

EMIR - CROSS-BORDER CLEARING UPDATE

With mandatory clearing approaching in the European Union (EU), and in light of recent developments taking place with respect to US Clearing Houses, we have set out a summary of the current cross-border clearing status.

WHY IS THIS IMPORTANT?

As set out in our previous notes [here](#) and [here](#), the clearing of OTC Derivatives in the EU is coming into force for many entities at the end of this year. As such, certain cross-border OTC transactions may become subject to mandatory clearing obligations in both the EU and another jurisdiction, such as the US, which has implemented its own mandatory clearing rules. As a transaction can only be cleared at one Central Counterparty (CCP)¹, then unless clearing on that CCP is acceptable under both jurisdictions' regulatory rules, any cross-border transaction would mean that the parties to the transaction subject to both regulatory regimes would be in breach of the other regulatory clearing regime applicable to it. This would severely disrupt cross-border OTC derivatives and fragment the market, a result that global regulators are keen to avoid.

HOW IS THIS CROSS-BORDER ISSUE DEALT WITH UNDER EMIR?

In order to prevent this fragmentation of the market, the European Commission (the **Commission**) may recognise that the legal, supervisory and enforcement framework of a third country is equivalent to the relevant regulatory framework established in the EU. A declaration of equivalence by the Commission ensures that compliance with that third country's regulation and enforcement procedures will satisfy the corresponding requirements under EMIR². Where equivalence has been granted, then in relation to the clearing obligation, transactions cleared with a CCP regulated by a third country in accordance with its regulatory framework will be deemed to have satisfied the clearing obligation under both the relevant third country regime and EMIR.

Equivalence may be limited solely to individual obligations established under EMIR, for example the regulation of CCPs, as opposed to a general equivalence to the entirety of EMIR. There must also be a reciprocal procedure in place with the third country regime in order for a declaration of equivalence to be issued by the Commission, to ensure the effectiveness of equivalence as a solution to the cross-border concern.

WHAT STEPS ARE REQUIRED TO CLEAR ONCE EQUIVALENCE HAS BEEN GRANTED?

Following a declaration of equivalence issued by the Commission, and subject to the co-operation agreement referred to below, a

third country CCP that is authorised by its regulator may submit an application for recognition by the European and Services Markets Authority (ESMA). If recognition is granted, transactions cleared with that third country CCP are deemed to satisfy the requirements of EMIR.

Prior to applying for recognition, ESMA and the relevant third country regime's appropriate regulatory body are required under Article 25(2)(c) of EMIR to enter into a co-operation arrangement regarding the exchange of information, co-ordination of supervision, assessment and on-going monitoring of the third country CCPs' compliance with local law and into an agreement on mechanisms for the automatic notification to ESMA of local breaches by a CCP. Once the co-operation arrangements have been signed by ESMA and the third country regime, the relevant CCP can then apply to ESMA for recognition.

Once a CCP has been recognised by ESMA, then provided it offers the relevant asset class, that CCP can be used by market participants to clear their trades. Market participants will of course need to ensure that a clearing relationship with the clearing member is in place under the appropriate documentation (as yet, you cannot use US agency style clearing documents to access an EU principal style CCP).

RECOGNITION OF INDIVIDUAL CCPS

As noted above, the declaration of equivalence enables third country CCPs to apply for recognition by ESMA, contingent on there being a co-operation agreement in place between regulators and certain conditions being met by the CCPs. Upon recognition by ESMA, a transaction that clears at an ESMA recognised CCP will be deemed compliant with the EMIR mandatory clearing obligation.

As of the date of publication of this note, the non-EU countries that have had CCPs recognised by ESMA are Australia, Canada, Hong Kong, Japan, Mexico, Singapore, South Africa, South Korea, Switzerland and the US. Though the choice of US CCPs is still limited, with the Chicago Mercantile Exchange, Inc. being the only US CCP to be recognised by ESMA as of the date of publication of this note, there are a number of on-going applications awaiting recognition from ESMA (including CCPs from the US, Australia, Brazil, Canada, Chile, Dubai, Korea, Japan, Russia and Singapore), which has 180 days from the submission of a completed application to either recognise or reject an application by a CCP.

As an additional benefit, a recognised third country CCP will be treated as a qualifying CCP under the Capital Requirements Regulation, meaning that clearing members will have better capital treatment with respect to their exposure to the qualifying CCP once the implementation of the enhanced capital requirements for non-qualifying CCPs comes into effect on the 15 December 2016.

¹ Technically, it may be possible for parties to give their trades up to different CCPs if there were suitable arrangements in place between them. However this would; (a) seem contrary to the idea of central counterparties, and (b) require extensive legislative, operational and practical hurdles to overcome. We understand that some CCPs are looking into this.

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

This will result in lower margin requirements for clearing members' counterparties. This is because a clearing member is otherwise obliged to hold additional capital against their exposure to non-qualifying CCPs which the clearing member typically passes on to its clients; the additional capital is not required where the CCP is deemed to be a qualifying CCP.

RECOGNITION OF US CCPS

On March 15 2016, the Commission declared, in respect of CCPs registered in the US and regulated by the U.S. Commodity Futures Trading Commission (the **CFTC**), that the legal, supervisory and enforcement arrangements over US CCPs by the CFTC were equivalent to the regulatory framework established under EMIR. On June 2 2016, ESMA and the CFTC entered into a Memorandum of Understanding (**Memorandum**) with respect to the monitoring and compliance of CCPs.

The Memorandum is solely in respect of US CCPs and does not extend to the monitoring of CCPs regulated in the EU looking to register as a Derivatives Clearing Organisation (**DCO**) with the CFTC. In order for US CCPs to be recognised by ESMA, the following EMIR Conditions must be fulfilled:

- ◆ Risk Management
A US CCP must introduce risk management procedures to limit pro-cyclicality for the calculation and collection of initial margin.
- ◆ Capital Requirement
The US CCP must ensure that it maintains sufficient pre-funded assets enabling it to continue following the default of the two clearing members to which the CCP is most exposed.
- ◆ Initial Margin
For initial margin collected from clearing members' proprietary positions on non-OTC derivative contracts, the US CCP must ensure that initial margin is collected on a net basis with a two day liquidation period.

As noted above, Chicago Mercantile Exchange, Inc. has now been recognised by ESMA, meaning these conditions have been satisfied.

RECOGNITION OF EU CCPS BY THE CFTC

Looking at this from a US Dodd Frank perspective, for US entities that clear swaps with EU CCPs, the CFTC issued a determination of compatibility with EU CCP requirements on 16 March 2016 and subsequently published a no-action letter that provides relief from the application of CFTC regulations to discrete aspects of CCPs' non-US Clearing activities. Following this determination, an EU CCP registered as a DCO with the CFTC may clear transactions for US customers which will satisfy US regulatory clearing requirements.

As a result, a trade between a US Person under Dodd Frank and an entity subject to EU clearing should now be able to be cleared on a single CCP and comply with both regimes. The trade could be cleared on either an EU CCP registered as a DCO in the US or a US DCO recognised as a qualifying CCP in the EU. The decision as to which will depend on agreement between the counterparties, and the clearing member arrangements each has in place.

WHAT WILL BE THE IMPACT OF A BRITISH EXIT FROM THE EU?

This will be dependent upon the terms agreed between the EU and Britain during the exit negotiations. Should the exit terms enable Britain to retain access to the EU single market and allow for British firms to passport (the ability for firms authorised and regulated in one European Economic Area (**EEA**) state to carry on permitted activities in any other EEA state) into the EU single market, then a British exit from the EU would not impact upon the clearing processes outlined above.

Should Britain lose its ability to passport into the EU single market, for trades cleared at British CCPs to comply with the EU clearing obligation, British CCPs would be subject to the same processes as discussed above for other third party jurisdictions. The Commission would have to issue a declaration of equivalence with the British regulatory regime, and British CCPs would then need to submit an application to ESMA for recognition.

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SEPTEMBER 2016

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This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

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