

FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY | 16 FEBRUARY 2016

EU-US Agreement on Regulation of Central Counterparties

On 10 February 2016, the European Commission and the CFTC announced a common approach regarding supervision of central counterparties operating in the US and EU, paving the way for cross-border equivalence and recognition decisions. The agreement promises to resolve a major and long-standing impasse which has threatened to paralyse the financial markets.

EU-US Agreement on CCPs

On 10 February 2016, the European Commissioner for Financial Stability, Financial Services and Capital Markets Union and the US Commodity Futures Trading Commission (**CFTC**) announced a common approach regarding recognition of their respective regulatory frameworks for clearing central counterparties (**CCPs**).¹

Following this agreement, the European Commission intends to adopt an equivalence decision to declare that the CFTC requirements for derivatives clearing organisations (**DCOs**) under the agency's jurisdiction are equivalent to requirements under the European Market Infrastructure Regulation (**EMIR**).² This will allow such US CCPs³ to be recognised under EMIR and to continue to provide services in the EU whilst complying with CFTC requirements, although they will need to comply with certain additional requirements under EU rules as discussed below. The European Securities and Markets Authority (**ESMA**) has also announced that whilst it has 180 days to recognise CCPs under EMIR, it will do everything within its powers to shorten that period, given the 21 June 2016 deadline for the start of the clearing obligation.

CFTC staff will propose a determination of comparability with respect to EU requirements, which will permit EU CCPs that are registered or intend to register with the CFTC as DCOs to provide services to US clearing members and clients whilst complying with corresponding EU requirements in lieu of CFTC requirements. CFTC staff will also propose streamlining the registration process for an EU CCP wishing to register as a DCO.

¹ The announcement is available [here](#).

² Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories.

³ The common approach does not address the equivalence of the US requirements applicable to securities clearing agencies that are registered with the US Securities and Exchange Commission (**SEC**) under the Securities Exchange Act of 1934. The statement notes that the European Commission continues to discuss with the SEC an approach that may lead to a similar EU equivalence decision for such clearing agencies. The announcement does not explicitly address how the common approach will apply to US CCPs that are both registered DCOs and securities clearing agencies (and such matters may therefore need to be addressed in the details of implementation), although such entities must at a minimum comply with the CFTC rules and, accordingly, one would expect that the common approach would apply at least with respect to activities within the scope of such CFTC rules that are to be deemed equivalent.

Equivalence under EMIR

Under EMIR, the European Commission may adopt equivalence decisions declaring that:

- the legal and supervisory arrangements of a third country ensure that CCPs authorised in a third country comply with legally binding requirements equivalent to requirements in EMIR;
- those third country CCPs are subject to effective supervision and enforcement in that third country on an ongoing basis; and
- the legal framework of that third country provides for an effective equivalent system for the recognition of CCPs authorised under third country legal regimes.

Such decisions are necessary for CCPs established in third countries to provide services in the EU. To date, the European Commission has adopted equivalence decisions for the regulatory regimes for CCPs in Australia, Hong Kong, Japan, Singapore, Canada, Mexico, South Africa, Switzerland and the Republic of Korea.⁴

Key Differences between the US and EU Regulatory Regimes

In September 2013, ESMA published its final technical advice on the US's regulatory equivalence to EMIR. The technical advice highlighted various differences between the US and EU regulatory regimes, resulting in a delay in the European Commission adopting an equivalence decision for the US. This delay has, in turn, contributed to the delayed application of capital requirements under the Capital Requirements Regulation (**CRR**)⁵ in the context of EU banking groups' exposures to CCPs, as absent an equivalence decision, European clearing members would need to hold more regulatory capital to clear on US CCPs than if recognition were granted to US CCPs.

The announcement that an equivalence decision from the European Commission is forthcoming is prefaced on the proposed resolution of a number of differences between the US and EU regulatory regimes which are of economic importance. In the absence of harmonisation, it has been feared that a flight of derivatives markets away from the EU may have occurred due to lower collateral requirements and therefore reduced costs of clearing transactions in the US. We discuss below the main differences between the EU and US regimes and resolutions that facilitate an equivalence decision under the new agreement:

Minimum Liquidation Periods

A liquidation period is the time period used for the calculation of the collateral that the CCP estimates is necessary to manage its exposure to a defaulting member. Essentially, a CCP examines the maximum predicted possible price movement over the liquidation period to calculate a baseline figure for initial margin. Under EMIR, the liquidation period applicable to exchange-traded futures contracts must be at least two business days. For customer positions, clearing members may post margin on a net basis (**Two Day Net**).

⁴ You may like to view our client note "Update on Third Country Equivalence under EMIR" dated 18 November 2015, available [here](#). Equivalence decisions are available [here](#).

⁵ Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms.

Under the US regime, the minimum liquidation period for exchange-traded futures contracts must be at least one day.⁶ For customer positions, clearing members must post margin on a gross basis (**One Day Gross**).

In December 2015, ESMA published a Consultation Paper⁷ proposing to amend the liquidation period provisions for customer accounts with the aim of addressing the difference between Two Day Net and One Day Gross. The proposal permits One Day Gross in the EU if certain conditions are met, including that the identity of the client is known to the CCP, the client is not an affiliate of a clearing member and the CCP implements procedures to: (i) calculate for each account, initial and variation margin requirements at least every hour during the day; and (ii) collect margins within one hour where the new margin requirement meets certain thresholds.

Whilst this new flexibility has been widely welcomed, the proposed conditions for One Day Gross are controversial. ESMA's proposals are intended to facilitate equivalence between the US and EU regimes but the conditions imposed by ESMA for One Day Gross have raised significant concerns in the market, including that such conditions are not required under the US regime or could lead to other undesired consequences and further non-equivalence. For example, it is a significant deviation from all other EU financial legislation to treat affiliates differently. It would be strange to exclude such positions when affiliates are often themselves acting as intermediaries for other clients. It is also to be hoped that ESMA will clarify that their "known to the CCP" condition is not intended to mandate so-called "leapfrog payments" by CCPs to clients, a structure proposed in EMIR which ESMA itself has acknowledged is unworkable in many situations.

The common approach contemplates that US CCPs seeking recognition in the EU will have to provide in their rules for two day margin on clearing members' proprietary accounts as a condition of equivalence. The common approach does not specifically address customer accounts, presumably pending the conclusion of the consultation on customer account margin.

Countercyclical Buffer

EMIR requires a CCP to establish transparent and predictable procedures for adjusting margin requirements in response to changing market conditions. In doing so, CCPs are required to employ at least one of a number of options including applying a margin buffer at least equivalent to 25% of the calculated margins which it allows to be temporarily exhausted in periods where calculated margin requirements are rising significantly. By contrast, the US regime does not contain such a specific or numerical procyclicality buffer. The common approach announcement states that US CCPs seeking recognition will need to have internal margin models that include measures to mitigate the risks of procyclicality, although the specific terms of this requirement remain to be seen.

"Cover 2" Default Requirements

Under EMIR, CCPs are required to maintain default resources sufficient to cover a default by the two largest clearing members (**Cover 2**). Certain US CCPs are only required to maintain default resources sufficient to cover a default by the largest clearing member. The common approach announcement states that US CCPs seeking recognition in the EU will need to maintain Cover 2 default resources. However, because US CCPs that

⁶ For cleared swaps on a financial underlying asset, both the US and EU require a minimum five-day liquidation period for the margin calculation.

⁷ The consultation paper is available [here](#).

have been determined to be systemically important and those that have elected to be subject to additional standards (so-called “subpart C DCOs”) are currently required to satisfy Cover 2 under CFTC rules, this condition is unlikely to have a significant effect on most DCOs seeking recognition.

Exception for Agricultural Derivatives

The common approach announcement provides that these additional conditions will not apply to US agricultural commodity derivatives traded and cleared domestically within the US, in light of the nexus of these contracts with the US economy, the importance of the contracts to US agricultural providers and the low degree of systemic interconnectedness of agricultural products with the rest of the financial system.

CFTC Actions under the Common Approach

The common approach contemplates that the CFTC will implement a substituted compliance regime for DCOs to facilitate the ability of EU CCPs to satisfy “a majority of” DCO requirements through compliance with EU supervisory standards, although it is not clear at this stage which DCO requirements will fall into this category. The common approach does not appear to change the CFTC’s position that EU CCPs will still need to register as a DCO in order to provide clearing services in the US or to US clearing members and clients, but would reduce the compliance burdens of such registration by allowing such DCOs to comply with EU requirements instead of CFTC requirements. The CFTC has also stated it will streamline the registration process for EU CCPs seeking DCO registration.

How precisely the CFTC will implement the common approach has not yet been specified. In particular, it seems likely that the CFTC must prepare and propose a determination of comparability concluding that the EU requirements for CCPs are comparable to most of the regulatory framework for DCOs, and in the process identify any requirements that are not comparable. With respect to streamlining the DCO registration process for EU CCP registrants, it is unclear whether the CFTC would proceed by amendments to its rules or through an exemptive order or no-action relief. In any such actions, the CFTC will likely need to consider and address any concerns that the relief to be extended to EU CCPs could threaten the competitiveness of, or otherwise adversely affect the position of, US CCPs. In any case, the common approach contemplates that such actions will be undertaken within the same timeframe in which the European Commission is expected to adopt an equivalence decision for US CCPs and complete the process for their recognition under EMIR.

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