Solutions to regulatory differences between the US Dodd Frank Act and the European Commission's proposal, in particular in ensuring equal conditions for market access for EU and third country central counterparties (CCPS) [Note]

Alexander, Kern

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SOLUTIONS TO REGULATORY DIFFERENCES BETWEEN THE US DODD FRANK ACT AND THE EUROPEAN COMMISSION'S PROPOSAL, IN PARTICULAR IN ENSURING EQUAL CONDITIONS FOR MARKET ACCESS FOR EU AND THIRD COUNTRY CENTRAL COUNTERPARTIES (CCPS)

NOTE

by Kern ALEXANDER

Abstract

This paper examines the legislative and regulatory proposals by the United States and the European Commission to increase regulation of the over-the-counter derivatives (OTC) market by requiring more OTC derivatives to be traded on exchanges and electronic trading platforms and to shift the clearing of these instruments away from opaque bilateral structures to centralised clearing through transparent and regulated central counterparties (CCPs). These proposals are designed in substantial part to control systemic risk in wholesale capital markets and in particular in the OTC derivatives markets, which was a source of the systemic risk that toppled Lehman Brothers in 2008 and nearly caused the collapse of the European and US financial systems. The paper suggests that the proposed EU Regulation has in key areas different prudential regulatory requirements for CCPs than what the US has proposed so far and therefore this could potentially create market access problems for CCPs based in the US seeking access to the EU market. But the EU and US proposals are at an early stage and future convergence remains possible. Other issues addressed concern the type of ownership model for CCPs and the role of the European Central Bank in overseeing CCPs.

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INTRODUCTION AND BACKGROUND

The efficient operation of financial markets depends on well regulated clearing and settlement systems. Clearing typically involves a central counter party (CCP) or clearing house acting for a fee as a buyer for every seller and as a seller for every buyer in a securities or derivatives transaction.[1] A CCP is a specialised financial institution that mediates between the buyers and sellers of securities. The centralised clearing of financial instruments usually occurs through a single clearinghouse,[2] interposed as the counterparty and guarantor to every trade, requiring standardised contracts, including minimum initial margins and margin variations, isolating counterparty risk and minimising risk through conservative risk management practices and multilateral netting so that CCP members have smaller exposures overall.[3]

To perform its clearing function, a CCP must have an effective risk management system that allows it to calculate and collect margins from its members, and maintain a default or guaranty fund to protect itself and its non-defaulting members from the risk of a member's default. A well-regulated and efficiently operating CCP will reduce counter-party credit risk in derivatives transactions, thereby mitigating systemic risk which can arise because of counterparty defaults in the over-the-counter (OTC) markets. The negative fallout from the collapse of Lehman Brothers and AIG in 2008 was exacerbated by the lack of transparency in the OTC markets which led to the failure of OTC counterparties to price adequately the risk they were exposed to, thereby increasing systemic risk.[4] A well-regulated CCP can result in more efficient pricing of financial risk in the securities and derivatives markets and a reduction in systemic risk.

The growth of CCPs in Europe in recent years has been dramatic with significant horizontal consolidation across Member States, allowing market participants to increase their netting capabilities across many more asset classes on European-referenced entities or indices based on these referenced entities.[5] In recent years, a key innovation is the development of a default management process whereby every member must participate in an auction of a defaulting member's portfolio. A facility can also be offered whereby non clearing clients can be offered clearing through a clearing member. If there is a default of this clearing member then positions can be transferred to another clearer. The clearance of financial instruments has strategic importance for financial stability and is beneficial for the efficient workings of the financial markets.

[1] The European Commission has defined clearing as the process for calculating and establishing net positions in settlement, and for ensuring that adequate securities and cash are available for settlement (European Commission, 2005). Similarly, the Committee on Payment and Settlements Systems (CPSS) has defined clearing as 'the process of transmitting, reconciling, and, in some cases, confirming payment orders or security transfer instructions prior to settlement, possibly including the netting of instructions and the establishment of final positions for settlement.' (CPSS, 2001).

[2] Clearing houses traditionally performed clearing for exchange-traded derivatives and commodities. As central counterparties (CCPs), they become the buyer to every seller and the seller to every buyer of a particular set of contracts (eg., those contracts executed on a particular exchange or exchanges). See Papathannassiou (2010, 1; observing that CCP services were first made available for commodities and for related exchange-traded derivatives, such as futures).

[3] A CCP should not be confused with a centralised deal registry, to which parties report as to the trades they have entered into bilaterally and related transfers of collateral. A CCP also is not a formal exchange, which provides transparency on prices and volumes of transactions processed, broader access including to retail investors, and even less counterparty risk due to the contribution of capital from market makers.

[4] A major weakness in the OTC derivatives market is that there are relatively few players involved in transacting a very large numbers of trades. Hedging can be cyclical, meaning that if one counterparty fails, there could be a domino effect with systemic implications.

[5] The CCP industry has begun to consolidate because of competitive pressures. In Europe, the main CCPs (owners in parenthesis) are: CC&G (London Stock Exchange), Eurex Clearing (Deutsche Borse/SIX), EuroCCP (US DTCC), Iberclear (Bolsas y Mercados Espanoles, MEFF (Bolsas y Mercados Espanoles), ICE Clear Europe (ICE) LCH Clearnet Ltd (user owned), and X-Clear. The main US CCPs are: CME Clearing (CME Group), Options Clearing Corporation (eight US options exchanges), ICE Trust (Intercontinental Exchange), ICE Clear US (Intercontinental Exchange), Canadian Derivatives Clearing (TMX Group), National Securities Clearing (Depository Trust and Clearing); see *Financial Times* 'Clearers' ownership model under scrutiny', (23 Dec 2010) p. 30.

Centralised clearing, however, also presents major challenges: it is a collateral intensive process that involves relatively complex documentation. Determining margins and valuing collateral for default funds requires a high level of operational complexity. Moreover, there could be regulatory concerns with mandatory clearing of derivatives because CCPs may find it very difficult to close-out some illiquid positions held by defaulting members, which could affect the liquidity of a group of members, especially large banks and financial institutions who are also CCP members and whose access to liquidity can become a financial stability issue.

The G20 Pittsburgh Summit Communique of September 2009 endorsed proposals for mandatory trading of standardised derivative contracts on exchanges or electronic trading platforms and mandatory clearing of such trades through a CCP by the end of 2012.[6] Non-centrally cleared contracts would be subject to higher capital requirements. Following this, the European Council agreed in its 'Conclusions' of 2 December 2009 of the need to substantially improve the mitigation of counterparty credit risk and enhancing the transparency, efficiency and integrity of the derivative markets,[7] and the European Parliament's Resolution of 15 June 2010 on 'Derivatives markets: future policy actions' called for mandatory central clearing and reporting of OTC transactions.

EU and US policymakers and regulators have spearheaded the G20 initiative by proposing legislation and regulations that would require most standardised OTC trades to be migrated on to CCPs and recorded in trade repositories. Specifically, the EU's proposed Market Infrastructure Regulation (EMIR)[8] and the Dodd-Frank Act of 2010[9] aim to shift more derivatives on to exchanges and other trading platforms and to be cleared through CCPs, which would increase market transparency and potentially reduce systemic risk. The obligation to clear OTC contracts under both laws would result in increased collateralisation of OTC and swap trades, reduced counterparty credit risk, and greater liquidity in the wholesale derivatives markets. Moreover, because of the size and influence of the EU and US financial markets, these laws will have a major global impact.

EMIR and Dodd-Frank will result in a substantial increase in the amount of OTC derivatives subject to a central clearing requirement. Accordingly, CCPs will need to establish more robust risk management practices and sound organisational structures. The Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions are already addressing the need for enhanced CCP risk management and governance by revising their 2004 international principles of best practice for securities clearing and settlement, which are expected to be proposed in early 2011 (ECB, 2010).[10] However, these recommendations only provide general principles for regulating clearing and settlement systems, while leaving much discretion for implementation to national authorities.

[6] The G20 Pittsburgh Summit Communique (Sept 2009) states in relevant part that:
- 'all standardised OTC derivatives contracts should be traded on exchanges [...] and cleared through a Central counterparty by the end of 2012 at the latest';
- OTC derivative contracts should be reported to trade repositories; and
- Non-centrally cleared contracts should be subject to higher capital requirements.'

[7] Council of the European Union, 'Council approves enhanced regulation of the OTC derivatives market', (2 Dec 2009). The EU welcomed 'the paradigm shift in the approach to derivatives markets [...] namely moving from so called "Light handed regulation" to a more ambitious and comprehensive regulatory policy, that is aimed at reducing counterparty and operational risks, increasing transparency of the derivatives market and strengthening market integrity and oversight and, operationally is expected to shift derivatives trading and clearing from predominantly OTC bilateral transactions towards centralised trading and clearing infrastructures'.

[8] See: Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories', COM(2010)265, 15.9.2010.

[9] The Wall Street Reform and Consumer Protection Act of 2010 ('The Dodd-Frank Act'), Public Law 111-203, 124 Stat. 1376 (2010). For example, section 619 provides the so-called 'Volcker Rule' that requires mandatory separation of proprietary activity from client activity. Previously the question of activity separation had been left to the discretion of the regulator.

[10] Also, the Committee of European Securities Regulators (CESR) and the European System of Central Banks (ESCB) addressed systemic risk and other financial stability issues with the publication in June 2009 of voluntary 'Recommendations for securities settlement systems and central counterparties in the European Union.' (CESR/ESCB, 2009).

EU and US policymakers and regulators are now moving ahead with EMIR and Dodd-Frank by proposing more detailed and possibly higher standards for regulating the OTC markets and CCP operations. This report considers some of the significant differences that have emerged between EMIR and Dodd-Frank over the regulation of CCPs which raise issues regarding EU market access for third country CCPs. The report also analyses these regulatory differences and related issues concerning the role of the European Central Bank in CCP oversight, the applicable international trade law principles to third country CCP access to the EU market, and what type of CCP ownership model is most suitable for achieving regulatory objectives.

1. REGULATORY DIFFERENCES FOR CCPS UNDER EMIR AND THE DODD-FRANK ACT

In considering some of the different requirements of EMIR and the Dodd-Frank Act, it is important to bear in mind that EMIR is intended to be more prescriptive as a legislative measure with the European Securities and Markets Authority (ESMA) clarifying certain technical standards over time, whereas the Dodd-Frank Act delegates substantial rulemaking authority to the US regulatory bodies – the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) – to define the most important regulatory requirements such as the exceptions for financial instruments eligible for clearing and defining the prudential regulatory requirements, governance and conduct of business standards for CCPs and acting with other federal regulatory bodies to define and regulate systemically important CCPs. In contrast, EMIR establishes most requirements for CCPs expressly in the proposed Regulation and the Commission will have an ongoing role to approve most substantive regulations adopted by ESMA covering prudential regulation, governance and conduct of business not already established in EMIR. Generally, US regulators will have broader authority to respond to market developments by adopting or modifying regulatory rules and standards and for enforcing regulations in administrative tribunals. In contrast, ESMA will be engaged in a challenging exercise of overseeing the implementation of EMIR across the EU in a harmonised way and in ensuring that Member State supervisory authorities interpret and apply EMIR in a similar way that promotes internal market objectives. US regulators will have more flexibility to respond to global financial developments and to coordinate with foreign regulators, whereas ESMA will be significantly constrained in responding to market developments because it will need Commission approval for substantive changes in many regulatory requirements which will likely involve amending EMIR.

Regarding regulatory differences for CCPs, it is important to realise that most of the US regulatory rules are not yet finalised and are undergoing review and efforts are ongoing to coordinate to achieve a high level of convergence between both regimes.[11] The US Commodity Futures Trading Commission (CFTC) has met to consider its proposed rules, including, among other things, the establishment of CCPs (the Act describes CCPs as 'derivatives clearing organizations' (DCOs), swap execution facilities, and end-user exceptions to the obligation to use mandatory clearing.

ESMA will take up its review of technical standards and harmonised implementation in 2011 and will begin soon to advise the Commission on further substantive rules and possible amendments to EMIR to address legitimate concerns. It is expected that there will be amendments to EMIR to address concerns regarding regulatory gaps and inconsistencies that could lead to arbitrage between the EU, US and other major jurisdictions.

US and EU regulators and Member State supervisors have a long way to go to reconcile any significant differences between the two regimes. The following discussion examines some of these differences in respect to the regulation of CCPs.

[11] EMIR is a proposed Regulation subject to proposed amendments by the Parliament and Council. ESMA was authorised to take up its responsibilities in January 2011 but its Board has not yet been appointed nor begun its work on proposing technical standards to implement EMIR. The deadline for ESMA's technical standards is 30 June 2012. In contrast, most of the proposed regulatory rules in Dodd-Frank are expected to be finalised by 15 July 2011 and to take effect by 15 September 2011. This creates considerable uncertainty for practitioners who will be subject to Dodd-Frank in September with EMIR possibly not taking full effect until the following July.

Eligible instruments

Both EMIR and the Dodd Frank Act aim to impose clearing and reporting requirements on a broadly defined class of OTC derivatives (with differences for some classes of derivatives) and provide regulators with the ultimate authority to decide when the clearing obligation should apply. Regarding differences in the scope of application of the clearing requirement, it should be noted that the Dodd-Frank Act applies to a broad class of OTC derivatives including any agreement, contract or transaction that is, or in the future becomes, commonly known to the trade as a swap. The US definition does not appear to cover spot foreign exchange transactions. Under the Act, the Treasury Secretary can exempt both foreign exchange swaps and forwards from the clearing obligation (but not the reporting and business conduct standards). Moreover, the US definition excludes some kinds of physically settled commodity transactions (and certain physically settled forward transactions in securities).

EMIR also applies to a broad class of OTC derivatives but unlike Dodd-Frank is limited to derivatives on specified underlying assets. The EU definition excludes some kinds of physically settled commodity transactions, although the exceptions differ from the US. The EU definition also does not cover spot foreign exchange transactions and the Commission has interpreted the relevant EU definition to exclude commercial forward foreign exchange transactions. However, it may be advisable for the Commission to subject certain other forex forwards and swaps to a clearing requirement. Although there is a view that forex forwards and swaps should not be subject to mandatory clearing because most of these trades are settled through the Continuous Link Settlement System (which mitigates settlement risk) thereby reducing systemic risk in the forex markets, most forex trading still poses significant counterparty credit risk because of longer-dated maturities. Indeed, based on notional value, over one-third of the outstanding forex forwards and swaps have a maturity of over one year.[12] Therefore, it is argued that policymakers should consider a mandatory clearing requirement for longer-dated forex forwards and swaps with some exceptions for commercial entities engaged in hedging.[13]

EMIR does not address whether or not standardised derivatives contracts which are subject to mandatory clearing are also required to be traded on an exchange or electronic platform because it explicitly applies only to post-trading systems (clearing and settlement), whereas the Market in Financial Instruments Directive (MIFID) applies to trading on exchanges or electronic platforms.[14] In contrast, Dodd-Frank requires that if a derivative is eligible for clearing, it must also be traded on an exchange or an electronic trading platform, such as a 'Swap Execution Facility' (SEF).

Both EMIR and the proposed US regulatory rules aim to achieve centralised clearing for standardised derivative contracts by adopting rules, procedures and technical standards for how CCPs should operate and by exempting certain end users from the clearing requirement. Indeed, EMIR contains exceptions for non-financial industrial groups, such as Siemens, Lufthansa and Rolls Royce, who argued that requiring them to process OTC derivatives through CCPs would be too expensive and eliminate the benefits they derive from hedging their commercial risk against, for instance, commodity price volatility.

[12] Bank of England (2010, 57).
[13] A mandatory clearing requirement for these forex instruments would complement the Continuous Link Settlement Bank's effective management so far of settlement risk in the foreign exchange markets.
[14] The Commission is now considering whether OTC derivative should be traded on exchanges or electronic platforms as part of its MIFID II review.

Capital and margin requirements

CCPs have typically not been required to hold regulatory capital which can absorb unexpected losses against payment, treasury, operational and business risks. EMIR attempts to address this by requiring a CCP, upon initial authorisation, to hold at least 5 million euros in permanent, available capital.[15]

Minimum capital levels must be maintained along with retained earnings and reserves must always be sufficient to cover an orderly winding down. In contrast, Dodd-Frank requires that a derivatives clearing organization (DCO) shall have adequate financial, operational and managerial resources as determined by the CFTC, but no specific capital formula is required.[16] A DCO's financial resources shall at a minimum exceed the total amount that would enable the DCO to meet its obligations despite a default by a member creating the largest financial exposure in extreme, but plausible, market conditions and enable the DCO to cover its operating costs for a 1-year period.[17]

Despite these requirements, because CCPs will be exposed to much greater counterparty risk with mandatory clearing, it will be necessary for them to increase the quantity and quality of the resources they hold against default. In this regard, the Bank of England has observed that 'there is a strong case for moving beyond the current requirement to cover the default of their largest member', and instead to hold adequate resources (ie., higher capital and margin requirements) against the unexpected default of two or more members under extreme, but plausible, market conditions.[18]

In addition, neither regime has addressed yet the potential risks of CCP members being exposed to large or concentrated client positions and the implications this can have for the CCP to meet its obligations. This should be addressed by the CFTC and the SEC in its rulemaking capacity under Dodd-Frank and in Europe by the European Securities and Markets Authority (ESMA).

Regarding margin requirements, EMIR requires that CCPs have access to liquidity in the form of central bank money and specifies that margins shall cover 99% of risk of exposure movements over an appropriate time horizon, with a relatively limited role for the adoption of delegated acts/technical standards to implement those requirements.[19] To do this, CCPs will be required to impose margins on clearing members and CCPs with whom they have interoperable arrangements. CCPs will be required to develop models and parameters based on those models to determine certain margin thresholds which will be tested under stress conditions in which the margin can be collected and called on a daily basis in order to determine the value at risk given a certain probability of loss. The SEC and CFTC have promulgated regulations for determining how to calculate the margin for standardised derivative contracts that cover similar but not identical risk exposures.[20] The US regulations do not yet provide for a particular value-at-risk exposure (ie., 99% as provided by EMIR), but instead provide that margin requirements shall be sufficient to cover unexpected losses under normal market conditions and models and parameters used in setting margin thresholds should be risk-based and tested based on available data and reviewed on a regular basis.[21] These differences in approaches for margin requirements should be reconciled at the bilateral level between the Commission/ESMA and the US regulators and in international bodies such as IOSCO.

[15] EMIR, art (1).
[16] Core Principle 8 requires that DCOs have adequate financial, operational, and managerial resources,' 'to discharge its obligations. 17 CFR ??
[17] 17 CFR Parts 1 and 39, *Federal* Register, Vol. 75 No 238, 77578-77582.
[18] Bank of England (2010, 57).
[19] EMIR, art. 39 (1) – (3).
[20] For example, US Core Principle (CP) 8 requires that 'a DCO, through margin requirements and other risk control mechanisms, shall limit the DCOs exposure to potential losses from defaults by members and participants to ensure that operations of the DCO would not be disrupted and non-defaulting members would not be exposed to unexpected losses.'
[21] See CP 8.

Systemically important CCPs

Title VIII of Dodd-Frank authorises the Federal Reserve and the CFTC to regulate systemically important derivatives clearing organizations (SIDCOs).[22] CFTC is devising rules to regulate SIDCOs as systemically-important institutions that may require higher capital and stricter margin and collateral requirements for its clearing members and their clients. In contrast, EMIR does not make a distinction between systemically-important CCPs and other CCPs. This could result in higher capital charges and stricter margin and collateral requirements for EU CCPs defined by US regulators as systemically-important if they clear US-traded products or clear certain non-US-traded products for US-domiciled firms subject to mandatory clearing under US law. The US Financial Services Oversight Council has authority, under the Dodd-Frank Act, to assess the systemic importance of non-US financial institutions, including non-US CCPs, and will adopt, no later than July 2011, rules that define which CCPs are systemically important.

In contrast, EMIR makes no distinction between systemically important and non-systemically important CCPs, presumably because EU policymakers consider all CCPs to be equally systemically important. The Commission should address this by assessing the systemic importance of CCPs by working with the US Financial Services Oversight Panel to establish thresholds for the value and volume of CCP clearing. Such an assessment of systemic importance should also include the type of financial instruments being cleared: certain financial instruments create greater externalities than others. This can be measured based on the level of leverage linked to these instruments and whether they have a longer term maturity. Therefore, CCPs which clear credit-linked instruments (ie., credit default swaps) which are linked to leverage and have medium to long-term maturities pose greater systemic risk than instruments linked to less leverage and with shorter maturities, such as equity derivatives.[23] These CCPs should be subject to more intensive scrutiny of their risk management, governance and ownership structures, including higher capital, and stricter margin and collateral requirements. This is similarly the case with certain types of foreign exchange derivatives, such as forex forwards and swaps, that have longer maturities (greater than 1 year) by notional value. As discussed above, these instruments pose greater counterparty and systemic risk and therefore should be subject to a clearing requirement, and the CCPs which clear them should be subject to higher capital requirements along with stricter margin and collateral requirements.

CCP institutional and ownership structure

The growth of CCPs has raised issues about what institutional structure they should adopt and who should own them. Some EU states require CCPs either to have a bank licence or to be owned by a bank. For example, Germany and France require a CCP to obtain a bank licence before it can begin clearing operations, whilst other EU states, such as the United Kingdom, do not require CCPs to be banks or to be controlled by banks, but rather to be authorised by the UK regulator as business. Such institutional regulatory differences pose barriers not only to cross-border trade in CCP services within the Union, but also to international trade in CCP services between the Union and non-EU third countries, such as the United States and Japan. Under EMIR, there are no requirements regarding what institutional form a CCP should take, nor who can own a CCP. By contrast, Dodd-Frank delegates authority to US regulators to adopt a harmonised set of regulations for the institutions structure of CCPs and their operations and governance. For example, US regulators have the authority to define what type of institutional entity a CCP should be (ie., does it require a bank licence or not) and to determine what limits, if any, to impose on its ownership structure, including whether or not they can be owned by large US banks and non-bank financial holding companies supervised by the Federal Reserve.

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[22] The Dodd-Frank Act, Title VIII provides for the Board of Governors of the Federal Reserve System together with the Financial Services Oversight Council (composed of representatives from all of the Federal Financial Regulators) to have authority to take steps to limit the size of systemically risky entities; reduce the ability to engage in activity regarded as unsafe or unsound; and to take other action to reduce or eliminate risk.
[23] See Bank of England (2010, 57).

EMIR contains extensive provisions directly regulating the organisation and conduct of business of CCPs whereas Dodd-Frank authorises regulators to act with discretion in deciding whether or not to place particular or general restrictions on the organisational structure, conduct of business rules, and ownership of CCPs. Rather than focusing on what type of institutional structure the CCP entity should take (which is left to Member States), EMIR focuses on the CCP's Board of Directors and how they exercise oversight and impose requirements, such as at least one-third of the board members must be independent (and in all cases at least 2 members should be independent).

The Dodd-Frank Act delegates to regulators the authority to micromanage the CCP's structure and to impose conduct of business rules and adopt principles to manage conflicts of interests within the CCP and in relation to its members and to regulate ownership interests and controls in CCPs. Although there are no provisions in EMIR equivalent to Dodd-Frank's ownership limits, holders of direct or indirect significant shareholdings in a registered CCP will require approval by the Member State supervisor. EMIR creates similar requirements for CCPs to manage conflicts of interest.

The Act contains provisions requiring collateral for cleared swaps to be held with a futures commission merchant or a broker, dealer or securities swap dealer, while allowing for the collateral to be held in omnibus accounts. The Act also specifically states that a registered CCP is not required to accept the credit risk of another CCP. EMIR does not create the same requirements regarding how the collateral for cleared swaps should be held, nor does it address the issue of whether a CCP should accept the credit risk of another CCP. But these are minor issues that can be worked out with further US regulatory rulemaking and Commission revision.

EMIR contains provisions which aim to ensure the portability of client positions and collateral in the event of a clearing member's default. It also permits interoperability for CCPs in relation to cash securities clearing. US regulations presently do not address this.

2. MARKET ACCESS CONDITIONS FOR THIRD COUNTRY CCPS

Regarding the application of EMIR to CCPs domiciled in third countries, there are a number of situations as discussed above where the requirements of the EU and US regimes are not harmonised and may create direct conflicts in legal and regulatory requirements. It should be recalled however that the US regulations are still in a formative stage and ESMA has not yet taken up its role in proposing technical standards and advising the Commission on further modifications or amendments to EMIR as well as proposing guidelines for determining whether third country jurisdictions meet EU legal and regulatory standards of equivalence.

Jurisdictional issues

In respect of jurisdiction, EMIR's scope of coverage is unclear in determining the application of a number of its provisions. Under certain circumstances, however, extraterritorial jurisdiction can be implied because the clearing obligation is applied expressly to financial counterparties (and non-financial counterparties which exceed the clearing threshold) which enter into eligible OTC derivatives with third country entities. For example, EMIR's clearing and reporting requirements would appear to apply to a EU domiciled counterparty who is trading a financial product referencing an EU-based asset, even though the trade is conducted with a counterparty domiciled in a non-EU jurisdiction and the product is trading on a trading platform outside the EU. In this case, Dodd-Frank would create jurisdiction because it applies both to US domiciled parties and to financial products that are trading on exchanges or platforms in the United States or subject to US jurisdiction. These overlaps of regulatory jurisdiction should be addressed by EU-US working groups.[24]

Third country equivalence

Both EMIR and Dodd-Frank seek to allow cross-border clearing into the EU market by recognising and in some cases exempting non-EU domiciled CCPs from the EMIR regime if the non-EU CCP can demonstrate that it is subject to an equivalent home country regulatory regime and has an agreement with the ESMA to provide timely information of the exposures and operations of the non-EU CCP. EMIR however is less flexible with recognising and/or exempting the incoming cross-border trade of repository services. The US is equally less flexible with trade repositories by requiring them to comply fully with the reporting and governance standards of Dodd-Frank. The EU goes even further by permitting recognition or exemption of trade respositories from EMIR only in cases where the home country of the non-EU repository has concluded treaty with adequate exchange of information with the European Union.

The legal and regulatory differences that divide the EU and US as discussed above are significant but can be overcome by US regulatory rulemaking and by ESMA's adoption of technical standards which can together bridge the regulatory divide in areas such as eligible instruments for clearing, margin and capital requirements, and CCP governance standards and conduct of business rules. This depends, however, on effective bilateral coordination between EU and US officials and multilateral efforts through the Committee of Payment and Settlement Systems and IOSCO.

[24] The Global Markets Advisory Committee will be many of the areas that need reconciliation. See also 'Derivatives Reform: Comparison of Title VII of the Dodd-Frank Act to International Legislation', prepared by CFTC Staff for the Global Markets Advisory Committee (5 October 2010).

2.1 General Agreement on Trade in Services and reciprocity

The WTO General Agreement on Trade in Services and its Annex on Financial Services provide the international legal framework governing cross-border trade in financial services. WTO members' national treatment and market access commitments are negotiated by each WTO member (including the EU acting for all EU Member States) and constitute the basis of their negotiated specific commitments to liberalise the services sectors of their economies, including financial services. Indeed, the WTO Appellate Body has recognised the centrality of the Members' schedules of commitments as binding international legal obligations, which means that WTO members cannot avoid their commitments or obligations unless expressly allowed under the GATS.[25] Regarding CCPs, the question is raised whether the EMIR's requirement in Chapter 4, Article 23 that a CCP established in a third country may provide clearing services to entities established in the EU only where ESMA determines that the laws and regulations of that third country CCP are equivalent to EMIR violates any GATS commitment undertaken by the EU? A review of the EU's schedule of commitments demonstrates that the EU has made no commitment – either for national treatment, market access or any other commitment – that would preclude it from imposing restrictions on entry into the EU market of a CCP established in a third country. However, the EU has incurred a most-favoured nation (MFN) obligation under Article II GATS to treat WTO members in a non-discriminatory manner with respect to market access. In other words, the MFN principle requires WTO members, such as the EU, to assess the equivalence of third country regulations and laws in an equal manner and not to asses, for instance, the regulatory regime of CCPs in one WTO member in a more that would be considered on objective criteria to be more favourable than how it would asses the equivalence of another WTO member's regulatory requirements. Under the GATS, the MFN principle prevents a WTO member from discriminating between other WTO members with respect to conditions for market access.

A related international trade law issue has arisen because of a European Central Bank legal opinion that was isused in January 2011 regarding Article 23's requirement that ESMA should assess the laws and regulations of a third country jurisdiction for equivalence in order to decide whether to allow a CCP based in that third country to have EU market access.[26] As discussed below, the ECB believes, based on its Treaty powers to ensure the smooth operation of the euro area payment system and its responsibility for securities settlement infrastructure (*i.e.* Target 2), that the European System of Central Banks (ESCB) should have oversight responsibility over securities clearing systems, including the operations of CCPs, mainly because of the integral operations of CCPs in securities settlement systems and because EU central banks, as central banks of issue, could be called on to provide liquidity support under EMIR to a CCP during exceptional or stressful market conditions.[27] In addressing the issue of what regulatory criteria should apply under Article 23 EMIR, the ECB argues that the principle of *reciprocity* should apply to determine whether the ESMA and the ESCB should recognise a third country CCP.[28] The ECB argues that 'the requirement for such recognition should be the reciprocal treatment of CCPs from the Union under the relevant laws of such third countries.'[29]

[25] Article XX:3 (GATS) provides that Members' Schedules are 'an integral part' of the GATS. See also GATS 2001 Scheduling Guidelines.

[26] European Central Bank, *Opinion of the European Central Bank of 13 January 2011 on a proposal for a regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories*, (CON/2011/1)(hereinafter ECB Opinion of 13 January 2011).

[27] ECB Opinion of 13 January 2011, p. 3.

[28] The ECB proposes that Article 23 (2) be amended (in bold) in relevant part to state:

> 'ESMA, **in close cooperation with the members of the ESCB,** shall recognise a CCP from a third country, where the following conditions are met: [...] **(d) the applicable laws in the jurisdiction of the third country CCP ensure reciprocity in respect of CCPs from the Union.'**

[29] Ibid.

The ECB's proposal for the requirement of reciprocity under Article 23 does not mention how it would be reconciled with the existing principle of equivalence as set forth in Article 23. Rather, the ECB reciprocity proposal could potentially have the effect of making the conditions for market access between the EU and United States reciprocal in a manner that might violate non-discrimination principles under other bilateral agreements entered into by the EU and possibly violating the EU's MFN obligation in the GATS.

As an international trade law matter, under the GATS, where a WTO member has incurred most-favoured nation and national treatment obligations, and has made market access commitments, it may not condition access to its markets based on the principle of reciprocity. The MFN and national treatment principles as set forth in the GATS are non-discrimination principles which preclude the application of the reciprocity principle.[30] Although the EU has not made any national treatment commitments under Article XVII GATS and no market access commitments under Article XVI GATS, it has incurred a most-favoured nation obligation which is essentially an obligation not to treat other WTO members in a discriminatory manner. The ECB's reciprocity proposal raises important issues about whether any reciprocal arrangements between the EU and US might have discriminatory effects on trade relations between the EU and other third countries in violation of the MFN principle of bilateral trade agreements and the GATS. The EU should therefore reject the ECB's reciprocity language and stick with the principle of equivalence as currently stated in Article 23 because the conditions for equivalence are less likely to violate any existing (or future) bilateral or multilateral trade obligations between the EU and other third countries based on the principle of non-discrimination.

[30] See Kern Alexander et al., *Global Governace of Financial Systems; the International Regulation of Systemic Risk* (2005, Oxford: OUP) p. 103. See also, Juan Marchetti 'What Should Financial Regulators Know About the GATS' *WTO Discussion Paper* (2003).

3. RELATED ISSUES

3.1 CCP ownership model

Should policymakers consider whether the for-profit shareholder ownership model provides adequate incentives for CCPs and their shareholders to mitigate systemic risks? And whether some other type of ownership model should be required to achieve regulatory objectives? Most of the biggest CCPs in Europe and the US operate with the for profit shareholder-ownership model: many of these CCPs are owned by exchanges which provide the CCPs with a steady order flow of business. The Bank of England in its December 2010 Financial Stability Report suggested that '[f]rom a risk perspective, not-for-profit, user-owned CCPs provide strong incentives for effective risk management.'[31] In contrast, the incentives for effective risk management are weaker among CCPs that operate with the shareholder-owned for profit model or those which are not user-owned. Although the Bank was mainly concerned that the shareholder for profit ownership model did not 'closely align the interests of CCPs and providers of risk capital', the real regulatory risk is whether the shareholder ownership model based on limited liability creates an incentive for the shareholders of a CCP to encourage the CCP to take on greater risks that could threaten financial stability.

The Bank suggested that enhanced capital requirements and stricter risk management standards for CCPs, along with 'user ownership and not for-for profit arrangements' would contribute significantly to financial stability objectives.[32] The issue will become especially important once EMIR and Dodd-Frank are implemented because many CCPs will have an incentive to increase revenues by attracting more of the OTC clearing business stemming from the regulatory reforms. The concern is that for profit CCPs will lower standards in areas such as margining, quality collateral and risk measurement in order to attract more business from their members and their clients. The Bank of England suggests that CCPs operating with an user-owned business model will have less of an incentive to reduce operating standards to attract more business than if the CCP is driven by the for profit shareholder ownership model.[33] This is an issue that merits further analysis.

3.2 The regulatory role of the ESCB

The European Central Bank adopted an opinion on 13 January 2011 that EMIR should be amended so that the European System of Central Banks (ESCB) would be given oversight responsibility for the operation of EU central counterparties and any third party central counterparty operating in EU markets. The legal authority cited for this proposal was the fourth indent of Article 127 (2) of the Treaty and Article 3.1 and Article 22 of the Statute of the European System of Central Banks and of the European Central Bank. One of the basic tasks to be carried out through the ESCB is the promotion of the smooth operation of the payment system.[34] Further, Article 22 of the Statute of the ESCB provides the ECB with the important power to adopt regulations to ensure the efficiency and soundness of EU clearing, settlement and payment systems within the Union and between the Union and other countries.[35]

[31] Bank of England, *Financial Stability Report,* (Dec 2010) p. 57.

[32] Indeed, the Bank of England observed that '[f]rom a risk perspective, not-for-profit, user-owned CCPs provide strong incentives for effective risk management.' Ibid.

[33] A related issue is whether Basel III should require banks to hold more regulatory capital against positions held in a CCP with a shareholder-ownership for profit business model, as opposed to holding less capital against positions in CCPs that are run as user-owned utility-type structures (Bank of England, 2010).

[34] Art 127 (2) (TFEU) – fourth indent.

[35] Article 22 of the Statute of ESCB provides : 'The ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure the efficient and sound clearing and payment systems within the Community and with other countries.' See Alexander et al (2005) p. 122 and p. 282.

Based on these treaty powers, the ECB has proposed that EMIR be amended so that the ESCB's role in exercising oversight of EU clearing systems is recognised and that it has joint authority with ESMA to review and approve regulations of CCPs and the infrastructure of clearing within the EU, and with ESMA to recognise the laws and regulations of third country clearing systems as a condition for allowing third country CCPs into the EU market.[36] In addition to the ESCB's responsibility for the smooth operation of payment systems, the ECB argues that the ESCB's responsibility 'to implement the monetary policy of the Union' in Article 127 (2) indent 1 (also provided in Article 3.3 of the Statute of the ESCB) depends on its ability to promote the smooth operation of clearing and settlement systems and infrastructures and therefore is a basic task of the Eurosystem.[37] The ECB also observes national central banks whose currency is not the euro would also have similar powers to oversee clearing and related infrastructure as the ECB would have in acting through the National Central Banks of the Eurosystem.

On the other hand, the ESCB's oversight authority over clearing may lead central banks and in particular the ECB operating through the Eurosystem to engage in supervisory oversight of CCPs, which are in many EU states authorised credit institutions, which cannot be subject to direct 'prudential supervision' by the ECB unless there is unanimous consent by the Council of Ministers.[38] This raises important issues regarding the scope of the ESCB's oversight of the EU clearing system and when does the scope of its oversight of the clearing and payment systems overlap with Member States' prudential supervision of CCPs. Generally, however, it would appear that the ESCB would have a strong claim as a legal matter to be involved in the oversight of the clearing system. Accordingly, the Commission may want to consider appropriate amendments to EMIR to recognise the ESCB's role in this area.

[36] See discussion in section 2.1 about the ECB's proposal for a reciprocity requirement for third country jurisdictions.

[37] See ECB Opinion of 13 January 2011 (Con/2011/1), p. 2.

[38] Art 127 (6) TFEU provides in relevant part: 'The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions.'

CONCLUSION

CCPs enhance the efficient operation and stability of financial markets because they offer a framework that embraces mark-to-market valuation, collateralisation and monitoring of all positions on a daily basis, multilateral netting, mutualisation of risk, and a default fund. EMIR and the Dodd-Frank Act both require central clearing of OTC derivatives and securities-based derivatives and that they be recorded in trade repositories, while the Dodd-Frank Act requires that eligible OTC derivatives are traded on exchanges or electronic trading systems. These regulatory reform initiatives are designed to increase transparency and reduce systemic risk in the opaque OTC derivatives markets, which was widely regarded as having exacerbated the financial crisis. This report examines the EU and US regulatory reform proposals for the OTC derivatives market regarding the regulation of CCPs and how their regulation can potentially create market access problems for CCPs based in third countries seeking access to EU financial markets. EMIR delegates to ESMA the authority to recognise a third country jurisdiction's laws and regulations as equivalent to EMIR in order to grant a CCP based in that jurisdiction access to the EU market. Although there are presently differences in some of the regulatory requirements for CCPs between EMIR and Dodd-Frank, most of these regulations remain under consultation and could be adopted and implemented in a way that would minimise any market access problems. Further, if ESMA exercises its authority to recognise third country regulations as equivalent in a reasonable manner there should be no market access problems with respect to CCPs established in third countries, such as the US, with robust regulatory requirements. Finally, Article 23 EMIR does not violate the EU's commitments under the WTO GATS, but the ECB's proposed amendment to Article 23 requiring a reciprocity test could possibly violate the EU's trade obligations under the GATS and bilateral trade agreements. Further, the ECB's proposal that EMIR be amended to take account of the ESCB's oversight responsibility in EU securities clearing and settlement systems is a reasonable interpretation of the ESCB's treaty powers the implementation of which can be adopted by amendment of the Regulation and implemented in coordination with ESMA.

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