London Stock Exchange Group response to the European Commission proposal for a regulation amending EMIR (Part II – Supervision of EU and third-country CCPs)

Introduction

London Stock Exchange Group ('LSEG' or 'the Group') is a financial market infrastructure provider with significant operations in Europe, North America and Asia. Its diversified global business focuses on capital formation, intellectual property and risk and balance sheet management. LSEG operates an open access model, offering choice and partnership to customers across all of its businesses.

LSEG operates multiple clearing houses. It has majority ownership of the multi-asset global CCP operator, LCH Group ('LCH'). LCH has subsidiaries in the UK (LCH Ltd), France (LCH S.A.), and the US (LCH LLC). LCH Group is a leading multi-asset class and international clearing house serving major international exchanges and platforms as well as a range of OTC markets. It clears a broad range of asset classes, including: securities, exchange-traded derivatives, commodities, energy, freight, foreign exchange derivatives, interest rate swaps, credit default swaps and euro, sterling and US dollar denominated bonds and repurchase agreements ('repos').

In addition, LSEG operates Cassa di Compensazione e Garanzia S.p.A. ('CC&G'), the Italian clearing house, providing clearing services for a range of European securities as well as exchange traded equity and commodities derivatives.

In this context, LSEG welcomes the opportunity to respond to the European Commission legislative proposal amending EMIR relating to the supervision of EU and third-country CCPs, leveraging from its experience supporting the operations of the CCPs of the Group in Italy, France and the UK.

I. GENERAL REMARKS

1. Supervision of EU CCPs

- **Overall supervisory structure** - LSEG agrees that it is essential to maintain the right level of supervision by National Competent Authorities ('NCAs'), in order to appropriately take into account the different models of local supervision and the diversity of European CCPs. Equally, we understand that the European Commission's (the 'EC' or the 'Commission') view is that further centralised supervision would reinforce consistency and supervisory convergence. From that perspective, and if EU regulation was to move to a more centralised model, we agree that ESMA would be the best placed entity to lead this task, provided that improvements are implemented relative to the current framework in particular in terms of skills, competences and communication with CCPs. In addition any new regulatory framework should allow for increased transparency of the policy decision process and ensure robust information sharing and communication arrangements.
- **Complexities of the proposed supervisory structure** - Certain aspects of the approval process proposed by the Commission seems too complex, and could create unnecessary delays and administrative burdens, both for the CCPs and the authorities: the adoption of supervisory decisions should be streamlined and not require approvals from four different supervisory bodies following four separate decision making processes. The input should be centralised and allow for direct communication between the CCP and the authority responsible for the adoption of decisions structuring its activities. This should also facilitate clear accountability for the decisions taken: clear lines of responsibility need to be defined and the proposed structure does not seem to allow for this.
- **New timelines for Article 49** - LSEG welcomes the EC proposal to impose timelines for the approval of significant changes to risk models and parameters under Article 49 of EMIR. This is essential in order to ensure a smooth and efficient supervision that encourages CCPs to continuously improve risk modelling in order to adapt to market needs and evolution.

2. Supervision of third-country CCPs

LSEG is fully supportive of a structured and constructive discussion around the efficiency of supervision, the strengthening of regulatory cooperation, disclosure and transparency, especially for internationally integrated businesses which bring material benefits to users in multiple jurisdictions, including in the EU. We believe that internationally integrated markets served by internationally integrated services need internationally integrated supervision.

The principles supporting this discussion should be consistent with the work undertaken in the last decade by the Financial Stability Board ('FSB') and its member jurisdictions to promote **cross-border arrangements between jurisdictions to enhance financial stability in the derivatives market**. Regulators and governments around the world, including the European Commission, are regularly emphasising **the need to use deference mechanisms, as agreed by the G20 Leaders, '*in order to avoid regulatory gaps, duplication, conflicts and inconsistencies which can lead to regulatory arbitrage and market fragmentation*[1]'.** This approach has been championed by the European Commission through EMIR equivalence processes allowing thirty-two CCPs established in third-

[1] See G20 Leaders' St Petersburg Declaration of September 2013 (paragraph 71): '*We agree that 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 regulatory regimes*.', as well as the G20 Leaders' Brisbane declaration of November 2014 (paragraph 12): '*We call on regulatory authorities to make further concrete progress in swiftly implementing the agreed G20 derivatives reforms. We encourage jurisdictions to defer to each other when it is justified, in line with the St Petersburg Declaration'*.

countries to offer services and activities in the European Union (the 'Union')[2]. Over the last decade deference has been constantly and consistently called upon by governments and regulators that have adopted numerous deference decisions across jurisdictions, including by the EU, Hong-Kong, Japan, Mexico, Singapore, Switzerland and the U.S.[3].

This approach to deference has very recently been confirmed by the U.S. Department of Treasury in its Capital Markets Report[4] which recommends '*clarity around the cross-border scope of CFTC and SEC regulations and make their rules compatible with non-U.S. jurisdictions where possible to avoid market fragmentation'*, and recommends '*that effective cross-border cooperation include meaningful substituted compliance programs to minimize redundancies and conflicts'*[5].

We would therefore urge the European Commission to adopt a proportionate approach when revising its third country framework in order to remain consistent with these internationally agreed principles and the development of practices of its peers.

More specifically, concerning the **framework** for the third country regime proposed by the EC, LSEG would like to make the following remarks:

- **Definition of systemic nature** - In defining the systemic importance of a CCP due consideration should be given to the different types of risks CCPs activities represent for the Union and the effects that CCPs day-to-day risk management, default management, recovery or resolution of specific activities would have for the Union specifically. The Commission proposal should be more precise in framing ESMA assessment of the systemic importance of a third country CCP.
- **Level of assessment** - In order to reflect the need to supervise certain market segments that are of specific systemic relevance for the Union, the assessment and recognition processes should be more granular. Indeed, we suggest this assessment to be conducted at the level of the CCP clearing service, activity or class of financial instruments and not at the level of the entire CCP. This would better address the concerns of the EU authorities, whilst ensuring that all EU members or EU clients who need to use a service to cover their risks are in a position to do so under the best conditions of safety and efficiency. Because of the very nature of the products cleared, CCP clearing services have completely different profiles and need different supervisory solutions. Contrary to cash settled OTC derivatives which are commercial tools used for hedging real economy risks, **some products such as EU sovereign debt repos play a direct role in the central banks' monetary policy operations which make them of particular importance for the EU.** Likewise, services clearing products with higher liquidity needs and which closure could have spill-over effects on the broader market could justify **heightened oversight from central banks of issue and specific cooperation between regulators**. This should be reflected in the Proposal, in line with the practice of other jurisdictions around the globe (e.g. U.S., Australia, Canada), as well as with EMIR authorisation process and risk management requirements, specifically reinforced when the CCP employs segmented default funds and segmented capital for each asset class it operates[6].
- **Transparency of recognition and equivalence processes** - LSEG encourages further transparency in the decision making processes: (i) leading to the determination of the systemic importance of a third country CCP for the EU and (ii) linked to the recognition of third country CCPs, including the decision to refuse the recognition of a third country CCP. This

[2] As of 9 October 2017 - https://www.esma.europa.eu/sites/default/files/library/third-country_ccps_recognised_under_emir.pdf
[3] FSB OTC Derivatives Market reforms – Twelfth Progress Report on Implementation – 29 June 2017. http://www.fsb.org/wp-content/uploads/P290617-2.pdf
[4] https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.
[5] Cross-border issues - Pages 134 and 135.
[6] http://www.lch.com/documents/731485/762448/ccpriskmanagement_whitepaper.pdf/4afc698a-2538-4f5b-b7fa-b8ade2dd594a

transparency towards regulated entities would further contribute to the predictability of any decision and ensure that the feedback received is duly taken into account before adopting any decision.

Concerning the **regime** proposed by the European Commission for third country CCPs, LSEG would like to make the following remarks:

- **Direct supervision and application of EMIR** - LSEG supports the Commission proposal that Tier 2 CCPs would have to directly register with ESMA and be subject to ESMA supervision as well as be compliant with the relevant prudential requirements under EMIR. We believe that direct registration allows a closer relationship with local regulators and clients and better protects financial stability. Throughout the development of its clearing services LCH Ltd has chosen to operate a direct registration model to serve its clients in the jurisdictions where this option was available. LSEG is and remains a strong supporter of the robust EMIR framework, which appropriately protects CCPs, their members, clients and the broader financial system against financial distress and has proven efficient in doing so through the most recent financial shocks.
- **Enhanced supervision of third country CCPs** - In principle, LSEG is fully supportive of the work undertaken by regulators and governments around the world, including the European Commission, to promote the use of deference mechanisms, as agreed by the G20 Leaders. In the specific cases where deference might not be deemed sufficient, LSEG is supportive of enhanced supervision of third country CCPs, and would welcome more concrete discussions on what it would entail. We believe that some agreements will need to be reached *ex ante* between the main authorities of the internationally integrated clearing services. These cooperation arrangements should ensure a stronger day-to-day supervision and a foundation for recovery and resolution mechanisms ensuring (i) strong cross-border effectiveness and enforcement of resolution actions as well as (ii) global regulatory coordination both in the drawing and activating of recovery and resolution plans, in line with the recent report of CPMI-IOSCO and the Financial Stability Board. The EC Proposal should be more specific on these aspects.
- **Duplication of recognition processes** - The EC proposes to maintain the current equivalence regime - including the adoption of an equivalence decision - as a pre-condition for the process of recognition for Tier 2 CCPs. This assessment of the third country regime by the EC seems an unnecessary pre-condition, as the Tier 2 CCPs will already be directly subject to EMIR requirements and ESMA direct supervision. In addition, it duplicates the ESMA comparable compliance process that allows ESMA to conduct such assessment. We suggest a strict separation between the equivalence regime (that should be applicable for Tier 1 CCPs only) and Tier 2 direct registration processes in order to ensure a more proportionate and streamlined third country regime, and avoid unnecessarily duplicative procedures by the EC and ESMA. These procedures should be alternative and not cumulative.
- **Denial of recognition ('location policy')** - LSEG and its customers are deeply concerned about the ability of ESMA and the central banks of issue to recommend that the Commission denies the recognition of third country CCPs of substantial systemic importance. The lack of transparency and predictability of such a proposal, and the actual effect it could have if it was to be adopted, are of particular concern. Denying EU markets access to third country CCPs despite the fact that these CCPs would directly comply with EMIR and be supervised by ESMA would not be a proportionate requirement. This would create undue market fragmentation, imposing EU customers to exclusively use CCPs established in the EU even in the case where they might prefer using another service, cutting them off from global markets and corresponding liquidity and efficiencies.
    - **The creation of an EU captive market** - LSEG has performed a detailed impact analysis in order to estimate the likely impact that a denial of recognition ('location policy') would have across the ecosystem in terms of market fragmentation and

increased costs for clearing members and clients. In the Interest Rates Swaps ('IRS') market, the LCH Ltd service SwapClear impact analysis shows that a denial of recognition covering the full portfolio cleared by EU institutions would very likely create a small local captive EU based liquidity market representing approximately 14% of SwapClear activities (the volumes of Euro-denominated IRS originated by EU firms represent 7% of SwapClear volumes, IRS originated by EU firms in all other currencies represent another 7% of SwapClear total volumes: this policy would therefore create a EU captive liquidity pool for both the Euro and other currencies). Being caught in this captive market would be detrimental to EU based customers as this means that they would have a limited choice of infrastructures to hedge their risks with or fulfil their clearing obligation and not be able to access international liquidity (approximately 86% of SwapClear activity). Confronted with fewer offers of clearing services (and beyond this client clearing services), clearing members and clients would suffer from higher costs and systemic risks. A captive market would also imply a reduced number of counterparties available to conclude transactions and therefore a reduced capacity for EU clearing members and clients to find counterparty willing to enter into a contract allowing the EU counterparty to hedge its risks.

- **Impact of a denial of recognition on execution costs -** The additional costs that SwapClear's EU members and clients would face per annum for each basis point of worsening execution prices (when compared to today's price) because of a European regulation forcing EU firms out of global liquidity for IRS in all currencies, would be approximately $25 billion. This would be a continuous, ongoing cost, recurring every year, resulting from structurally deteriorated market conditions. As it is a recurring cost, should the structural imbalance remain over a five year period, this could amount to $125 billion.
- **Impact of a denial of recognition on financial stability -** A denial of recognition ('location policy') would increase systemic risk caused by weakening the default management process: we estimate that in a number of default scenarios, the assessments faced by clearing members would be three times higher when the pool is fragmented following a denial of recognition/location policy in comparison with the current pool. In addition, this would create financial stability risk associated with splitting and migrating liquidity from one CCP to another.

A denial of recognition ('location policy') would, therefore, give rise to an ongoing punitive effect on EU market participants which will have less choices and face higher costs, contradicting the EC legitimate objectives expressed in the Capital Market Union action plan.

In addition, when discussing these elements, we would suggest keeping in mind **the effects of a restriction based on euro-clearing on the perception of the Euro as an international currency**. Indeed, the trust in the stability and value of the Euro is a driving factor in its use as an international trading and reserve currency bringing several benefits to the EU and Member States' economies, such as **reduced borrowing rates for business and governments across Europe or reduced trading costs**. A policy potentially restricting the use of the Euro currency risks affecting investor and market confidence in the Euro as a currency, which could affect its status as a global currency. There is a risk that, by undermining the position of the Euro and reducing the benefits that come with it, such policy has wider consequences if it is seen as a shift towards a more local use of the Euro currency.

Therefore, based on the LCH Ltd experience of serving clients in multiple jurisdictions, **we consider that a set of alternative requirements could provide EU authorities with the tools to appropriately monitor the risks third country CCPs manage in the EU market**. As described in this submission, these mechanisms should build on (i) the direct application of EMIR by third country-CCPs systemic services and (ii) the direct supervision of third country CCPs systemic services by EU authorities, developing the appropriate cooperation arrangements.

II. SPECIFIC COMMENTS

1. Supervision of EU CCPs

LSEG welcomes the Commission's objectives to streamline the current supervisory arrangements for CCPs established in the EU. As noted by the Commission, it is essential to promote a level playing field amongst the European CCPs, as well as ensure homogeneity in the application of EMIR across the EU[7]. We support the objectives of the Commission concerning the supervision of EU CCPs, but we believe that some areas could benefit from further adjustments in order to improve their efficiencies and better fulfil the Commission's objectives. We are pleased to share some recommendations below.

1.1. ESMA supervisory responsibilities

The proposal provides that National Competent Authorities ('NCAs') will continue to exercise their current supervisory responsibilities under EMIR. It also includes increased supervisory responsibilities for ESMA, notably through the creation of the CCP executive session, corresponding tasks and powers[8], while maintaining the existing CCP supervisory colleges. In addition, the Proposal introduces new powers for central banks of issue to review NCAs decisions on an extensive number of issues.

LSEG agrees that it is important to strike the right balance between local supervision and supervision at EU level. We believe that such balance will continue to contribute to increased supervisory convergence and consistent application of the EMIR requirements by EU CCPs, while accounting for the diversity of CCPs operating within the EU.

We agree that it is essential to maintain the right level of supervision by NCAs, in order to appropriately take into account:

- **The different models of local supervision**. Contrary to banks, where central banks are the NCAs in charge of banking supervision, Member States have various supervisory models for CCPs, including supervision by central banks, financial market authorities and ministries of finance, or a combination of these entities. These different models reflect the fiscal responsibilities of the relevant authorities of the Member State in which the CCP operates, and should, therefore, be preserved.
- **The diversity of European CCPs.** A wide variety of CCPs are currently operating in the EU, with significant differences in terms of activity (local vs. cross-border), membership structure, markets served, and scope of products cleared. The NCAs are the authorities the most familiar with the day-to-day operations of their domestic CCPs, and have acquired a deep knowledge of the market participants, products and activities of the CCPs they supervise.

In light of the above, we agree that NCAs should remain the primary supervisory authorities for CCPs, and we welcome the fact that it is still the case under the Commission's proposal. The supervision of CCPs by their NCAs has proven to be an effective approach, especially as it is complemented by a supervisory college, which is an efficient mechanism to ensure the balance of interests of all relevant market participants and Member States. In addition, ESMA actively contributes to foster supervisory

[7] Commission Proposal – Explanatory Memorandum, page 14, first bullet point.
[8] Commission Proposal - Article 1(7) – page 40 inserting Articles 44a, 44b and 44c.

convergence and harmonisation of EU CCP supervision, for instance in conducting peer reviews or publishing opinions, guidelines and Q&As. Therefore, we respectfully wonder whether the structural changes provided in the proposal are required and what they bring to the effectiveness and harmonisation of CCP supervisory practices.

We understand that the European Commission's view is that further centralised supervision could reinforce consistency and supervisory convergence. From that perspective, and if EU regulation was to move to a more centralised model we believe that in the current EU regulatory architecture ESMA could be the best placed entity to lead this task, in addition to its current responsibilities on the matter.

To be supported by the industry, we think it is crucial that any revision of the current supervisory framework to incorporate additional EU-wide considerations in CCP supervision is designed in a way that constitutes an improvement from the current framework in meeting the following objectives:

- **Ensure a level playing field**, both at the international and European levels. It is key to promote the global reform of derivatives markets and the CCPs that sustain them, maintain financial stability, and ensure international consistency at proportionate cost for market participants, in line with the Capital Market Union objectives[9]. We agree with the Commission that EMIR is a robust and proportionate framework and would not necessarily consider it beneficial to introduce a different level of supervision in EMIR.
- **Ensure CCPs competitiveness**: All the authorities, including ESMA in its current or potentially expanded role, should contribute to the competitiveness of European CCPs, across the EU and globally. Such competitiveness, including reasonable time to market, should be enshrined in ESMA missions, as it is for many NCAs. Examples of enhanced CCP competitiveness include allowing a carefully conducted while reactive assessment of CCPs' improvements of their product range and risk modelling. The assessment process should only require a proportionate number of approvals, and be subject to clear and transparent binding timelines. ESMA should, as a crucial objective, ensure that CCP improvements and adaptation to market risks are not impeded in any way, provided that it is done soundly.
- **Provide increased transparency**: A transparent policy decision process and appropriate communication of policy decisions are essential to ensure a common understanding and consistent application of the EMIR requirements. Therefore, we would encourage ESMA to intensify its activities in relation to: (i) consultations with relevant industry stakeholders, authorities or dedicated working groups on CCP policy matters; and (ii) the development of publicly-disclosed guidelines relating to interpretation and implementation of EMIR requirements. In order to provide clarity, ESMA should have the statutory duty under the ESA regulation (as modified by EMIR) to conduct a public consultation process similar to the one applying to regulatory and implementing technical standards for all its guidelines, opinions and Q&As. Policies adopted by ESMA should be clearly stated and shared with CCPs when they affect them. This transparency towards regulated entities would further contribute to the success of the Regulation.
- **Include robust information sharing and communication arrangements**. We recommend the implementation of methods to facilitate multilateral discussions between ESMA, the CCPs and their NCAs, to further increase the level of coordination and the efficiency of the decision making process on CCP supervisory matters.
- **Ensure the appropriate level of resources**: it is central to ensure that ESMA benefits from adequate resources. This includes staff with the specific skills and competences needed to ensure ESMA new functions over CCPs.

These elements would allow ESMA, NCAs and CCPs to ensure a sound and safe supervisory environment and should be reflected in the Commission Proposal.

[9] Commission Proposal – Explanatory Memorandum, page 9 paragraph 1.3.

1.2. Approval process

LSEG welcomes the Commission's objective to streamline the supervision of EU CCPs. It is crucial that the new supervisory arrangements result in a smooth, efficient, and reasonably fast process for the approval of expansion of the CCPs' services or improvement to its risk models.

a. <u>New timeline for Article 49</u>

Indeed, market factors and the regulatory environment increasingly drive the use of central clearing and bring more market participants and products into clearing. Thus, CCPs must continue to upgrade their technologies and extend the range of products they clear to properly manage the systemic risks associated with specific asset classes. They must also continuously refine and improve their risk management frameworks to increase resilience and ensure commensurate margins, to the benefit of safer, integrated and efficient financial markets.

The approval process should, therefore, ensure a rigorous risk assessment of the changes and appropriate consultation of the relevant stakeholders, be subject to clearly defined binding timelines, and avoid duplication of supervisory tasks. Otherwise, an overtly complex and unnecessarily lengthy process would put European CCPs at a competitive disadvantage and discourage the safe process of continuously improving the product range and risk modelling. This would unhelpfully contrast with some third country jurisdictions where changes can be approved in a matter of weeks, using a self-certification regime.

In light of the above, we particularly welcome the inclusion of defined milestones and a maximum duration for the approval of significant changes to risk models and parameters under Article 49 of EMIR. We fully support this approach, which should be applied to all supervisory decisions. To be efficient, this approach should be supported by adequate allocation of staff and resources to the relevant authorities so they can support this revised process and meet the specified deadlines.

Furthermore, we agree that the CCP's NCA should have the ability, in consultation with ESMA, to allow for a provisional adoption of a significant change the CCP's risk models or parameters prior to its validation where duly justified[10]. We believe this could be accompanied by a fast-track approval of changes that: (i) are the result of supervisory reviews; or (ii) are unambiguously risk-reducing.

b. <u>Approval process</u>

However, certain aspects of the approval process in the Commission's proposal seem too complex, and could create unnecessary delays and administrative burdens, both for the CCPs and the authorities. Our main concerns are:

- **Increased complexity.** Under the proposal, many of the supervisory decisions would require three, and up to four, different approvals, which is an increase compared to the current regime. For instance, the extension of activities and services under Article 15 of EMIR currently requires an assessment by the NCAs and an opinion from the college. The proposed model increases the number of approvals from two to four by requiring: (i) a draft decision by the NCA; (ii) the consent of ESMA CCP executive session; (iii) the consent of the central bank of issue; and iv) an opinion from the college, in addition to the consultations imposed on the CCP. As such, the proposal would lead to an accumulation of supervisory opinions/decisions

[10] Commission proposal, Article 2(11). Page 60 inserting paragraph 1(e) in Article 49.

as well as duplications, as the same entities would potentially participate in the ESMA CCP executive session and the CCP supervisory college. These multiple interventions and approvals do not allow for clear definition of responsibilities. It, therefore, seems difficult to determine which authority will ultimately be accountable for the decisions taken.

This approach creates additional complexity, and is contrary to the objective to streamline the approval process. Moreover, the cooperation between NCAs, ESMA and central banks of issue should be fully recognised and reflected in a clear and efficient process. It is not the case with the multiple overlapping provided in the proposal, and seems contrary to the objective to promote regulatory convergence and a high level of coordination amongst authorities.

- **Duplication of tasks and supervisory overlaps.** The definition of supervisory tasks under the proposal is unclear. In particular, the tasks performed by ESMA and the college appear to be duplicative. In addition, some authorities participate several times in the decision making process, either in their own capacity or as members of the ESMA CCP executive session and the college, which may cause overlaps and redundant assessments.

We consider that the objectives pursued by the Commission would be better fulfilled with a more streamlined approach, and would therefore like to make the following recommendations for the approval process:

- **Supervisory decisions should not require approvals from four different supervisory bodies**: the system proposed seems quite duplicative and could be limited to (i) a draft decision by the NCA; and (ii) the consent of ESMA CCP executive session or the supervisory College. It might imply extending the participation to the CCP executive Session to include additional authorities and ensure a more active role for the central bank of issue to the CCP executive session. This consistent and proportionate number of approvals would create a more efficient and streamlined process as per the objectives of the Commission.
- **NCAs should retain their current supervisory responsibilities.** They would preserve local supervision which is essential to recognise the different supervisory models in the various Member States and the diversity of CCPs operating in the EU (as per our comment under section 1.1).
- **ESMA consent should be granted, where appropriate, in consultation with the relevant authorities and central banks of issue.** The need for consultation, or the authorities consulted would vary depending on the type of decision. The recommendation would be for ESMA to assess which stakeholders need to be involved for which *ad hoc* approval process, and to organise their consultation within the given timeline. Criteria for consultation and duration of the process should be clearly defined to ensure transparency and predictability. This approach would ensure appropriate involvement of all CCP stakeholders, alignment of supervisory actions, and increase the level of coordination amongst authorities without duplicating approval procedures.
- **The college role should be carefully assessed** in view of the establishment of the CCP executive session in order to avoid the risk of duplication and supervisory overlaps that contradicts the Commission's objectives.
- **Robust communication arrangements should facilitate bilateral and multilateral discussions between the CCPs, their NCAs, and ESMA.** This would enable CCPs to

provide their NCAs and ESMA with any relevant supplementary information in relation to the changes or improvements the CCPs intend to introduce. This approach would assist the authorities in making an informed assessment and facilitate the decision-making process.

- **Each step of the process should be subject to binding deadlines and the overall process should have a maximum duration**, in the same spirit as the amendments proposed for Article 49. The applicable timelines, defined *ex-ante* in clear and transparent rules, could vary depending on the type and complexity of the decisions. For instance, a slightly longer timeline could apply to the first authorisation of a CCP, while a shorter one would apply for the extension of the authorisation for new activities and services. This approach would be proportionate, promote a level playing field, both in the EU and internationally, and contribute to the competitiveness of EU CCPs.

NCAs should inform the CCPs at the end of the process of whether the validation has been granted or refused, and provide a fully reasoned explanation. This would ensure transparency, legal certainty, and allow the CCP to better prepare for the next round of validation.

We would therefore suggest amending the procedures and consultations proposed by the Commission to align it with its own objectives to streamline CCP supervision.

2. Supervision of third-country CCPs

We note the Commission's view that the current supervisory arrangements for third-country CCPs may need to be revisited and enhanced in light of the growing size, complexity and cross-border dimension of clearing in the European Union and globally, especially in light of the upcoming exit of the United Kingdom from the European Union[11].

LSEG, LCH Group and CC&G are fully supportive of a structured and constructive discussion around efficiency of supervision, strengthening of regulatory cooperation, disclosure and transparency, especially for internationally integrated businesses which bring material benefits to users in multiple jurisdictions, including in the EU. We believe that internationally integrated markets served by internationally integrated services need internationally integrated supervision.

On that basis, we would like to share our views and make some recommendation on the adjustments proposed by the European Commission for the supervisory arrangements for third-country CCPs.

2.1. Definition of systemic importance

The EC proposal does not define the notion of systemic importance. In its explanatory memorandum, the European Commission explains that '*large scale, uncontrolled termination and close-out of contracts cleared by CCPs could lead to liquidity and collateral strains across the market, causing instability in the underlying asset market and the wider financial system. Like some other financial intermediaries, CCPs are also potentially susceptible to 'runs' due to clearing members losing confidence in the solvency of a CCP. This could create a liquidity shock for the CCP as it attempts to meet its obligations to return the principal collateral (i.e. initial margin)*[12]*.*'

[11] Commission Proposal, Recital 4.
[12] Commission Proposal – Explanatory Memorandum, page 4 paragraph 1.1.

These elements, which seem to underline the considerations for the systemic importance of a CCP, are not reflected in the text. In particular, in line with recent ECB comments this seems to relate to liquidity issues which seem much more acute in the context of the clearing of some products. We would therefore suggest introducing a clear definition of systemic importance which would frame ESMA assessment pursuant to Article 25 (2a) and (2c) and allow clarifying the type of systemic risks aimed by the Commission Proposal in line with the points made below. In particular, in defining the systemic importance of a CCP, due consideration should be given to the different types of risks its activities represent for the Union and the effects that day-to-day risk management, default management, recovery or resolution of specific activities would have for the Union.

2.2. Determination of systemic importance of third-country CCPs

The EC proposal implies that the determination of systemic importance should be conducted at the CCP Legal entity level. This is **contradictory to other regulators practice** (e.g. US, Australia, Canada…) and **does not reflect the need to specifically supervise certain market segments** that are of idiosyncratic systemic relevance for the Union.

Certain clearing services are tailored to respond to local needs, of less important size and complexity or with limited interdependencies with the Union and EU clearing members. We believe that these services should be left out of the scope of Tier 2 requirements.

Likewise, each CCP runs a variety of separate clearing services/products with different characteristics. Depending on the type of product, the clearing service may be of **specific** relevance for the Union.

For example, contrary to the clearing of cash settled OTC derivatives which are commercial tools used for hedging real economy risks, some clearing services can be considered of **specific** systemic importance for the EU because of the **nature of the product itself** (cleared or not cleared) which can be used for monetary policy transmission by central banks of issue and the closure of such a clearing service due to a CCP failure could limit the capacity of central banks of issue to react to money market conditions. In addition, as some particular products allow counterparties to refinance their activities or operate collateral transformation, such closure could limit counterparties ability to refinance their activities in order, for example to use the assets transformed as collateral in subsequent operations. Besides, some products (cleared or not cleared) have material **liquidity and physical settlement requirements** that need to be managed and could lead, in case of severe liquidity stress to access to central bank liquidity needs. The clearing of such particular products could justify heightened oversight from the central bank of issue.

The clearing of IRS/futures is not systemic because of the product *per se* (cleared or not cleared) but potentially because of the size of the relevant market which reflects the global size, efficiency and breadth of the market place. IRS clearing is therefore not systemically relevant to the EU specifically as IRS products are not a monetary policy transmission tool by the central banks of issue and have much smaller liquidity needs and **no** physical settlement requirements.

For these reasons we believe **that an internationally integrated supervision based on direct registration and enhanced cooperation is the appropriate remedy** to continue to bring the relevant level of transparency and comfort to the various regulatory authorities involved in an international service that could be considered of systemic importance to several jurisdictions.

The assessment of systemic relevance and recognition processes as well as supervisory solutions responding to EU authorities specific needs should therefore be conducted at **asset class level, based on the characteristics of the said products**. Clearing services with **higher liquidity needs** and which closure could have spill-over effects on the broader market could therefore be considered of systemic importance for the financial stability of the European Union specifically and could justify heightened oversight **from central banks of issue and specific cooperation with regulators**, whereas the **other clearing services** of the CCP (for example, services with limited interconnectedness with the EU, or with limited EU aggregate exposure to EU counterparties) could be left out of the scope of Tier 2 requirements or be supervised through **internationally integrated mechanisms.**

Structural characteristics of interest rates swaps

Provided that the assessment of systemic relevance and recognition processes are conducted at asset class level to recognise the specificity of products, we can expect to have dedicated assessments of several specific assets classes. For these discussions to lead to the right solutions for EU authorities, clearing members and clients it is essential to thoroughly distinguish the different types of markets/products.

In the case of a clearing member default, the CCP becomes responsible for its cleared positions and must hedge and ultimately dispose of the defaulter's positions while meeting the financial obligations of the defaulter. This includes paying variation margins to the counterparties of the defaulting participants in replacement to the defaulting clearing member, until its portfolio is ported or liquidated for both Repo transactions and OTC IRS/exchange traded derivatives ('ETD') futures transactions. However, **for some products, the CCP also has to fulfil the principal obligation (exchange of cash v. assets), which is of much larger scale than the variation margins ('VM') requirements.** The clearing of OTC IRS/ETD futures transactions does not imply such liquidity needs.

In order to understand the very specific nature of this asset class, we highlight in the table below **the specificities of OTC IRS/ETD futures products and how they differ from other products, in particular EU sovereign debt repo products (cleared or not cleared)**. While it is important to acknowledge these differences, it is equally important to remind that **these differences are today very closely monitored and successfully addressed via specific risk management solutions that give regulators and CCPs equal confidence of successfully handling both a repo and a swap default**.

	OTC IRS/ETD futures
Obligations of counterparties in business as usual	
The exchange of variation margins	**Yes.** Throughout the life of an OTC IRS/ETD future or a repo, counterparties exchange variation margins ('VM') representing the **net change of value of the portfolio of individual IRS contracts per currency throughout each trading day.** On a daily basis, CCPs conduct valuations of each individual contract (known as 'marking to market') or assets and collects losses from participants on the losing side of the trade to pay gains to participants on the gaining side of the trade. Variation margins collected by the CCP from the 'losing' members are passed through the 'winning' ones.
Principal obligation	**No.** OTC IRS/ETD futures are contracts for difference, there is **no principal exchanged between counterparties.**
Obligations of the CCP in case of default	
The payment of variation margins	The CCP has to pay variation margins in cash to non-defaulting clearing members representing the **net change** of value of the portfolio of interest rate swaps contracts per currency.

Liquidation of non-cash IM	The CCP might be required to liquidate non-cash IM of the defaulting member in order to meet the cash variation margin obligation owed to non-defaulted clearing members. **Relative to the settlement obligation of a repo product, for example, this would always be small in scale**.
Settlement of the principal obligation?	**No.** When stepping into the defaulter's positions, the CCP has to fulfil the payment of **variation margins** that represent the **net change of value of the portfolio**. Contrary to repos, the CCP does not have to fulfil the principal obligation, the contract itself.
Liquidity needs	**Limited.** The volumes are more limited as the liquidity needs only cover VM. The liquidation of assets might not be required: the CCP **potentially** needs liquidity arrangements to allow the payment VM (much smaller amount than principal).
Defences against liquidity shortfall	**Needs are limited to the deposit of VM.** The CCP sets up strong defences against liquidity shortfall in case the CCP has to ensure the payment of VM to non defaulting clearing members. This implies the same kind of defences (Contingent Committed Liquidity facilities and in some cases access to central bank accounts) but in **smaller scale than for repo products, for example, where the CCP also has to fulfil the principal obligation**.
Recovery/resolution	
Link of the CCP clearing service to the broader market	**Low.** OTC IRS/ETD futures products are used by counterparties to **manage their assets and liabilities** by allowing them to exchange fixed rates for floating rates. They **do not involve physical deliveries** and have a direct if somewhat delayed real economy impact (**they do not affect the total borrowing or lending in the real economy**). IRS clearing **can be systemic to several jurisdictions, not just the EU,** not because of the product but of the **size of the particular clearing service** which reflects the global size, efficiency and breadth of the market place, in all currencies.
Links to sovereignty issues	**Low.** **Unlike for EU sovereign debt repo products (cleared or not cleared), there is no direct link to monetary policy operations or the issuance of government debt.** Besides, counterparties do **not necessarily trade on their national currency**, for example only half of the SwapClear volumes originated by EU firms are denominated in Euros. Likewise only 25% of SwapClear Euro-denominated trades are originated by EU firms.
Spill over effects of risks management decisions of the CCP (level of haircuts, collateral acceptance etc.) or closure of a CCP clearing service on the broader market	**Low.** The closure of an OTC IRS/ETD futures service would mean that counterparties cannot hedge their liabilities but it would **not affect counterparties' ability to finance their activities in other markets or ensure collateral transformation like the closure of a repo service could have.** Likewise the channels of transmission of central banks monetary policies are limited in comparison to the repo market. The spill-over aspects observed for repos would not be observed, or to a lesser extent, for IRS markets.

These elements show that OTC IRS/ETD futures are very different products in nature to products with high liquidity needs (contract for difference, no principal obligation). They imply completely different needs - in particular in terms of liquidity – and have a completely different impact on the wider market.

Their systemic relevance, in particular, and the link to sovereignty of local government and the ability of local central banks to align money market conditions with their monetary policy intentions, is therefore to be assessed separately. In particular, **a service that clears products of systemic importance to a specific jurisdiction has to be treated in a different way to clearing services which could be considered systemically important in different jurisdictions, not just the EU, not because of the product but because of their size which reflects the global size, efficiency and breadth of the market place, in all currencies**.

Asset classes should thus be treated in a completely different manner and call for different supervisory solutions. Asset classes, including EU sovereign debt repos that can involve strong spill-over effect and can be directly linked to the issuance of Eurozone government debt and the operations of ECB monetary policies could deserve heightened oversight from the central bank of issue.

For the above mentioned reasons, we would support a **systemic assessment and a recognition process conducted at the CCP clearing service, activity or class of financial instruments level**. Such assessment could be subject to specific requirements ensuring that the risk of contagion between asset classes is minimised for example by employing segmented default funds and segmented capital for each asset class. We would suggest amending Article 25(2a) to achieve this.

2.3. Requirements for Tier 2 CCPs

The Commission's proposal sets-out specific requirements that Tier-2 CCPs must fulfil for recognition, including ongoing and full compliance with EMIR, and direct supervision by ESMA.

Throughout the development of its clearing services LCH Ltd has preferred to operate a direct registration model to serve its clients in the jurisdictions where this option was available. This is based on the belief that direct registration most often can allow a closer relationship with local regulators and clients and better protects financial stability.

Where legally possible we favour direct licensing and direct supervision as the best mechanisms to establish a clear and strong relationship with regulators in order to benefit from their understanding and expertise of the local regulatory requirements and abide by local laws, especially for matters such as client asset protection, despite the structural adaptation of the services it sometimes requires.

In line with this conviction, we support the Commission proposal that Tier 2 designated CCPs would have to directly register with ESMA and be subject to ESMA supervision as well as be compliant with the relevant prudential requirements under EMIR.

We are also very supportive of the Commission Proposal to allow for a comparable compliance mechanism, in line with the FSB calls to use deference mechanisms, as agreed by the G20 Leaders, in order to avoid regulatory gaps, duplication, conflicts and inconsistencies which can lead to regulatory arbitrage and market fragmentation.

LSEG is and remains a strong supporter of the robust EMIR framework, which appropriately protects CCPs, their members, clients and the broader financial system against financial distress and has proven effective and efficient in doing so through the most recent financial shocks.

However, we would like to point out the duplicative nature of the Tier 2 requirements with the current process for recognition. Indeed, since the Tier 2 CCP would directly and fully comply with EMIR requirements and be directly supervised by ESMA, the criteria of Article 25(2) do not seem necessary to allow a solid recognition process of Tier 2 CCP.

Indeed, Article 25(2) of EMIR imposes:

- **The adoption of an equivalence decision by the European Commission**: this seems an unnecessary pre-condition as the Tier 2 CCP will be directly subject to EMIR requirements and subject to ESMA direct supervision. In the context of direct application of EMIR, the CCP local requirements become only relevant in case of comparable compliance, a separate process established by Article 25a and led by ESMA.
- **Effective local supervision and enforcement**: the third-country CCPs will be directly registered and supervised by ESMA, this condition is therefore also unnecessary for Tier 2 CCPs.
- **Cooperation arrangements**: ESMA would be granted direct supervisory powers over the third-country Tier 2 CCP, including access to documents, records, information and data as investigation powers pursuant to Article 25(2b)(b). It is unclear what these cooperation arrangements as they are defined in Article 25(7) of EMIR would add to ESMA supervisory direct powers. Instead, specific arrangements for the supervision of Tier 2 CCPs should be introduced in Article 25 (2b) covering the specific needs incurred by the direct supervision of a CCP by multiple regulators. We elaborate further on this point under section 2.4.
- **Anti-money laundering**: this is the only requirement not already covered by the Commission Proposal in Article 25 (2b) and which could indeed be added to the list of requirements of this paragraph.

In light of these elements, we suggest a strict separation between the CCP Tier 1 and Tier 2 processes in order to ensure a more proportionate and streamlined recognition process, and avoid unnecessarily duplicative procedures by the European Commission and ESMA. The procedures for Tier 1 and Tier 2 third-country CCPs should be alternative and not cumulative.

This would allow a more efficient and proportionate way to achieve the Commission objectives and permit third-country CCPs to directly register with ESMA to obtain an EMIR license:

This mechanism would be consistent with the direct registration model used in other jurisdictions, for instance the Derivatives Clearing organisation (‘DCO’) license delivered by the CFTC in the US. The CFTC can also exempt DCOs, conditionally or unconditionally, from registration for the clearing of swaps if the CFTC determines that the DCO is subject to comparable, comprehensive supervision and regulation by the appropriate government authorities in the home country of the DCO (in line with EC proposed approach for Tier 1 CCPs).

This ensures full compliance with EMIR, independently from the legal framework in the third-country (both at the time of recognition and afterwards). The third-country CCP would be subject to the same requirements as a CCP in the European Union, and would be required to comply with EMIR on an on-going basis.

This clarity may also incentivise some third-country CCPs which have been classified as Tier 1 to voluntarily follow the Tier 2 procedure if considered more transparent and stable. Indeed, the creation of an EMIR license would remove the dependency on the adoption of an equivalence decision, and the corresponding uncertainty linked to the Commission’s ability to amend, suspend, review or revoke an equivalence decision at any time. Some third-country CCPs may choose to comply with more stringent requirements under the Tier 2 procedure, in order to benefit from the enhanced stability of the legal and supervisory arrangements. This would create a virtuous circle, and effectively contribute to the promotion of EMIR outside the European Union.

We would, therefore, suggest the deletion of the references to Article 25(2)(a), (b), (c) in the first paragraph of point 2b and only refer to the requirement of Article 25(2)(d) which is the only non-duplicative requirement. Besides, concerning the conditions imposed by Article 25 (2b), we would like to share the following comments:

- It is unclear what '*requirements imposed by those central banks of issue in the carrying out of their monetary policy tasks*' refers to in (Article 25(2b)(b)). This requirement seems to duplicate the consultation already put in place in Article 25(2) and the proposal does not describe how the two procedures would interact. Moreover the text does not define the scope that the '*requirements imposed by those central banks of issue in the carrying out of their monetary policy tasks'* would cover, and what would be their legal basis. We would suggest either clarifying this interaction (for example by modifying Article 25 (3)) or, deleting this requirement which seem duplicative.
- We understand the need for written consent by the third-country CCP that ESMA may access any information held by the CCP and may access any of its business premises upon request. This is required to enable ESMA to exercise its new supervisory responsibilities.

2.4. Potential denial of recognition/requirement to force relocation of third country CCPs (Article 25(2c)

Whilst we welcome the vast majority of the European Commission proposal on third-country CCP supervision as explained above, LSEG and its customers are deeply concerned about the possibility of ESMA and the central banks of issue recommending that the Commission denies the recognition of third country CCPs which are deemed to be of such substantial systemic importance that they cannot be recognised. The lack of transparency and predictability of such a proposal, and the actual effect it could have if it was to be adopted, are of particular concern.

Requiring certain third country CCPs to be established in the EU, despite the fact that, under the current Commission's proposal these CCPs would directly comply with EMIR and be supervised by ESMA, would not be a proportionate requirement. Also, on the basis of past experience and stress simulation of our existing portfolios, we fundamentally disagree with the view that it would not create undue market fragmentation or would imply minimum cost for market participants.

LSEG shared some of these concerns and supporting analysis based on SwapClear's portfolio of transactions ahead of Commission's Proposal. However, we respectfully question whether there has been sufficient time for stakeholders' views to be taken into account when drafting this far-reaching Proposal as the impact assessment was presented two weeks after the adoption of the Communication[13] and therefore before several industry associations and data and fact-rich participants could submit their responses. Besides this proposition was not included in the Consultation conducted by the European Commission on the review of EMIR conducted during summer 2015. This seems at odds with the European Commission better regulation agenda.

In considering the systemic relevance of a third-country CCP for EU markets, it is essential to perform such systemic assessment at CCP clearing service, activity or class of financial instruments level, as recommended under section 2.1. This granular approach would take into account the specificities of the different markets, and enable third-country CCPs to propose a set of tailored solutions for each of their service deemed systemically important to the EU. This would better address the concerns of the EU Authorities, whilst ensuring that all members or clients who need to use a service to cover their risks are in a position to do so under the best conditions of safety and efficiency.

For instance, clearing services for repos, in light of the role of these financial instruments in the central banks' monetary policy operations, could form part of a specific discussion. CCPs could consider how to accompany safely the possible desire of the market to clear debt in its issuance location. These markets can have a local nature and close to the location of the sovereign issuing the underlying debt.

[13] Commission Proposal – Explanatory Memorandum, page 13, paragraph 3.3.

However, the situation differs significantly for cash settled commercial hedging instruments, such as Interest Rate Swaps ('IRS'). These instruments are traded on internationally integrated markets served by internationally integrated services. A location policy/denial of recognition would run contrary to the international nature of these markets, which we expect would make its impacts particularly detrimental. We have, therefore, conducted a quantitative analysis focusing on IRS.

Starting from the assumption that a clearing service like SwapClear (IRS clearing) could be designated as Tier 2 under the new regime (more on the basis of its size than on the systemic nature of the product cleared) and in order to provide constructive feedback to the Commission on the idea of forcing the location of a business, or denying the recognition of segments of such business, LSEG performed a detailed analysis of the likely impact that a location policy/denial of recognition applied to this service would have across the financial system in terms of market fragmentation and costs increases for clearing members and clients. To illustrate the accuracy of using SwapClear as a reference point for its specific market, it is worth noting that this service cleared 90[14]% of OTC interest rates derivatives globally last year. It is, therefore, a representative basis from which to assess the dynamics that would be at stake in the case of a market fragmented between EU and non-EU users for interest rates derivatives, the relative importance of the swap market and the structure of its participants.

Our detailed impact analysis is based on the Legal Entity Identifier[15] of counterparties. It is therefore representative of the underlying market structure of the swap market as the data used is based on the location of end-users, not on the booking location of the cleared transaction. In addition, the analysis is based on initial margins amounts of members and clients as of 28 April 2017. It reflects the actual positions of the underlying market participants and their corresponding commercial activities, thus providing a reference point which is not expected to dramatically change in a short timeline. The detailed analysis is, therefore, an accurate assessment of the gravitational nature (or lack of) of certain segments of the internationally integrated portfolio of transactions.

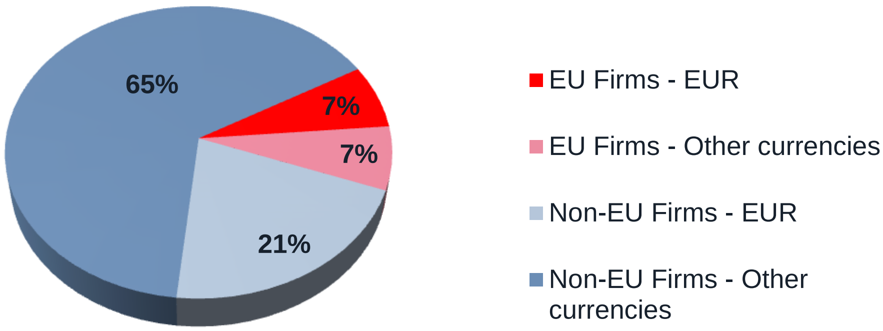
Cost of market fragmentation and size of EU portfolio

A policy that would restrict the clearing of all derivatives transactions of EU firms in all currencies to the EU, as suggested by the European Commission Proposal would fragment markets and lead to the formation of an EU captive market and an internationally integrated market outside the EU. Such a constraint on global market liquidity would have a direct impact on EU firms.

Taking SwapClear as a reference, we can draw an understanding of the pools of liquidity created by the imposition of the location policy or denial of recognition proposed by the European Commission. We analysed SwapClear overall volumes to determine the portion of IRS originated by EU firms[16] and by non-EU firms, with a distinction between Euros and other currencies.

[14] LCH Ltd is particularly active in the OTC interest rates derivatives segments, but other assessments could be conducted on any international service representing an important share of global market, for example on Credit Default Swaps or Exchange Traded interest rates derivatives segments which are concentrated in other CCPs, mainly for market efficiency reasons.
[15] The Legal Entity Identifier (LEI) is a 20-character, alpha-numeric code, to uniquely identify legally distinct entities that engage in financial transactions.
[16] In this analysis, 'originated by EU clients' means transactions that include at least one EU firm. For the sake of clarity, this covers both IRS trades between two EU clients, or between an EU client and a non-EU client.

Participation of EU clients in the overall volume



This data shows that the majority of the activity of SwapClear is conducted by non-EU firms: indeed, **86% of SwapClear's activity is by firms located outside the EU** (Euro-denominated IRS originated by non-EU clients represent 21% of SwapClear volumes, and IRS originated by non-EU clients in all other currencies represent 65% of SwapClear total volumes).

A location policy/ denial of recognition **covering the full portfolio cleared by EU institutions would, thus, very likely create a restricted captive EU based liquidity pool representing 14% of SwapClear activities** (the volumes of Euro-denominated IRS originated by EU firms represent 7% of SwapClear volumes, IRS originated by EU firms in all other currencies represent another 7% of SwapClear total volumes).

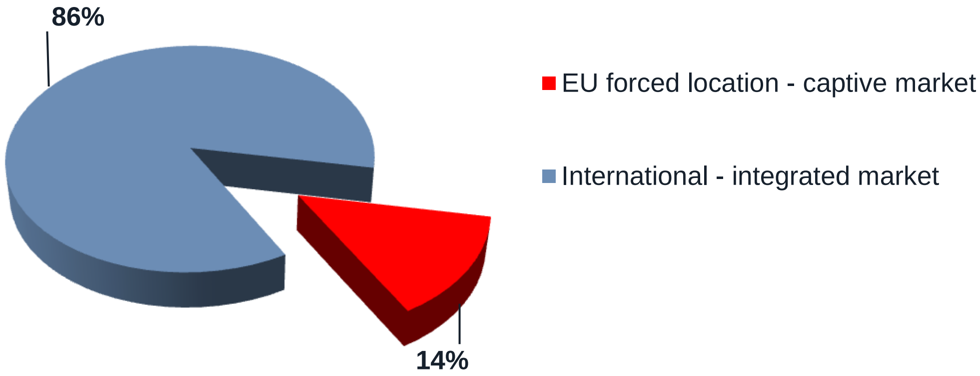
This analysis shows that the activity of EU firms, whilst important, is relatively small in comparison to non-EU activity. Fragmenting this portion (14%) away from the global market is very unlikely to have a gravitational effect on the rest of the liquidity (86%). SwapClear's experience in adjusting to clients' needs across the 55 jurisdictions it serves shows that the integrated market is likely to stay where most of the liquidity is, and the current underlying volume of business shows that it will not be in an isolated EU based pool.

EU firms would therefore have a limited choice of infrastructures to hedge their risks or fulfil their clearing obligation and not be able to access international liquidity (approximately 86% of SwapClear activity). Confronted with fewer offers of clearing services (and beyond this, of client clearing services), EU firms would suffer from higher costs and systemic risks.

A captive market would also imply a reduced number of counterparties available to conclude transactions and therefore a reduced capacity for EU clearing members and clients to find counterparty willing to enter into a contract allowing the EU them to hedge their risks.

A significant share of the market participants not subject to a clearing obligation today is already voluntarily centrally clearing. These participants generally have a profile which carry significant risk but drive relatively small flows. Therefore, we do not expect that the application of the EMIR clearing mandate to these additional categories of financial counterparties will significantly change the volume originated by EU firms.

Market fragmentation post denial of recognition / forced location



Therefore, we would expect that the **international market structure for IRS will remain broadly unchanged even in the case where the Commission would force a relocation of the cleared portfolio from EU institutions in the EU, leading to the isolation of EU institutions in a captive, less liquid market suffering from structurally higher costs.**

Indeed, the price of a derivative depends on where it is cleared: in particular, this **price is linked to the liquidity of the said market**. The market fragmentation will create a situation whereby transactions with the same economic terms will have a different price depending if they are traded in the internationally integrated pool and the EU pool. As it is expected that **the smaller EU pool will offer a more limited choice of execution venues and set of liquidity providers, the inevitable response to these factors would be worse execution prices for EU firms. This may well be exacerbated by an imbalance of flows, leading to a problematic CCP basis**[17].

Market fragmentation will, therefore, **create aggregated structural costs for EU firms**. Whilst LSEG is not in a position to assess the widening of the price gap between the International and the EU market, **we have calculated the aggregate present value of a 1 basis point change in rate ('PV01')[18], i.e. the additional cost SwapClear members would face if they were getting execution prices 1 basis point worse than today**. This simulation provides a **frame of reference for additional costs** generated by a location policy/ denial of recognition, and measure the sensitivity of SwapClear's current portfolio to each basis point worsening of market conditions.

The additional costs that SwapClear's EU members and clients would face per annum for each basis point worsening of execution prices (when compared to today's price) because of a European regulation forcing EU firms to use EU CCPs for all interest rates swaps in all currencies (as per the European Commission Proposal), would be approximately $25 billion[19].

[17] CCP basis is the difference in simultaneous mid-market prices between a type of swap (e.g. 5yr USD, fixed vs 3M LIBOR, out of spot) cleared at CCP1 versus the same type of swap cleared at CCP2. It is caused by excess demand for the swap relative to available supply within each CCP liquidity pool.

[18] PV01 is a commonly-used measure of activity in swap markets, and we believe this may also be useful in this context. Note that we do not expect that the price of every Euro swap done by every EU firm in the future would move by a basis point against them. Rather, we offer the aggregate PV01 figures to promote a sense of the scale of the wealth transfers / revenues / costs at stake. Furthermore, the effect could be as small as tenths of a basis point, or could be whole numbers of basis points. We offer the basis point sensitivities as an enabler of the discussion.

[19] This is a linear cost, i.e. a 2 basis point gap would mean $50Bn, half a basis point gap would mean $12.5Bn, etc. This cost would be a direct cost, and would have to be added to the series of other costs linked to the segregated EU pool (margins, CCP memberships, legal costs, etc.)

This would be a continuous, ongoing cost, recurring every year, resulting from structurally deteriorated market conditions. This means that, should the **structural disadvantage** of the restricted pool remain unchanged over a five year period, EU market participants could contemplate a cost as high as $ 125 billion.
The structure of SwapClear portfolio of transactions demonstrates that it is very unlikely that the entire liquidity of the currently internationally integrated liquidity pool will move to the EU. Thus, **the costs of fragmenting the market will mainly be felt by EU entities and permeate to the EU real economy as they become a captive pool of liquidity isolated from the international pool**.

Having global CCPs serving clients globally is not only in the interest of the international community but also of EU clearing members and firms. The fragmentation caused by forcing EU clearing members and clients to use EU CCPs would create a close intra-EU competition, therefore a captive onshore market, benefitting very few actors but inevitably detrimental to EU clearing members and clients.

This fragmentation and the forced migration of positions from one CCP to another would have financial stability implications. Indeed, there is currently no mechanism to migrate the numerous positions implied by a forced relocation of third country CCP in the EU. Provided that such transfer is feasible, disruption on derivatives markets and systemic risks could arise due to: (i) operational complexity, as every migrating counterparty would need to close-out its positions at its current CCP to open new corresponding positions in at another (with the associated challenge of finding counterparties with perfectly equal offsetting positions in the EU in order to replace the positions resulting from transactions with counterparties from numerous and diverse jurisdictions); (ii) the prudential impacts, as at least one CCP would need be able to on-board thousands of trades and billions of margins and default fund contribution in a short timeframe; and (iii) the complex legal interactions entailed by the migration between different CCP rulebooks, each subject to potentially conflicting legal frameworks.

LSEG strongly believes that the interests of EU firms are best served by allowing international integrated markets to be cleared in internationally integrated and supervised CCPs to compete globally, with a focus on the CCPs' compliance with regulatory standards (either directly or through deference mechanisms) and direct supervision.

These additional costs would not be limited to the financial industry: they would be passed on to EU real economy businesses and government agencies, and adversely impact the EU beyond its financial sector. Indeed, the risks that are managed via derivatives have their origin in the real economy (for example, loans to businesses in domestic or foreign currencies). Consequently, unless clearing members decide to absorb all the costs described above, it would be expected that these costs would be passed on to the very large diversity of actors (e.g. corporates, government agencies, funds, pension funds, mid-size and small banks) which use IRS in the real economy to cover the risk linked their daily activity.

A location policy/denial of recognition would give rise to an ongoing punitive effect on EU market participants which will have less choices and face higher costs, contradicting Commission's legitimate objectives expressed in the Capital Market Union action plan.

Cost of breaking integrated multi-currency portfolio and negative impact on financial stability

A location policy/denial of recognition focused on Euro-denominated products would have additional effects on the SwapClear's integrated multi-currency portfolios. The policy would indeed fragment in, at least, two segments, integrated multi-currency portfolios by extracting Euro-

denominated swaps. This **would increase EU clearing members' margins by around 29%** (around $5 billion) **and non-EU members' margins by 17%** (around $ 6 billion).
LSEG respectfully disagrees with the European Commission's view that these additional costs have to be weighed against the gains in systemic risk mitigation[20]. These additional costs are in fact further compounded by an increase in systemic risk. In particular, such a policy would **create financial stability risks** associated with:

- **the weakening of CCP's default management processes**: we estimate that in a number of default scenarios, the assessments faced by clearing members would be **3 times higher when the pool is fragmented** following a location policy/denial of recognition than in the current pool.
- **the forced split and migration of the trading liquidity** of EU firms from an integrated global pool to an isolated local one, and
- **the fragmentation of a currently integrated pool of open positions:** initial margins covering counterparty risk. Fragmenting the integrated pool of risk and margins into two or more pools creates more margin needs and therefore equal additional systemic risk added to the system. This will necessarily manifest itself during defaults where multiple CCPs are trying to close out defaulters positions.

In addition, we do not believe that the cost of breaking integrated multi-currency portfolios could be mitigated through increased portfolio margining within EU based CCPs. Margin offsets are only permitted insofar as the portfolio risk model complies with strict risk management rules, and the robust regulatory framework governing portfolio margining. In addition, portfolio margining must be closely aligned with the CCP default management process. There is a clear requirement to only consider portfolio of contracts that can be priced, managed and liquidated together in case of a member default. Thus, the scope of instruments that can be considered together within a single portfolio must be carefully considered. In practice, it means that portfolio margining is restricted to portfolios of similar assets, for instance rates or equities, but not both.

A location policy/denial of recognition would adversely impact both the EU and international markets, and be contrary to the initial objective of the Commission to reduce systemic risks. Therefore, LSEG respectfully requests an amendment of the Commission's Proposal by the co-legislators in order to fully take into account the data and analysis produced by key industry participants and, as a consequence, (i) remove the potential requirements to force relocation of third country CCPs in the EU/procedure to deny recognition as well as (ii) ensure a more proportionate approach, by asset class, to the supervision of third country CCPs.

2.5. Enhanced supervision

LSEG is supportive of the work undertaken in the last decade by the Financial Stability Board (FSB) and its member jurisdictions to promote **cross-border arrangements between jurisdictions to enhance financial stability in the derivatives market**. Regulators and governments around the world, including the European Commission, are regularly emphasising **the need to use deference mechanisms, as agreed by the G20 Leaders, '*in order to avoid regulatory gaps, duplication, conflicts and inconsistencies which can lead to regulatory arbitrage and market fragmentation*[21]'.** This approach has been championed by the European Commission through EMIR

[20] Commission Proposal, Explanatory Memorandum, page 9, paragraph 2.3.

[21] See G20 Leaders' St Petersburg Declaration of September 2013 (paragraph 71): 'We agree that 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 regulatory regimes.', as well as the G20 Leaders' Brisbane declaration of November 2014 (paragraph 12): 'We call on regulatory authorities to make further concrete progress in swiftly implementing the agreed G20 derivatives reforms. We encourage jurisdictions to defer to each other when it is justified, in line with the St Petersburg Declaration'.

equivalence processes allowing thirty-two CCPs established in third-countries to offer services and activities in the Union[22]. Over the last decade deference has been constantly and consistently called upon by governments and regulators that have adopted numerous deference decisions across jurisdictions, including by the EU, Hong-Kong, Japan, Mexico, Singapore, Switzerland and the U.S.[23].

This approach to deference has very recently been confirmed by the U.S. Department of Treasury in its Capital Markets Report[24] which recommends '*clarity around the cross-border scope of CFTC and SEC regulations and make their rules compatible with non-U.S. jurisdictions where possible to avoid market fragmentation'*, and recommends '*that effective cross-border cooperation include meaningful substituted compliance programs to minimize redundancies and conflicts'*[25].

In the specific cases where deference might not be deemed sufficient by the primary authorities which have a direct involvement in a service provided to their markets by an infrastructure based in a third country, LSEG is supportive of enhanced supervision of third country-CCPs, and would welcome more concrete discussions on what it would entail. We believe that some agreements will need to be reached *ex ante* between the main authorities of the internationally integrated clearing services.

In line with this objective, we would recommend introducing **specific cooperation arrangements for the supervision of Tier 2 CCPs** in Article 25 (2b) replacing point (e). These cooperation arrangements would cover **the specific needs incurred by the direct supervision of a CCP by multiple regulators**, including the coordination between authorities on the scope of day-to–day supervision clearly defining the scope of each supervisor, the reporting to be made and the processes to deal with specific events, in particular coordination for the main events affecting CCPs operations as listed in Article 21a (1)(a) - including for example the extension of CCPs activities and services as well as substantial changes in risk models and parameters – as well as in case of default of a clearing member providing clarity on how regional authorities should be involved (e.g. notification) in the liquidation of assets, defaulting member's and clients' portfolio.

These cooperation arrangements could also be used to properly adjust not only a **stronger day-to-day supervision** but also as a **foundation for recovery and resolution mechanisms** ensuring (i) harmonised and coordinated recovery tools agreed with EU authorities and applicable across jurisdictions (ii) a **strong cross-border effectiveness and enforcement of resolution actions** as well as (iii) **global regulatory coordination** both in the drawing and activating of recovery and resolution plans, in line with the recent report of CPMI-IOSCO[26] and the Financial Stability Board[27].

These clear and organised *ex-ante* cooperation arrangements would generate a clear and organised cooperation, which could be smoothly implemented in case of crisis. In this view, we remain fully committed to contribute to the definition of the EU CCP Recovery and Resolution framework so that international infrastructures can continue to provide choice and efficiencies to all the clients who might want to use them, in a way which is transparent and safe for the various jurisdictions of these clients.

2.6. Transparency of recognition and equivalence processes

It is crucial that any revision of the current supervisory framework to incorporate the direct supervision by ESMA of third country CCPs is designed in a way that constitutes an improvement from the current framework in providing transparency and predictability in the adoption of policy decisions, including the recognition processes.

[22] As of 9 October 2017 - https://www.esma.europa.eu/sites/default/files/library/third-country_ccps_recognised_under_emir.pdf
[23] FSB OTC Derivatives Market reforms – Twelfth Progress Report on Implementation – 29 June 2017. http://www.fsb.org/wp-content/uploads/P290617-2.pdf
[24] https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.
[25] Cross-border issues - Pages 134 and 135.
[26] CPMI-IOSCO revised report on Recovery of financial market infrastructures – 5 July 2017.
[27] FSB Guidance on Central Counterparty Resolution and Resolution Planning – 5 July 2017.

As developed in point 1.1. above (ESMA supervisory responsibilities), a transparent policy decision process and appropriate communication of policy decisions are essential to ensure a common understanding and consistent application of the EMIR requirements, in particular by third country CCPs that would be directly subject to EMIR requirements (Tier 2 CCP) following the adoption of the Commission Proposal.

In addition, and specific to third country CCPs regime, we encourage further transparency in the decision making processes (i) leading to the determination of the systemic importance of a third country CCP for the EU and (ii) linked to the recognition of third country CCPs. This includes the decision to refuse the recognition of a third country CCP as per Article 25 (2c).

The determination of systemic importance of a CCP, the recognition or the refusal of recognition of a third country CCP will directly and hugely affect the said third country CCP, EU market participants and EU firms. It is therefore essential that those affected by such decisions are given the opportunity to provide input in their development.

ESMA should have the statutory duty under the ESA regulation (as modified by EMIR) to ensure a public consultation process similar to the one applying to regulatory and implementing technical standards applies for all its determination of systemic relevance, recognition and refusal of recognition of third country CCPs. This transparency towards regulated entities would further contribute to the predictability of any decision and ensure that the feedback received is dully taken into account before adopting any decision.

2.7. Transitional provisions

Article 89(3b) of the Commission Proposal imposes a review of recognition decisions adopted within 12 months of the entry into force of the adoption of the relevant delegated acts.

Whilst LSEG fully understands the overall context in which the Commission Proposal will be discussed, we would like to emphasise the absolute need for clarity and transparency from the co-legislators and European authorities on the scope and timeframes of any new requirement. Our customers are sharing their growing concerns on the lack of clarity on criteria and viable alternatives, which will increasingly create unnecessary market instability and volatility, introducing additional risks to financial stability, especially in the event of a cliff-edge scenario. **We would suggest that, at the very least, the co-legislators should ensure a transitional period to the new regime for CCPs not covered currently by the third country regime.**

We would therefore suggest to introduce a paragraph 89(3c), ensuring that until a decision is made under Article 25 on the recognition of a CCP, the current authorisation under EMIR shall continue to apply. This would ensure that, in line with Article 89(3) and (4) respectively for EU and third country CCPs, CCPs and their customers benefit from a smooth transition and avoid any unnecessary cliff-edge effect.

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We hope that the European Commission finds this submission useful and we look forward to engaging further as policies are developed. As an international group serving clients globally operating three EMIR authorised CCPs across Europe, we would, of course, make ourselves available to discuss our practical experience of meeting regulatory requirements and responding to customer needs across the globe and to provide further analysis on the potential consequences of a policy restricting the clearing of EU institutions to the EU. Should you have any questions on the response or wish to discuss it in detail, please do not hesitate to contact us at Corentine Poilvet-Clediere: cpoilvetclediere@lseg.com; Julien Jardelot jjardelot@lseg.com; Jean-Phillipe Collin: Jean-Philippe.Collin@lch.com; Fabrizio Plateroti: Fabrizio.plateroti@borsaitaliana.it; Isabella Tirri: Isabella.Tirri@lseg.com; Paola Fico: paola.fico@borsaitaliana.it.