Our position

Third-country aspects of financial regulation: the EU's evolving approach

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Introduction

Third-country regimes and the related supervisory and regulatory practices determining third-country treatment are a crucial pillar of the EU's financial services policy.

The American Chamber of Commerce to the EU (AmCham EU) has long supported strong and constructive cooperation between EU and US authorities in these matters, which we acknowledge has not always been without its challenges. We set out these views in our 2016 paper on 'Building a Transatlantic Capital Markets Union'.

The continued willingness to cooperate on both sides of the Atlantic on some of the most sensitive post-crisis reforms should be seen as a success for international regulatory cooperation, promoted by bodies like the G20, the Financial Stability Board (FSB), International Organization of Securities Commissions (IOSCO), Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS), amongst others. The hard-fought equivalence agreement between the European Commission and the Commodity Futures Trading Commission (CFTC) on Central counterparty (CCP) recognition is a case in point of this continued regulatory cooperation between the EU and the US.

Today, as Brexit negotiations unfold, EU policymakers are considering the future of EU regulatory cooperation with third-country jurisdictions.

In this paper, we outline our high-level views on the third-country aspects of the European Commission's 13 June **proposal on CCP Supervision ('European Markets Infrastructure Regulation 2.0'[1])**. **This proposal is one of the key aspects of a newly emerging EU approach on how financial firms access European markets from non-EU jurisdictions, which we believe will have consequences for transatlantic relations.**

Generally speaking, we welcome ESMA's enhanced role in supervision as well as the enhanced model of joint supervision for tier 2 CCPs. However transatlantic relations and the EU-US markets will potentially be strongly impacted if the EU approach goes down the route of negative recognition/forced relocation. We outline in this papers risk related to:

- **Uncertainty –** The proposed approach may have a destabilising effect on international capital markets.
- **Fragmentation –** There is a risk of liquidity splits leading to higher margin and default fund requirements.
- **Reciprocal action –** No other jurisdiction is currently pursuing a relocation policy.
- **Financial stability –** The proposal may lead to larger aggregate exposures to CCPs across the market through loss of netting.

To mitigate these risks, we believe **the right way forward is to pursue the route of joint/enhanced supervision for CCPs that are considered material for the EU**, without a possibility of forced relocation/negative recognition.

[1] The 13 June 2017 Commission proposal to amend EMIR's provisions as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs (2017/0136(COD)).

Although we focus on CCP supervision in this paper, we also recognise the close link with the-third country aspects of the European Supervisory Authorities (ESAs) review[2].[3] AmCham EU generally supports the centralisation of powers as long as it stimulates a model of 'supervisor/regulator of reference' which facilitates coordination of the transatlantic regulatory relation and brings clarity to the EU's diverse supervisory landscape.

However, we have concerns over some of the aspects of the ESAs review proposals. In particular, **we urge policymakers to use the drive towards supervisory convergence as a tool for openness of the EU market, and avoid it becoming a tool for fragmentation.** In this respect, we are most concerned over the perceived push against **delegation/outsourcing and risk transfers to third countries**. While we understand the need to ensure that management companies have sufficient substance on the ground (risk management, oversight and compliance), restricting the ability to delegate portfolio management undermines the open nature of European funds frameworks and may hurt the attractiveness of the EU market, as well as its successful UCITS (Undertakings for Collective Investment in Transferable Securities) brand.

CCP Supervision – third country aspects

On 13 June, the European Commission published its proposal on CCP oversight, which proposes new supervisory rules and powers over EU and non-EU-based CCPs.

The proposal does not go as far as explicitly referencing 'relocation' of non-EU CCPs to the EU. Instead it proposes new powers to the European Commission to issue 'negative recognition decisions' for non-EU CCPs that are deemed of 'substantial systemic significance'. We understand such a decision would *de facto* require the relocation of a non-EU CCP to the EU if it wishes to continue providing services to EU counterparties.

This proposal will impact non-EU based CCPs, clearing members, and of course end-user investors, including several AmCham EU members. It could potentially re-open the EU-US CCP equivalence agreement that took a long time and much political capital on both sides to put in place with the CFTC.

The derivatives markets are global in nature. In order to operate smoothly and efficiently, they require global convergence in supervisory approaches. We urge policymakers not to pursue an inward-looking approach that would lead to the creation of incentives for reciprocal action, increase market uncertainty, impact financial stability, and fragmentation.

Risks of reciprocal action by other jurisdictions

The European Commission's proposal for EU authorities to potentially resort to forced relocation of CCPs within the EU is a highly material change to the global regulatory response to the financial crisis, and could invite other jurisdictions to rethink their relationship with the EU.

This, together with the proposed two-yearly review process of equivalence decisions, could create a climate where reciprocal action from other jurisdictions could be triggered, most notably from US regulators.

In a sign of how this may be reciprocated by US agencies, Chris Giancarlo, Chairman of the CFTC, said in May: '*Given the closeness of the US and European derivatives markets, what Europe chooses to do on the supervision*

[2] The 20 September 2017 Commission proposal to amend the founding Regulations of the European Supervisory Agencies, which is accompanied by proposals for targeted revisions of other crucial financial services legislation (2017/0230 (COD)).

[3] In this paper we only comment on the delegation and equivalence aspects of the ESAs review proposal. This does preclude AmCham from having views on other aspects of the ESAs review.

of CCPs undoubtedly will inform the evolution of US regulatory policy for cross-border swaps clearing.'[4] Yet, the current European Commission proposal to amend EMIR has the potential to reopen our agreement.

Uncertainty

EU policymakers should take into account the destabilising effect that legal and business uncertainty would bring to the international capital markets.

The extreme option of relocation, exacerbated by the large discretion of EU authorities over this decision in the Commission's proposal, would create strong and continued market uncertainty.

The lack of framing as to how and when CCPs would be classified as systemically important, or of substantial systemic importance (and potentially be required to relocate to the EU in order to serve EU counterparties) creates uncertainty for the market. This could lead to market participants having to take early action based on an analysis of the worst-case scenario, which could lead to significant unnecessary expenditures on contingency arrangements and may not lead to the best outcome for the overall market structure over the longer term.

The two-yearly equivalence review process would also create an environment of 'short-term' thinking in the markets. This is particularly problematic as clearing members are required to tie in significant levels of regulatory capital as well as capital expenditure into the CCP, and having long-term certainty over the regulatory environment facilitates making long-term capital commitments.

Fragmentation

Cross-border market fragmentation could heighten financial stability risks and would negate or reduce the intended benefits of reforms to the derivatives markets agreed by the G20 leaders following the financial crisis, with the goal of making markets more transparent and resilient.

In particular, any loss of netting and trade compression could lead to larger aggregate exposures to CCPs across the market and less efficient risk management.

The denial of recognition to a non-EU CCP will render that CCP inaccessible to EU27 counterparties, which will restrict them to what is likely to be a smaller liquidity pool. There would only be one CCP accessible to EU27 counterparties for certain products subject to the clearing mandate, meaning there would be no a back-up CCP available. The splitting of liquidity pools could also lead to lower market liquidity in stressed periods.

Higher costs – especially through higher initial margin and default fund requirements under EMIR – could result from portfolios being split across one or more CCPs, particularly during a transition period. A range of estimates have been published in a number of industry studies, which vary depending on underlying models. Nevertheless, any increase in costs would reduce access to clearing and would be borne by end-users and clearing members in the EU and beyond.

Financial stability

We understand the Commission's concerns about the systemic significance of non-EU CCPs for the EU financial stability and are supportive of an enhanced comprehensive approach to supervision of CCPs (as we develop further in our paper). However, the forced 'relocation' tool does not appear to respond to EU policymakers' concerns over preserving financial stability.

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[4] Remarks by Acting Chairman J. Christopher Giancarlo before International Swaps and Derivatives Association 32nd Annual Meeting, Lisbon, Portugal, May 10,2017: (available here)

Indeed, if forced relocation of CCPs leads to fragmentation, that in turn would diminish the number of market participants around one CCP – and hence reduce the 'shoulder bearing' capacity of that CCP in difficult times, further concentrating risks in the hands of a smaller number of market participants. All those outcomes will not help preserve financial stability.

More practically, any requirement to transfer positions from one CCP to another would need to be coordinated across the market and would create significant challenges for market participants, particularly given differences in governing law and jurisdictional provisions. For instance, different CCPs may not offer or have authorisation for the same contracts and may not have the same clearing members. Client positions would also need to be moved, requiring client communication and consent. This process would be highly complex. The market would require time for the planning and implementation of a transfer of this scale.

Enhanced joint oversight of CCPs is therefore a more appropriate way forward

The EU should pursue the route of joint/enhanced supervision for CCPs that are considered material for the EU.

This approach will offer effective risk mitigation without fragmenting markets, and could address financial stability concerns associated with CCPs without resorting to the threat of *de facto* relocation. Stepping away from the relocation approach will also significantly reduce the risks of reciprocal action by other jurisdictions (including the US), while also reducing market uncertainty.

In essence, this approach is in line with the spirit of the European Commission's approach for 'systemic' tier 2 non-EU CCPs in its June proposal. An essential component of the Commission's approach for these CCPs is 'comparable compliance' which offers the possibility for third-country entities to be exempted from applying EMIR's prudential requirements if the home jurisdiction is deemed comparable. This aspect is a crucial component of a joint supervision approach. We would still recommend a number of minor changes to the proposed approach:

- **Clearer definition of what is 'tier 2'** – Designating a firm as systemic should be clearly defined to avoid market uncertainty.

- **Asset class level rather than CCP level** – The assessment of the systemic nature of CCPs' activities should be conducted at an asset class level, not at the CCP level.

- **Comparability with CFTC rules** – In order to avoid reciprocal action from the US, the EU rules on enhanced oversight should strongly mirror those of the US CFTC. Most notably, the CFTC does not require non-US firms to register (or obtain an exemption from registration) from the CFTC. The CFTC oversight also only pertains to products cleared for US persons, and therefore not necessarily to the entire CCPs. We view this approach as more proportionate than that suggested by the European Commission.

Global examples of enhanced supervision/safeguards

Clearing derivative transactions outside the home jurisdiction of the currency it is denominated, or the home jurisdiction of the counterparties to the trade, in is by no means a unique European/Eurozone practice. In many jurisdictions, these practices are supported by cross-border supervisory arrangements similar to those proposed by the European Commission, as well as by central banks swap lines.

- The CFTC's framework for oversight of non-U.S. CCPs does not require CCPs providing access to U.S. customers to be located in the US. Instead non-US CCPs performing swaps clearing for US persons register with the CFTC and provide the CFTC with access to certain data and ability to make onsite visits as needed. According to CFTC Chair Giancarlo, this supervisory framework allows the CFTC to "monitor risk by entity and across markets providing an appropriate level of oversight for each of our registered CCPs." (Remarks of CFTC Chairman J. Christopher Giancarlo before the Eurofi Financial Forum, September 14, 2017)
- Many Asia-Pacific currencies are also successfully cleared in foreign CCPs, despite differences in time zone, language and law.

The benefits of coordinated oversight and deference have been recognized by the G20 leaders who stated in September 2013: '*[…] jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes*.'*

*G20 Leaders' declaration, St Petersburg, September 6, 2013: (available here)

ESAs review - Delegation, outsourcing and risk transfers

We welcome the European Commission proposal to review the ESAs framework, seven years after the creation of the ESAs, which overall we consider to be a success.

This paper focuses only on the proposal's suggested changes to delegation/outsourcing/risk transfers, and therefore does not address some other crucial aspects of this review that may impact our members.

Overall, we welcome an enhanced role of the ESAs in third-country decision-making processes. It will increasingly elevate the ESAs (particularly ESMA) as a go-to regulator in Europe, which has the potential to streamline the EU's scattered supervisory and regulatory landscape. Supervisory convergence in the EU should be urgently fostered, especially in the context of both the impeding Brexit, the Capital Markets Union project and, for the banking sector, the work towards completing the Banking Union and fostering the single rulebook.

Delegation, outsourcing and risk transfers

The European Commission's proposal includes a stronger coordinating role for ESAs with regard to **delegation, outsourcing, and risk transfer arrangements** to third countries authorised by National Competent Authorities (NCAs). According to the European Commission's proposal, the ESAs would be able to make recommendations on delegation, outsourcing and risk transfer arrangements addressed to Competent Authorities, including to review a decision or to withdraw authorisation. If a recommendation is not followed, the Competent Authority needs to state its reasons, which will be made public.

These provisions are of significant importance to our members as these practices are widely used in a variety of financial services sectors, including banking, insurance and asset management.

AmCham EU has strong concerns over the perceived attempts to restrict these arrangements by EU policymakers and regulators (the June ESMA and EIOPA opinions on relocation also hinted at this), as we believe they provide strong value to the EU financial sector and its customers, while not jeopardising financial stability:

- **Difference with equivalence –** Allowing firms to delegate/outsource to a third country does not equal treating that third country as equivalent. All entities and arrangements are directly overseen by EU supervisors at all times, and none of the requirements are waived. This means that the EU supervisor retains oversight of the delegator/outsourcer as well as the terms of the activity.

- **EU industry and end-users may be hurt –** The more restrictions to pooling capital and expertise across borders are put in place, the more restrictions for financial companies to deliver value for the end client arise. A good example is the potential impact on Undertakings for Collective Investment in Transferable Securities (UCITS) funds, one of the EU's main success stories in financial services. The success of the UCITS brand depends on the ability for UCTS managers to benefit from expertise from all over the world. The success of the UCITS brand in turn helps attract investment in the EU, including from the US.

- **Possibility of reciprocity –** There is a risk that restrictions to delegation and outsourcing will lead to reciprocal action from other jurisdictions. This could have material consequences for the EU, as e.g. many US asset managers manage US assets from the EU.

- **No market failure –** We are not presented with a market failure where additional scrutiny is called for with regard to third-country delegation. Delegation has worked extremely well historically and has been critical in making UCITS not just a European, but a truly global success story. Singling out third-country delegation among the many other practices and activities of funds, could cast this practice in a negative light unjustifiably. This risks sending mixed messages to the US and other jurisdictions around the globe about the openness of UCITS as a product and the EU as a jurisdiction. This would come at a time when UCITS are facing increasing competition from new cross-border fund frameworks being developed especially in Asia.

- **Existing tools –** ESMA has a number of existing tools at its disposal to monitor third-country delegation. They ensure it is up to standard and companies do not operate out of empty shells. An ESMA opinion published in July called for the set-up of a new working group to give greater scrutiny in additional to peer reviews. These new constructs are as yet untested.

Role of ESAs in third-country equivalence regimes

The European Commission proposes an enhanced role for the ESAs in third-country equivalence decisions, both *ex-ante* and *ex-post*.

Most notably, the ESAs would be able to continuously 'monitor regulatory and supervisory developments and enforcement practices and relevant market developments' in third countries for which equivalence decisions have been adopted. This would be done on the basis of administrative arrangements with those countries. On the basis of this monitoring, the ESAs would be able to file annual confidential reports to the European Commission.

Overall, AmCham EU supports this approach as it could facilitate dialogue between EU and US regulators, however:

- **ESAs reports on third country jurisdictions should be made public –** In order to ensure transparency and foster predictability for the industry, annual reports should be made public.

- **Clarity over what to monitor –** The concept of monitoring 'relevant market developments' is vague and arguably open to arbitrary interpretation. The monitoring mandate should focus only on 'regulatory and supervisory developments and enforcement practices'.