Infrastructure Regulation

1. Applies to registered DCOs that are authorized to operate as central counterparties in the European Union (EU).
2. The CFTC's comparability determination provides for substituted compliance with respect to certain requirements for financial resources (CFTC Reg. 39.11), risk management (CFTC Reg. 39.13), settlement procedures (CFTC Reg. 39.14) and default rules and procedures (CFTC Reg. 39.16). Determinations are based on a finding that the relevant requirements under EMIR are comparable and comprehensive to the corollary requirements under the CEA and the CFTC's regulations, taking into consideration all relevant factors, including but not limited to: the comprehensiveness of the requirements under EMIR, the scope and objectives of such requirements, the comprehensiveness of the European Securities and Markets Authority's (ESMA) supervisory compliance program and the EU's authority to support and enforce its oversight of the registrant.
3. The CFTC's no-action letter provides limited no-action relief from certain requirements under Part 22 and Part 39 of the CFTC's regulations for which the CFTC did not make a comparability determination.

e. Exemption from CFTC Registration
   i. Pursuant to terms of exemption letters, exempt DCOs may clear (as applicable based on application for exemption): (I) swaps for "U.S. persons" (as defined by the CFTC) and futures commission merchants (FCMs) that are clearing members, or affiliates of clearing members, of the applicable DCO, but may not clear for *customers* (*i.e.,* persons not identified in the definition of "proprietary account" in CFTC Reg. 1.3(y)) and (II) futures.[7]
   ii. Exemption is with respect to specified products (which may not include all products cleared by the relevant CCP).
   iii. Typically, exemption letters related to clearing *swaps* have required the following with respect to *swaps* covered by the exemption letter:
      1. Open access;
      2. Consent to U.S. jurisdiction and designation of an agent for service of process in the U.S.;
      3. Making of all books, records, reports and other information related to operations covered by exemption letters available for inspection by the CFTC;
      4. Annual certification regarding compliance with the CPMI-IOSCO *Principles for Financial Market Infrastructures* (PFMIs);
      5. Annual statement of good standing with home country regulator;
      6. Reporting of (with respect to swaps clearing):

[7] Note that ISDA continues to advocate that exempt DCOs should be able to clear swaps for customers of U.S. persons and FCMs. ISDA does not believe that full registration should be required to clear such swaps. ISDA made this point in its April 2017 letter to U.S. Treasury and plans to address the point in connection with the CFTC's Project KISS.

a. On a daily basis: initial margin requirements and initial margin on deposit for U.S. persons; and variation margin for U.S. persons.
b. On a quarterly basis: Aggregate clearing volume for U.S. persons; average open interest for U.S. persons; list of U.S. persons and FCMs that are either clearing members or affiliates of clearing members.
c. Changes in home country regulatory regime that are material to observance of PFMIs or requirements of exemption letter.
d. Assessment of PFMI observance by CCP or its home country regulator (as available to the CCP).
e. Examination report, examination findings or notification of commencement of any enforcement or disciplinary action by the CCP's home country regulator (as available to the CCP);
f. Any change with respect to licensure, registration or other authorization in home country;
g. Default by a U.S. person or FCM (and information about relevant positions held and financial obligations).
h. Actions taken by CCP against U.S. persons or FCMs.
i. Any other information that the CFTC deems necessary.

II. Systemically Important CCPs[8]
   a. Title VIII of the Dodd-Frank Act (12 U.S.C. Subchapter IV) applies to designated "financial market utilities" (FMUs),[9] which include, among other things, CCPs.
   b. Financial Stability Oversight Council (FSOC) determinations (per Section 804 of the Dodd-Frank Act, 12 U.S.C. 5463) and FSOC final rule:
      i. Based on:
         1. The aggregate monetary value of transactions processed by the [CCP];
         2. The aggregate exposure of the [CCP] to its counterparties;
         3. The relationship, interdependencies or other interactions of the [CCP] with other FMUs or payment, clearing or settlement activities;
         4. The effect that the failure or a disruption to the [CCP] would have on critical markets, financial institutions or the broader financial system; and
         5. Any other factors that FSOC deems appropriate (but note that in makings its determinations, FSOC stated that it did not explicitly rely on any other factors because it believed that factors i-iv provided an appropriate basis for making determination).
      ii. Designated DCOs registered with the CFTC include:
         1. Chicago Mercantile Exchange, Inc. (CME)
         2. ICE Clear Credit LLC (ICC)

[8] Note that this section focuses on designated FMUs that are registered as DCOs with the CFTC. The same analysis would generally apply to designated FMUs that are registered as "clearing agencies" with the SEC.
[9] Generally, FMUs include the same entities covered by the globally used term "financial market infrastructures" or "FMIs" except that FMUs do not include trade repositories.

    iii. Designations do not explicitly focus on the U.S. exclusively but conclusions state:
        1. [CME/ICC] processes a significant volume of high-dollar-value transactions on a daily basis for critical U.S. markets.
        2. A significant disruption or failure of [CME/ICC] could have a major adverse impact on the U.S. financial markets, the impact of which would be exacerbated by the limited number of clearing alternatives currently available for the products cleared by [CME/ICC].
        3. A failure or disruption of [CME/ICC] would likely have a significant detrimental effect on the liquidity of the futures and options markets, clearing members, which include large financial institutions, and other market participants, which would, in turn, likely threaten the stability of the broader U.S. financial system.

c. Standards for systemically important [CCPs] (per Section 805 of the Dodd-Frank Act, 12 U.S.C. 5464):
    i. For registered DCOs for which the CFTC is the "supervisory agency," the CFTC may prescribe regulations, in consultation with FSOC of the Board of Governors of the Federal Reserve System (FRB), containing risk management standards, taking into consideration relevant international standards and existing prudential requirements.
    ii. The FRB may determine that existing prudential requirements imposed by the CFTC on designated DCOs are insufficient to prevent or mitigate significant liquidity, credit, operational or other risk to the financial markets or to the financial stability of the U.S. Subject to a notice, response and FSOC review process, FSOC may require the CFTC to prescribe risk management standards to address insufficiencies.

d. Operations of designated [CCPs] (per Section 806 of the Dodd-Frank Act, 12 U.S.C. 5465)
    i. The FRB may authorize a Federal Reserve Bank to establish and maintain and account for the designated [CCP].
    ii. The FRB may authorize a Federal Reserve Bank to provide a designated [CCP] with discount and borrowing privileges in unusual or exigent circumstances.
    iii. A designated [CCP] must provide 60 days advance notice to [the CFTC] and the FRB of proposals to change its rules, procedures or operations that could materially affect the nature or level of risks presented by the designated CCP (subject to an exception for emergency situations).

e. Examination of and enforcement actions against designated [CCPs] (per Section 807 of the Dodd-Frank Act, 12 U.S.C. 5466)
    i. Performed at least annually by [the CFTC]
    ii. [The CFTC] shall consult annually with the FRB and the FRB may participate in any examination led by [the CFTC].
    iii. The FRB has emergency authority to take enforcement action upon consultation with [the CFTC] and approval by FSOC.

f. Request for information reports or records (per Section 809 of the Dodd-Frank Act, 12 U.S.C. 5468)
    i. FSOC allowed to request any information necessary to determine systemic importance (if reasonable cause to believe systemic importance).

        ii. FSOC and the FRB allowed to require submission of reports or data necessary to assess the safety and soundness of the designated [CCP] and the systemic risk that its operations pose to the financial system (subject to requirement to first coordinate with the [CFTC] to determine if information is available from the [CFTC]).
        iii. Requirements for information sharing and coordination among FSOC, the FRB and the [CFTC].
    g. FSOC, the FRB and the [CFTC] are authorized to prescribe rules and issue orders as necessary to administer and carry out Title VIII (per Section 810 of the Dodd-Frank Act, 12 U.S.C. 5469).
    h. CFTC Part 39 Regulations
        i. Subpart C – Provisions Applicable to Systemically Important Derivatives Clearing Organizations and Derivatives Clearing Organizations that Elect to be Subject to the Provisions of this Subpart
            1. Applies to registered DCOs that have been designated as systemically important under Title VIII of the Dodd-Frank Act for which the CFTC is the supervisory authority (*i.e.,* CME and ICC), as well as registered DCOs that elect to be subject to subpart C (which currently include, based on CFTC filings, ICE Clear US, Inc., LCH.Clearnet, LLC, Minneapolis Grain Exchange, Inc. and Nodal Clear, LLC).
            2. In addition to implementing relevant provisions of Title VIII of the Dodd-Frank Act, intended to implement the PFMIs (which is consistent with implementation of Title VIII) (see CFTC Reg. 39.40 and CFTC Memorandum 15-50).
            3. Covers:
                a. Governance (CFTC Reg. 39.32)
                b. Financial resource requirements (CFTC Reg. 39.33)
                c. System safeguards (CFTC Reg. 39.34)
                d. Default rules and procedures for uncovered credit losses or liquidity shortfalls (recovery) (CFTC Reg. 39.35)
                e. Risk management (CFTC Reg. 39.36)
                f. Additional disclosure (CFTC Reg. 39.37)
                g. Efficiency (CFTC Reg. 39.38)
                h. Recovery and wind-down (CFTC Reg. 39.39)

III. Comments on comparability to provisions applicable to "Tier 2 CCPs" the European Commission's proposal to amend Regulation (EU) Nos1095/2010 and 648/2012
    a. *Overall*: Supervision for Tier 2 CCPs covers all activities of the CCP, not just applicable activities or service lines. CFTC registration or exemption applies to relevant activities, and supervision is then generally limited to those activities.
    b. *Article 25(2a)*: Criteria for determining whether a CCP is a Tier 2 CCP (*i.e.,* it is systemically important or likely to become systemically important for the financial stability of the EU or for one or more EU member states) is similar to criteria for FSOC designation but, importantly, FSOC has applied the criteria to U.S. CCPs only and FSOC's conclusions regarding designation were based on the U.S. financial system.
    c. Article 25(2b): Requirements for (i) central bank confirmation regarding compliance with requirements and (ii) legal opinion regarding validity of consent to produce

documents, records, information and data and to allow ESMA access, go beyond any aspects of CCP supervision in the US.

d. *Article 25(2c)*: U.S. does not have similar power to refuse recognition based on degree of systemic importance (but, note that CCPs may not clear swaps for clients ("customers") of U.S. persons unless register as a DCO[10]).
e. *Article 25a Comparable compliance*: Need to know what "minimum elements" will be assessed for determining "comparable compliance." In the U.S. DCO exemption is typically based on compliance with the PFMIs.
f. *Article 25b Ongoing compliance with the conditions for recognition*: Role of central bank goes beyond U.S. regime.
g. *Article 25c Request for information*: Right to request information from relevant third parties goes beyond U.S. regime.
h. *Article 25d General investigation*
i. *Article 25e On-side inspections*: Right to request third-country competent authorities to carry out investigations and inspections goes beyond U.S. regime.

[10] See footnote 7 noting that ISDA continues to advocate that exempt DCOs should also be allowed to clear swaps for clients ("customers") of U.S. persons.

Appendix 2: Location policies in other jurisdictions

Location policies have been considered in jurisdictions other than the EU and have either been abandoned as a policy option (in Canada and Australia) or drastically scaled down (Japan).

In the Canadian case, a working group chaired by the Bank of Canada including other Canadian regulatory agencies assessed the case for 'onshoring' clearing for Canadian counterparties from late 2010, but concluded against it in 2012, opining that global CCPs support liquidity and efficiency in a global OTC derivatives market, making them more robust in their resistance to financial shocks. This in turn supports derivatives users' ability to prudently manage risk. The Canadian regulators view adherence to the CPMI-IOSCO Principles for Market Infrastructures by such global CCPs as a sufficient safeguard.

See http://www.bankofcanada.ca/2012/10/statement-by-canadian-authorities/.

The Australian (ASIC) clearing regime stipulates mandatory clearing of certain interest rate derivatives denominated in AUD, USD, EUR, GBP and JPY, but permits counterparties to these trades to clear these trades either at local CCPs or in a number of overseas ('prescribed') CCPs. ASIC cited a wish to minimize disruption to Australian participants in OTC derivatives markets and referred to the adequacy of CPMI-IOSCO standards for foreign CCPs in this regard.

Where an 'onshore' clearing requirement has been mandated in derivatives markets of a material size in other jurisdictions, the requirement has been limited to local market participants trading swaps (with identified local nexus) with each other (e.g. Japan). Even here, volumes are insignificant in comparison to the volume of euro-denominated derivatives in LCH Limited, and the final regime represents a scaling back from the original counterparty scope of the requirement.

For example, looking at daily trading activities, average of cleared volume in Yen-denominated swaps at JSCC over 10 trading days (May 18 -31) was ¥3,888 billion (€31.1 billion) at JSCC, in contrast to €670.8 billion traded in euro-denominated swaps at LCH on May 31.