

# COMMITTEE ON CAPITAL MARKETS REGULATION

August 21, 2014

Michel Barnier  
Vice-President of the European Commission,  
Responsible for the Internal Market, Services  
BERL 12/181  
B-1049 Brussels, Belgium

Timothy Massad  
Chairman, Commodity Futures Trading Commission  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

RE: European Commission and CFTC Should Recognize Derivatives Clearinghouses (“CCPs”)

Dear Messrs. Barnier and Massad:

The Committee on Capital Markets Regulation (the “**Committee**”) is concerned that the European Commission and the Commodity Futures Trading Commission (the “**CFTC**”) have yet to reach an agreement regarding the cross-border recognition of CCP regulatory regimes for swaps and futures. This is a priority matter. If the European Commission fails to do so by December 15 then E.U. legislation will severely disrupt the cross-border derivatives market, by requiring European banks and U.S. banks’ E.U. affiliates clearing on a U.S. CCP to increase capital held against exposures to U.S. CCPs by thirty to sixty times the current capital requirement. The effect will be to force the affected parties to clear on an E.U. CCP, fragmenting the swaps and futures market and decreasing market participants’ access to all cleared derivatives.

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-five leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The European Commission and CFTC made several promising steps towards recognizing each other’s CCP regulatory regimes in 2013. On July 11, 2013, the European Commission and the CFTC acknowledged the importance of preserving the cross-border derivatives market and reached the *Common Path Forward* agreement, which stated that any equivalency or substituted compliance decisions would permit U.S. CCPs to clear swaps and futures for E.U. persons and vice-versa.<sup>1</sup> In a subsequent step on September 3, 2013, the European and Securities Marketing Authority (ESMA)

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<sup>1</sup> The European Commission and the CFTC reach a Common Path Forward on Derivatives, July 11, 2013. Available at: <http://www.cftc.gov/PressRoom/PressReleases/pr6640-13>

recommended that the European Commission recognize the U.S. regime for CCPs as equivalent to the E.U. regime.<sup>2</sup>

Also in September 2013, the derivatives regulators of the G-20 nations, including the CFTC and European Commission, released the *Agreed Understandings to Resolving Cross-Border Conflicts, Inconsistencies, Gaps and Duplicative Requirements* (“G-20 Agreed Understandings”).<sup>3</sup> This agreement envisions that substituted compliance for derivatives rules should be based on a flexible assessment of whether both regimes reach comparable regulatory outcomes, rather than a line-by-line comparison of technical regulatory requirements.<sup>4</sup> It is notable that in instances where differences between E.U. and U.S. rules exist, applying the stricter rule of either the E.U. or U.S. would also allow for CCP recognition. However, such an approach would impose unnecessary costs where different E.U.-U.S. rules reach the same regulatory outcomes. The Committee thus agrees with the derivatives regulators of the G-20 nations, that a flexible, outcomes-based approach to substituted compliance is preferable.

Although the European Commission and the CFTC continue to collaborate on recognizing each other’s CCP regimes, the European Commission announced in late June that they would grant equivalence for the derivatives CCP regimes of Hong Kong, Japan, Singapore, Australia, and India but that they would only be able to do so for the U.S. CCP regime if such a determination is reciprocated by the CFTC approving substituted compliance for E.U. CCPs with respect to swaps.<sup>5</sup> According to European regulators, the European Markets Infrastructure Regulation (“EMIR”) requires that the CFTC have a substituted compliance process in place for foreign swaps CCPs, or else the European Commission cannot recognize the U.S. CCP regime.<sup>6</sup> In any event, substituted compliance needs to be done on a reciprocal basis.

The CFTC recently attempted to address these concerns at its Global Markets Advisory Committee meeting, unveiling a draft rule proposal to implement a comprehensive substituted compliance process for foreign swaps CCPs, including those in the E.U.<sup>7</sup> However, that draft rule proposal would only permit foreign CCPs that qualify for substituted compliance to clear for U.S. dealers and *not* for U.S. clients (which primarily includes large asset managers, insurance companies, pension funds, and non-dealer banks).<sup>8</sup> European regulators have pre-emptively responded to the draft rule proposal, contending that because the process would not allow U.S. clients to clear swaps with E.U. CCPs, it would not satisfy EMIR and the European Commission would thus be unable to recognize U.S. CCPs.<sup>9</sup>

If this issue is not resolved by December 15 then the E.U. Basel III legislation, Capital Requirements Directive IV and Capital Requirements Regulation, will subject all futures and swaps

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<sup>2</sup> Technical advice on third country regulatory equivalence under EMIR-U.S., European Securities and Markets Authority, Final report, September 1, 2013. Available at: [http://www.esma.europa.eu/system/files/2013-1157\\_technical\\_advice\\_on\\_third\\_country\\_regulatory\\_equivalence\\_under\\_emir\\_us.pdf](http://www.esma.europa.eu/system/files/2013-1157_technical_advice_on_third_country_regulatory_equivalence_under_emir_us.pdf)

<sup>3</sup> OTC Derivatives Regulators Group, Report on Agreed Understandings to Resolving Cross-Border Conflicts, Inconsistencies, Gaps and Duplicative Requirements at 2, September 2013.

<sup>4</sup> Id.

<sup>5</sup> Statement by Commissioner Barnier on Global Derivatives Regulation, June 27, 2014. Available at: [http://europa.eu/rapid/press-release\\_STATEMENT-14-211\\_en.htm?locale=en](http://europa.eu/rapid/press-release_STATEMENT-14-211_en.htm?locale=en)

<sup>6</sup> David Bailey, Head of Market Infrastructure and Policy at the UK’s Financial Conduct Authority, Risk Magazine interview, June 5, 2014.

<sup>7</sup> “Buy side hits out at CFTC’s foreign CCP proposals,” Lukas Becker, Risk Magazine, June 5, 2014.

<sup>8</sup> Id.

<sup>9</sup> Id.

cleared by European banks and the E.U. affiliates of U.S. banks with a U.S. CCP to a capital charge up to 62.5 times higher than the current requirement.<sup>10</sup> This would force these entities to terminate relationships with U.S. CCPs for all cleared derivatives activity and direct their swaps and futures to E.U. CCPs. This December 15 deadline is a fixed legislative deadline that *cannot* be extended any further.<sup>11</sup>

Despite the short amount of time remaining, E.U.-U.S. CCP recognition is still possible, so long as the CFTC and European Commission take the following steps to address concerns related to differences between E.U. and U.S. rules for initial margin for futures, customer segregation and application of bankruptcy law.

First, the CFTC and European Commission should act consistent with the *G-20 Agreed Understandings* to resolve the impasse regarding initial margin for futures. In the *Common Path Forward* agreement, the CFTC and the European Commission expressly identified initial margin for futures as the one material line-item difference with respect to CCPs, as the E.U. rules require 2-days of margin and the U.S. rules require only 1-day. The CFTC and European Commission should not require line-by-line equivalence for daily margin for futures, as we understand that outcomes-based analyses have demonstrated that, due to a variety of different factors that impact initial margin levels, the U.S. and E.U. requirements result in broadly consistent customer margin levels. For example, the U.S. rules calculate customer margin requirements on a gross basis, while the E.U. rules allow for CCPs to apply a net margining standard.

Second, the CFTC is concerned that the collateral protection and segregation rules of certain countries may not be equivalent to the U.S. rule for swaps CCPs. For example, the E.U. rules permit E.U. CCPs to offer two forms of collateral protection, one of which is stricter than the U.S. rules and the second of which is less protective than the U.S. rules.<sup>12</sup> In this instance, the CFTC can remedy any deficiencies in the E.U. segregation and collateral protection rules by requiring E.U. CCPs to offer customer protection that is consistent with the customer protection rules required by Dodd-Frank. The European Commission should do the same, by requiring U.S. CCPs to offer E.U. customers' protections that are consistent with EMIR.

The CFTC is also concerned that if U.S. clients clear swaps with a foreign CCP then foreign bankruptcy laws, which do not provide recovery and protections consistent with U.S. bankruptcy laws, would be applied to these U.S. clients. The CFTC can address this matter in precisely the same way it did for U.S. clients clearing futures with a foreign CCP. To the extent that US clients clear futures with a foreign CCP through a registered Futures Commission Merchant (FCM), those U.S. clients qualify for the application of U.S. bankruptcy laws in the case of their FCM's insolvency.<sup>13</sup> A similar approach, allowing the application of U.S. bankruptcy laws to U.S. clients clearing swaps with a foreign CCP through a registered U.S. swaps dealer, could be taken to ameliorate the CFTC's concerns.

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<sup>10</sup> Directive 2013/36/EU of the European Parliament and of the Council and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012. Available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013L0036>  
<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0575>

<sup>11</sup> *Id.*

<sup>12</sup> Council & Parliament Regulation 648/2012, OTC Derivatives, Central Counterparties and Trade Repositories, 2012 O.J. (L201) (EU).

<sup>13</sup> Commodity Broker Liquidation, 11 U.S. Code Chapter 7, Subchapter IV

The Committee thus recommends that the CFTC implement a substituted compliance process for foreign CCPs to clear swaps for U.S. dealers and U.S. clients, as described above, and that the CFTC then immediately grant substituted compliance for the E.U. At this point, any legal impediments to the European Commission's recognition of U.S. CCPs would be resolved. The European Commission should then deem the U.S. regime for CCPs as equivalent to the E.U. regime, which would enable the ESMA to do the same. If these regulators follow the steps that the Committee has laid out, then the uncertainty regarding cross-border clearing between the E.U. and U.S. would finally be resolved, without any undue risk to financial stability in the E.U. or U.S. Considering that E.U. and U.S. persons account for close to 95% of the \$630 trillion global derivatives market, this would be a very important step towards implementing the post-financial crisis G-20 reforms.

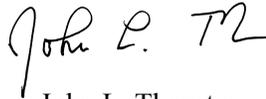
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Thank you very much for your consideration of the Committee's opinion. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott ([hscott@law.harvard.edu](mailto:hscott@law.harvard.edu)) at your convenience.

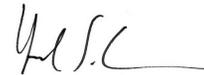
Respectfully submitted,



R. Glenn Hubbard  
Co-CHAIR



John L. Thornton  
Co-CHAIR



Hal S. Scott  
DIRECTOR