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ARTICLE

CCPs: EU Equivalence and Regulatory 'Bazookas'

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Abstract

This paper discusses various aspects of equivalence and (re)location issues in relation to central counterparties ('CCPs'). We will inevitably focus on the consequences of Brexit for the position of the London-based CCPs and the potential impact thereof on the derivatives clearing landscape in the European Union ('EU'). We will first describe the regime applicable to CCPs under the 2012 EMIR regime. This is followed by an introduction to EMIR 2.2 and the tiering of third-country CCPs. Subsequently, we will review the ESMA assessment of substantially systemically important clearing services and summarise the EMIR 3.0 proposal and its implications. Subsequently, the potential impact of the imposition of a location policy will be addressed. Finally, we will comment on how the European regime applicable to CCPs aligns with what may be referred to as the 'international legal order' providing the regulatory parameters within which cross-border clearing services may be conducted. We contend that imposing additional requirements for Tier 2 CCPs and the implementation of a (partial) location policy could prove to be regulatory 'bazookas'. Acting in breach of the international order of mutual recognition and deference could well backfire to the detriment of the European clearing industry.

Keywords CCP · Equivalence · OTC derivatives · Clearing · EMIR · EMIR 3.0 · Active account · LCH · Comparable compliance · Location policy · Mutual recognition · SwapClear

The opinions and thoughts expressed in this article reflect only the authors' views.

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1 Introduction

This paper discusses various aspects of equivalence and (re)location issues in relation to central counterparties ('CCPs'). We will inevitably focus on the consequences of Brexit for the position of the London-based CCPs and the potential impact on the derivatives clearing landscape in the European Union ('EU').

The discussion is largely triggered by the commanding position that two London-based CCPs, London Clearing House Ltd. ('LCH') and ICE Clear Europe Ltd. ('ICE Clear Europe'), have built over the years. LCH's SwapClear service attained a (quasi-)monopoly for the clearing of interest rate derivatives ('IRDs'), while ICE Clear Europe and ICE Clear Credit LLC (US) achieved a similar strong market position in credit default swaps ('CDSs') and short-term interest rate derivatives ('STIRs'). This is the result of various factors, including an ever-increasing volume of cleared derivatives trades, the preference of clearing members ('CMs') and end users to clear with CCPs enjoying a strong market position, a broad product range, deep liquidity pools, and efficiencies in collateral netting opportunities. The strong network effects of these institutions further enhanced their commanding positions. Basically, market forces bring about that once you have a relatively strong market position as a CCP, further concentration ensues in your favour.

In this paper, we will first discuss the regime applicable to third-country CCPs under the 2012 EMIR framework. This is followed by an introduction of EMIR 2.2[1] and the tiering of third-country CCPs. Subsequently, we will discuss the ESMA assessment of substantially systemically important clearing services, summarise the EMIR 3.0 proposal[2] and its implications, and then address the potential impact of the imposition of a location policy. Finally, we will comment on how the European regime applicable to CCPs aligns with what may be referred to as the 'international legal order' providing the regulatory parameters within which cross-border clearing services may be conducted.

2 EMIR 2012—Mutual Recognition and the International Order

2.1 The Baseline Model

The baseline model adopted in 2012, when the European Market Infrastructure Regulation ('EMIR'[3]) was promulgated, basically comprises a 'one tier' equivalence test, whereby third-country CCPs will be recognised if certain conditions are met, irrespective of their scale or location. The equivalence test takes place at two levels, whereby the European Commission has the prerogative to assess the third country concerned as a whole (country-level assessment) and, subsequently, the European

[1] Regulation (EU) 2019/2099 of 23 October 2019 (EMIR 2.2) amending EMIR.

[2] European Commission (2022a).

[3] Regulation (EU) No 648/2012 of 4 July 2012 (EMIR).

Securities and Markets Authority ('ESMA') may assess individual applications of a CCP in that third country (CCP-level assessment).

2.2 Country-level Assessment

The most important condition for equivalence is that the European Commission needs to adopt an implementing act determining that the legal and supervisory regime of that third country is sufficiently equivalent with the legal and supervisory regime in the EU.[4] Such determination in respect of a third country is the prerogative of the European Commission. Article 25(6) of EMIR stipulates that for such an implementing act to be issued, the European Commission has to determine that (i) the requirements with which a third-country CCP must comply are equivalent to the requirements set out in EMIR; (ii) those CCPs are subject to effective supervision and enforcement in the third country; and (iii) the legal framework of that third country provides for an effective equivalent system for the recognition of third-country CCPs. This latter requirement is an application of the so-called reciprocity principle, based on mutual recognition and deference to the local regime applicable to the third-country CCP in question; this is a key component of the 'international legal order' discussed in Sect. 9 below.

In addition to reciprocity, the third-country equivalence determination by the European Commission makes a distinction in terms of assessing compliance with these requirements depending on the relative size and importance of the clearing markets. Although EMIR itself does not make any such distinction, in practice the European Commission applies the so-called proportionality principle and takes a lighter approach when assessing smaller markets:

> The significantly lower risks inherent in clearing activities carried out in financial markets that are smaller than the Union financial market should therefore be taken into account. …. More stringent risk mitigation requirements are necessary for CCPs carrying out their activities in larger financial markets whose inherent level of risk is higher than for CCPs carrying out their activities in smaller financial markets whose inherent level of risk is lower.[5]

In conclusion, EMIR as adopted in 2012 and implemented in practice can be deemed to be in broad alignment with what may be regarded as the preferred 'international legal order' discussed in Sect. 9 below.

[4] EMIR, Art. 25(2) and (6).

[5] Commission Implementing Decision (EU) 2022/1683 of 28 September 2022 on the equivalence of the regulatory framework for CCPs in Colombia, Recitals (2-3). Similar wording can be found in many other equivalence decisions.

2.3 CCP-level Assessment

Over time, the European Commission has issued equivalence decisions for many countries, including all of the major derivatives markets.[6] On the basis of such a third-country equivalence decision, ESMA may recognise a CCP established in such a third country, provided that (i) the CCP is authorised in that third country and is subject to supervision and enforcement ensuring full compliance with the prudential requirements applicable in that third country; (ii) cooperation arrangements have been established with the third country's supervisors, ensuring appropriate information sharing; and (iii) the third country has equivalent systems for combating money laundering and terrorism financing.

This equivalence regime is essentially still in place for CCPs which the EU regards as not being systemically important ('Tier 1' CCPs).[7] However, since 2019, EMIR 2.2 provides for additional requirements for systemically important CCPs.

3 Tiering of Third-Country CCPs Under EMIR 2.2

3.1 Systemically Important Third-Country CCPs

The tiering of CCPs introduced in the EMIR 2.2 revisions of 2019 is based on the notion that additional requirements should be imposed if a CCP is *systemically important*. Such CCPs should then be classified as 'Tier 2' CCPs, while others remain classified as Tier 1 CCPs. This determination is based on an assessment in accordance with Article 25(2a) EMIR, whereby ESMA should take into account five groups of quantitative and qualitative considerations with respect to: (i) the nature, size and complexity of the business; (ii) the effect of a CCP failure; (iii) the CCP's membership structure; (iv) the availability of alternative CCPs; and (v) CCP interdependencies with other infrastructures and service providers.

These considerations are elaborated on in a Delegated Regulation (CDR 2020/1303).[8] At first glance, there appears to be a comprehensive list of assessment criteria, reflecting the wide variety of factors on the basis of which a CCP must be considered systemically important. They are, however, subjective in nature and it is

[6] List of Implementing and Delegated Acts for (EU) No 648/2012, https://finance.ec.europa.eu/regulation-and-supervision/financial-services-legislation/implementing-and-delegated-acts/otc-derivatives-central-counterparties-and-trade-repositories-regulation_en.

[7] The list of third-country ccps recognised to offer services and activities in the union (https://www.esma.europa.eu/sites/default/files/library/third-country_ccps_recognised_under_emir.pdf) mentions 38 CCPs, 36 of which as Tier 1 CCPs (26 October 2023).

[8] Commission Delegated Regulation (EU) 2020/1303 of 14 July 2020.

unclear which of these various criteria are more decisive.[9] Note also that certain relevant criteria appear to be missing.[10]

Arguably, the assessment criteria and the quantitative indicators mentioned below appear to have been devised to ensure that the large London-based clearing houses will qualify as systemically important.

3.2 Quantitative Indicators

As a counterbalance to the more subjective criteria mentioned above, CDR 2020/1303 contains a number of more objective quantitative exposure 'indicators' to be taken into account by ESMA when determining whether a third-country CCP is systemically important.[11] These indicators are measured over a 1–2 year period: (a) the maximum open interest of securities, repo and ETD[12] transactions denominated in EU currencies exceeds EUR 1 trillion;[13] (b) the maximum notional outstanding amount of OTC derivative transactions denominated in EU currencies exceeds EUR 1 trillion; (c) the net margin and default contributions of EU CMs exceed EUR 25 billion; and (d) the largest payment obligation of EU entities resulting from the default of the two biggest CMs would be more than EUR 3 billion in extreme but plausible market conditions.

At least one of these indicators must apply in order for ESMA to be authorised to determine that a non-EU CCP should be classified as systemically important: a Tier 2 CCP. The more of these indicators apply, the more likely that ESMA will conclude that the CCP is systemically important. Implementation of these quantitative indicators may be seen as an application of the proportionality principle, which is a key feature of the 'international legal order' discussed in Sect. 9 below.

3.3 Transparency

Despite the apparent granularity of EMIR 2.2 and CDR 2020/1303, the overall process is not necessarily transparent. It may thus be hard to predict the outcome of these assessments. Although political considerations may not be taken into account by ESMA, the wide discretion given to ESMA means that political interference could take place on an unspoken basis (see, however, Sect. 3.6 below). There might be inferences or accusations to the effect that the outcome of these assessments is politically motivated. Given that supervision of third-country CCPs is politicised and sensitive, this is something to be taken into account.

9 Lehmann (2022), p 17.

10 Turing (2023), who mentions the impact of default management on market liquidity, the ability of CMs to participate in default auctions, and procyclicality. One might perhaps also add the efficacy of recovery and resolution regimes and legal oversight by the judiciary. It can also be argued that these missing criteria are covered by the considerations mentioned in Art. 25(2a) EMIR.

11 Recital (8) and Art. 6 CDR 2020/1303.

12 Exchange-traded derivatives are traded on a regulated market, EMIR, Art. 2(7).

13 These indicators are linked to Art. 1(2) CDR 2020/1303.

Note that a Tier 2 determination impacts all services provided by the CCP in question. Is this outcome proportional in all circumstances, given the potentially far-reaching consequences? This question becomes relevant if a CCP is only systemically relevant to one of the (smaller) EU member states and/or offers other (significant) clearing services which by themselves are not systemically important.

3.4 Recovery and Resolution Aspects

The risk of European dependency on London-based CCPs is in part dependent on the effectiveness of recovery and resolution regimes. Effectiveness should address three aspects: *recovery*; *resolvability and pre-resolution intervention powers*; and *resolution* itself. The likely most important aspect of these is the ability of national resolution authorities to intervene in the pre-resolution phase. The European Recovery and Resolution of Central Counterparties Regulation ('R&R Regulation'[14]), in combination with the EMIR governance and risk requirements, is generally thought to be a relatively robust piece of legislation, which (despite its flaws[15]) provides the tools to more or less adequately address the dangers of EU CCP insolvency.

The R&R Regulation, however, does not deal with the issue of non-EU CCP failure in any practically meaningful manner. In comparison, the UK legislation, as Turing notes, is 'outdated and [has] a weak toolkit',[16] and this is likely to be of concern to ESMA in classifying UK-based CCPs as Tier 2. However, a robust third-country recovery and resolution regime does not in itself resolve the financial stability risk. A comparison between the UK and the European resolution toolkit was made in an ISDA/FIA publication of 26 May 2021.[17] A meaningful comparison is difficult to make: effectiveness will depend on the manner in which national resolution authorities exercise, in practice, the resolution functions accorded to them, particularly as to the application of 'soft law' and the use of informal persuasive supervisory powers.

3.5 Legal Oversight

A meaningful comparison between oversight by the European Court of Justice ('ECJ') and that by a third-country court system is also especially difficult to make. Nevertheless, legal oversight is paramount to the effectiveness of regulatory supervision, and it follows that if there are concerns over the position of the third-country judiciary in this context, these concerns must be taken into account when considering a Tier 2 classification. It is difficult to imagine that legal oversight considerations would be a decisive factor when making such classifications; this should, anyhow, not be the case with respect to UK- or US-based CCPs.

[14] Regulation (EU) 2021/23 of 16 December 2020.

[15] Binder (2021), pp 295 ff.; de Serière (2023).

[16] Turing (2023).

[17] FIA (2021).

3.6 General EU Principles of Administrative Law

Finally, in this context, it is worth noting that the tiering decision-making process is subject to general EU principles of administrative law. These principles are not codified in EU law,[18] but are gradually crystallised through ECJ case law. This means that their content and application in a given set of circumstances may be subject to debate. Failure to apply any such principle may expose EU decisions to nullification action by interested parties (e.g., affected third-country CCPs and/or the governments of the countries where they are established). These principles include: (a) the equality principle; (b) the proportionality principle; (c) the principle of the right to be heard; (d) the principle of legitimate expectations; (e) the principle of effective defence rights in judicial proceedings; (f) the principle of *détournement de pouvoir*; and (g) the principle of good governance by EU institutions. Application of these principles in tiering decisions requires careful formulation of underlying motives. This will require adherence to the rule of law; political motives (including 'sub-surface' considerations) should not be permissible. However, the dividing line between economic considerations on the one hand and politics on the other is not always easy to draw.[19]

4 Tier 2 Requirements

4.1 General

The Tier 2 requirements are set out in Article 25(2b)(a) EMIR 2.2.[20] In the words of the ESMA Assessment Report[21] of 17 December 2022, these

> aim to ensure that [these] CCPs comply with the requirements under EMIR on an ongoing basis so that, in principle, the risks stemming from services provided by a Tier 2 CCP would be the same if such services were instead to be provided by a CCP established in the Union.

To achieve this, Tier 2 CCPs need to comply with the core CCP provisions included in Article 16 and Titles IV and V of EMIR.[22] Article 16 contains CCP capital requirements, whereas Title IV deals with a wide range of topics: (i) organisational requirements, including governance and outsourcing rules; (ii) business conduct rules, including client access, segregation and portability; and (iii) prudential requirements, which include margin and default management requirements. Title

18 Except partially in the European Charter of Fundamental Rights.

19 Lehmann (2022), p 11.

20 EMIR 2.2. (n. 1).

21 ESMA (2021b) and the underlying ESMA (2021a), p 35.

22 EMIR, Art. 25(2b)(a).

V relates to rules dealing with interoperability, which is less relevant to derivatives clearing.[23]

4.2 Comparable Compliance

The Tier 2 requirements amount to an extra-territorial approach for Tier 2 CCPs, which then have to comply with two legal regimes: that of EMIR and that of their own national regime.

To mitigate this, EMIR 2.2 introduced the concept of comparable compliance. This can be regarded as the application of the proportionality principle (see Sect. 9). Article 25(2b)(a) EMIR states that ESMA shall take into account, in accordance with Article 25a EMIR, the extent to which a CCP's compliance with those EMIR requirements is satisfied by its compliance with comparable requirements applicable in the third country. This provision appears to provide ESMA with a certain measure of flexibility, although it remains unclear to what extent this provision, in practical terms, provides relief to a third-country CCP. Effectively, it still means that Tier 2 CCPs must generally be in compliance with the provisions of two legal regimes.

In any case, comparable compliance is a whole new concept. An equivalence decision in favour of a third-country CCP will not automatically mean that it will be easy for that CCP to meet the comparable compliance standards. For the current UK-based Tier 2 CCPs concerned it should, for the time being, not be problematic to comply with EMIR, or to achieve comparable compliance, given that EMIR remains largely incorporated in UK law. However, if, in the future, CCPs in other third countries are designated as Tier 2 CCPs, or where the UK regime would deviate from EMIR, this will put the comparable compliance system to the test.

ESMA will have to make an assessment on a (sub)clause-by-(sub)clause basis, whereby CDR 2020/1304 will provide the minimum elements that the Tier 2 CCP needs to comply with for each requirement mentioned in Title IV of EMIR.[24] At first glance, this appears to provide more granular detail, but at a closer reading it seems that the CDR does little more than sum up essentially all the requirements mentioned in the relevant EMIR (sub)clauses. It is possible that ESMA will decide that comparable compliance can be granted with respect to a number of clauses but not all of them. ESMA will then have to take an ultimate decision on whether the CCP as a whole has met the comparable compliance standards, leading to deference to the third-country's regulatory system. It is expected that ESMA will generally take a broad, outcomes-based and proportional approach. However, it remains to be seen how the comparable compliance standards will be applied in the future and if this will truly provide third countries with a meaningful way to mitigate the impact of full EMIR compliance.

[23] It follows from EMIR Art. 1(3) that interoperability only applies to transferable securities and money market instruments.

[24] Commission Delegated Regulation (EU) 2020/1304 of 14 July 2020, pp 13–26.

4.3 ESMA's Critical Views on Comparable Compliance

In its Assessment Report of 17 December 2021, ESMA provides critical comments on the comparable compliance regime. It argues that it was not given appropriate tools to fully assess compliance with EMIR, because CDR (EU) 2020/1304 does not provide any flexibility for ESMA to take into account the degree of systemic importance of the Tier 2 CCP that is subject to ESMA's assessment.[25] Also, ESMA states that the application of comparability requirements may lead to different supervisory outcomes. It is not clear from EMIR that ESMA has (extra-territorial) supervisory and enforcement powers in respect of requirements on the basis of which the Tier 2 CCP may be deemed comparably compliant with EMIR. ESMA considers it important that it is given express authorisation to take supervisory action to ensure EMIR compliance, especially if there is an urgent need, or where there are vastly different supervisory outcomes under both regimes.[26]

Furthermore, on page 115 of said Assessment Report ESMA states that the divergence of rules under two regimes may weaken its direct supervisory powers over Tier 2 CCPs; for example, it would have to defer to the definition of significant risk model changes as adopted by the third country's competent authority and would only have the authority to check that a Tier 2 CCP obtained an independent validation and a validation from its competent authority in respect of such changes. Apparently, ESMA sees a danger of risk model changes being adopted by a Tier 2 CCP which are in line with the third-country regulatory requirements involved, but which it would itself, under strict EMIR rules, deem unsatisfactory.

4.4 Direct Supervision by ESMA

Tier 2 CCPs are subject not only to EMIR obligations as set out in Article 24(2b) EMIR, but also to ESMA's direct supervision. This means that third-country CCPs that have Tier 2 status are subject to two (perhaps comparable but in any event independently exercised) supervision regimes: primarily that of their home country, and additionally that of ESMA. Applicability of two regimes is not without complications, and ESMA considers its supervisory authorities in this context less than ideal to ensure that its powers over Tier 2 CCPs can be adequately exercised.

4.5 ESMA Supervisory Powers Involving Third Parties

ESMA supervision not only involves the third-country CCP itself. For instance, Article 25(2b)(b) EMIR requires ESMA consultation on third-country central bank measures relating to the efficiency, soundness and resilience of CCPs that fall under such central bank's jurisdiction. This third-country central bank must consult ESMA and 'shall duly consider the amendments proposed in the opinions of

25 Regarding ESMA's supervisory authority generally in respect of third-country CCPs, see, *inter alia*, Lehmann (2022), pp 21-22.

26 ESMA (2021a), p 143.

ESMA'. Central banks are also under a duty to inform the European Parliament and the Council of such measures prior to their application. In addition, there is information sharing on a continuous basis, and ESMA has unrestricted access to the third-country CCPs in question. Article 25(2b)(7) EMIR envisages 'effective cooperation arrangements with the relevant competent authorities of third countries whose legal and supervisory frameworks have been recognised as equivalent'.

4.6 Current Tier 2 CCPs and ICE Clear Europe's Cessation of CDS Clearing Services

At present, ESMA has determined two third-country CCPs as providing Tier 2 services in accordance with Article 25(2a) EMIR, i.e., LCH (London) and ICE Clear Europe.

On 30 June 2022, ICE Clear Europe announced that it would cease its CDS clearing services for all asset classes and that it would consolidate its CDS clearing services by the end of October 2023 into ICE Clear Credit LLC in Chicago.[27] This resulted in the closure of ICE Clear Europe's CDS clearing services on 28 October 2023. Although the announcement does not provide any rationale, this decision was likely driven, or at least accelerated, by the fact that the UK is no longer part of the EU and that temporary equivalence for UK-based CCPs is currently set to expire mid-2025.

The cessation of CDS clearing services by ICE Clear Europe had a profound impact on the CDS clearing market in the EU, because clients of ICE Clear Europe were forced to clear their CDS transactions elsewhere, with ICE Clear Credit LLC (US) and LCH SA (CDSClear) in Paris being likely candidates. This has triggered an outflow of CDS transactions which were previously cleared in the UK, to CCPs in the US and the EU.[28] The cessation of CDS clearing services does not alter the fact that ICE Clear Europe is a Tier 2 CCP because its remaining clearing services are deemed of systemic importance as well.

4.7 Possible Consequences

In Sect. 3.2 we discussed that the relevant quantitative indicators for a Tier 2 determination relate to the amount of transactions cleared in EU currencies and the exposures of EU CMs and clients. When it comes to the notional outstanding amount of euro-denominated CDS transactions, ICE Clear Credit is much larger than ICE Clear Europe and already hit one of the quantitative indicators before ICE Clear Europe announced its closure of CDS clearing services.[29] The cessation by ICE

[27] ICE Clear Europe (2022a, b).

[28] According to Clarus, in Q3 2023, the market shares of ICE Clear Credit LLC and LCH SA increased to roughly 70% and 30% respectively; the majority (>75%) of the ICE Clear Europe volume in euro-denominated index CDSs (iTraxx)—which have to be mandatorily cleared—has gone to LCH SA and the volume in single-name CDSs has been more equally split, see https://www.clarusft.com/3q23-ccp-volumes-and-share-in-crd-and-fxd/.

[29] Clancy (2023) mentions that ICE Clear Credit LLC already hit the outstanding notional amount trigger.

Clear Europe has further increased the amount of euro-denominated CDS transactions cleared by ICE Clear Credit LLC.

This could potentially mean that ICE Clear Credit LLC, currently designated as Tier 1, comes in scope for a Tier 2 determination.[30] In theory, ESMA could, on the basis of Article 25(5) EMIR, determine that a Tier 2 classification is appropriate for the CDS activities carried out in Chicago. If ICE Clear Credit LLC were designated as a Tier 2 CCP, this would be the first US CCP required to comply with EMIR and subjected to direct ESMA supervision. Designating a US CCP as a Tier 2 CCP could be a game changer, as it may be perceived as going against the grain of the 'international order' discussed in Sect. 9 below. It would likely open up a whole new political dimension and may put the hard-fought equivalence agreements between the EU and the US at risk.[31] Increased EU supervisory involvement in the operations of a US-based CCP might trigger reciprocal actions by the US supervisory authorities, to the detriment of EU-based CCPs. But the European Commission and ESMA will likely be hesitant to designate a US-based CCP as a Tier 2 CCP, and this could even prompt them to tweak the tiering assessment criteria accordingly. It will be interesting to see how this plays out. In any case, it may give the market a better idea of how the Tier 2 criteria are applied in practice.

5 Forced (Re)location: A Regulatory 'Bazooka'?

5.1 Substantially Systemically Important CCPs

Apart from the classification as a Tier 1 or Tier 2 CCP, EMIR 2.2 also introduced the possibility for the EU *not* to grant (or to revoke) equivalence or recognition, if a CCP or some of its clearing services are deemed to be of substantial systemic importance to the EU or one or more of its member states in accordance with Article 25(2c) of EMIR (sometimes called: Tier 3). Taking such action would have a major impact as it forces EU market participants to relocate their clearing activities (see Sect. 8).

On 5 July 2011, the European Central Bank ('ECB') already observed in its Eurosystem Oversight Policy Framework[32] that it had concerns over the development of a major euro financial market infrastructure outside the EU. It stated the following:

> As a matter of principle, infrastructures that settle euro-denominated payment transactions should settle these transactions in central bank money and be legally incorporated in the euro area with full managerial and operational control and responsibility over all core functions for processing euro denominated transactions, exercised from within the euro area.

[30] This is especially relevant if more EU clients and EU CMs start using ICE Clear Credit LLC because this may trigger additional Tier 2 indicators. Most EU clients have expressed a preference for LCH SA.

[31] For a description of the US-EU dynamics, see Saguato et al. (2021), pp 63–72; Pearson (2023).

[32] ECB, Eurosystem Oversight Policy Framework, Sect. 6, https://www.ecb.europa.eu/pub/pdf/other/eurosystemoversightpolicyframework2011en.pdf.

The ECB underpinned this principle with clear exposure thresholds. However, this effort by the ECB to assume jurisdiction over CCP location issues was thwarted at the behest of the UK, by decision of the General Court of the ECJ. This decision annulled the above-mentioned ECB Policy Framework on the basis of legalistic arguments, because of the ECB's lack of competence.[33] However, EMIR 2.2 brought the location policy back to the table.

5.2 Central Bank Involvement

Nevertheless, there is intense central bank involvement, either directly or through the relevant CCP Supervisory College. The central banks of issue ('CBoIs') are a member of the CCP Supervisory Colleges and may exert their influence in the course of the decision making process of these Colleges.[34] In addition, CBoIs are given specific authorities under EMIR. Under EMIR 2.2, for instance, the CBoI (the ECB in the case of euro-denominated central clearing services) needs to be consulted when it comes to tiering the CCPs.[35] Of course, consultation does not allow for blocking a tiering decision, but the CBoI's point of view will be heard and, representing the voice of the national jurisdiction of the CCP in question, will evidently carry weight.

When it comes to the determination of a CCP or clearing service as being of substantial systemic importance, the relevant CBoI needs to provide its formal approval:[36] the ECB in its capacity as CBoI would be able to make its approval conditional upon certain requirements being met. Moreover, under Article 25(2b)(b) EMIR, the ECB has the ability to impose operational requirements on third-country CCPs to be applied 'in exceptional situations'; these requirements can cover issues such as liquidity risk control, margin requirements, collateral, settlement arrangements and interoperability arrangements. The ability to impose these requirements should mitigate the risks associated with third-country CCP failures. In addition, Article 24b(3) EMIR states that it will be necessary to 'seek the agreement of the central banks of issue' in respect of the matters referred to in that Article; these are matters relating to cooperation agreements and ESMA reporting to the European

[33] ECJ, 4 March 2015, T-496/11 stated: 'The ECB lacks the competence necessary to regulate the activity of securities clearing systems as its competence is limited to payment systems alone' (para. 110). This interpretation was based on a narrow interpretation of Art. 127(2) TFEU and on the fact that Art. 22 of the Eurosystem Statute did not specifically refer to clearing systems. Following a recommendation of the General Court, the ECB proposed to amend this Statute on 23 June 2017, but this was later withdrawn because the amendments suggested by the Parliament and Council were not acceptable to the ECB. The question remains whether the provisions of EMIR (including EMIR 2.2 and 3.0) sufficiently address the concerns of the ECB relating to financial stability.

[34] EMIR, Art. 18 mandates the setting up of a supervisory CCP college consisting of a range of competent authorities supervising the CCP, its main CMs, the relevant trading venues/CSDs and interoperable CCPs as well as independent members, the ESCB and the CBoIs.

[35] EMIR, Art. 25(3f).

[36] EMIR, Art. 24(b3). On certain operational issues, the CBoIs have to be consulted, see EMIR, Art. 24(b1).

Commission, *inter alia*, with respect to financial stability. The provision does not clarify what is to happen if agreement is sought but not obtained.[37]

5.3 Increasing Concern over Financial Stability Risks

Since 2017, concerns have been increasingly expressed in Brussels about risks to EU financial stability, arising, in the words of the European Commission, from 'excessive concentration of clearing in some third-country CCPs, notably in the United Kingdom, in a stress scenario'.[38] In equivalence decisions for UK-based CCPs, European market participants (i.e., EU-based CMs) were called upon to reduce their excessive exposures to systemic CCPs outside the EU. The market, however, largely ignored this call. This was partly due to the scarcity of alternative clearing venues, but also to prevent losing benefits that come with using larger CCPs (e.g., increased netting possibilities), and concentrated pools of liquidity. The costs of 'repapering contracts' will also have been a concern. In its 16 December 2021 Assessment Report, ESMA concluded that some services provided by those CCPs were of such substantive systemic importance that the existing EMIR 2.2 framework could be insufficient to manage the risks to EU financial stability.

Whereas the determination of a CCP as Tier 1 or Tier 2 relates to the CCP itself, the determination of clearing services as being of substantial systemic importance may relate to one or more of such CCP's clearing services. A CCP that complies with the conditions applying to Tier 2 CCPs may be denied recognition if that CCP is deemed substantially systemically important (see Article 25(2c) EMIR, which contains safeguards ensuring that a denial is based on sound and properly reasoned legal grounds (see also Sect. 3.6)). The European Systemic Risk Board ('ESRB') must be consulted, and the European Commission must adopt an implementing act to confirm a denial. This option enables the EU to impose what is essentially a location policy on EU market participants, if only CCPs authorised in the EU may provide services to such market participants. Despite the safeguards in Article 25(2c) EMIR, any such decision may well be perceived by the market to be at least partially politically motivated.

If subjecting Tier 2 CCPs to EU regulations and requiring them to accept direct EU supervision can be regarded as breaking the 'international order' (Sect. 9), the possibility for the EU to actually enforce a location policy through denial of recognition might prove a regulatory 'bazooka'.

[37] See Lehmann (2022), pp 17 and 23, regarding ECB involvement in the tiering process.

[38] European Commission (2022b), p 1.

6 EMIR Assessment of Substantially Systemically Relevant Clearing Services

6.1 First Tier 2 Assessments

On 17 December 2021, ESMA finalised its first assessment of Tier 2 CCPs, being LCH and ICE Clear Europe, and identified the clearing services mentioned below as substantially systemically important to the EU or one or more of its member states.[39] As stated above, ICE Clear Europe has ceased its CDS clearing services as of October 2023 (Sect. 4.6).

Tier 2 CCP	Country	Clearing service	Derivatives type	Currency/denomination
LCH Clearnet Ltd (SwapClear)	UK	Interest rate derivatives (IRDs)	OTC	EUR Zloty
ICE Clear Europe Ltd	UK	Short-term interest rate derivatives (STIRs)	ETD	EUR
		Credit default swaps (CDSs) – *Cessation 28 October 2023*	OTC	EUR

6.2 Derecognition of a CCP

ESMA could (at least in theory) have concluded, in accordance with Article 25(2c) EMIR, after consulting with the ESRB and in agreement with the relevant CBoIs, that the above-mentioned clearing services were of such substantial systemic importance that recognition regarding the provision of these clearing services should no longer be granted. Although ESMA concluded that in certain stress scenarios these clearing services might have a potentially negative impact on EU financial stability, this did not automatically mean that their recognition should be revoked. ESMA needed to make an assessment of the costs, benefits and consequences of such a decision, which included taking into account whether alternative EU clearing services were available, as well as the impact on outstanding contracts which were currently cleared at the relevant non-EU CCPs.[40] Based on this analysis, ESMA recommended not to derecognise the above-mentioned clearing services because '*at this point in time*' the disadvantages of derecognition outweighed the benefits. The phrase in italics makes it clear that the option of derecognition remains on the table.[41]

Accordingly, the EU has allowed UK-based CCPs to, temporarily, keep on providing their services in the EU. On 8 February 2022, the European Commission announced that the temporary equivalence period would be extended until 30 June

39 ESMA (2021a).

40 EMIR, Art. 25(2c)(c).

41 ESMA (2021a), p 141.

2025.[42] But temporary equivalence is not intended to be there forever. In February 2022, European Commissioner McGuiness stated explicitly that June 2025 would be the end of the equivalence for UK-based CCPs, with the intention of shifting clearing to the EU, while acknowledging that this 'will not happen organically, which is why we will need to intervene'. The Commissioner's remarks emphasise that the EU is firm in its intent to reduce its exposure to UK-based CCPs.[43] It remains questionable whether the EU will wield the axe in 2025, or decide to extend once again (see Sect. 7.2).

At present, EU market participants and EU CCPs are not ready for a massive transfer of derivatives positions. Even if that capacity were available, enforcing a location policy would be challenging (see Sect. 8 below).

7 EMIR 3.0

The EMIR 3.0 proposal is dated 7 December 2022.[44] The aim is to improve the attractiveness of EU CCPs; to reduce the excessive reliance of EU market participants on non-EU CCPs; to safeguard EU financial stability; and to enhance the EU's open strategic autonomy. The following proposals merit discussion.

7.1 Active Account Requirement and Transparency

Pursuant to a proposed controversial new Article 7a EMIR, market participants subject to the clearing obligation will be required to clear a proportion of their contracts at EU CCPs. Ultimately, the aim might be that substantially systemically relevant derivatives are, as much as practically feasible, cleared by EU-based CCPs, which could then possibly result in a situation where the large London-based CCPs are no longer substantially systemically important, making them eligible for a lighter Tier 2 status.

The reach of this proposed new Article 7a EMIR would be limited. Firstly, it would apply only in respect of trades deemed by ESMA to be of substantial systemic importance which initially included IRD contracts denominated in euro and Polish zloty and to euro-denominated CDSs and STIRs. However, in light of recent developments, this will most likely no longer include euro-denominated CDS transactions (see Sect. 4.6). Secondly, the majority of these contracts are between non-EU market participants (see Sect. 8.2). Only EU market participants would be bound by this new active account requirement. Probably, the proportion of contracts subject to this requirement would initially be relatively modest, and would likely be expanded over time.

The list of financial instruments in scope of the active account requirement is proposed to be dynamic: the European Commission would be able to amend this list

[42] Commission Implementing Decision EU/2022/174 of 8 February 2022, p 40.

[43] Fleming and Pickard (2023).

[44] European Commission (2022a).

whenever ESMA determines certain non-EU clearing services to be of substantial systemic importance for the EU or one of its member states.[45]

ESMA is to draft implementing technical standards determining the thresholds involved and the manner of calculating compliance. For now, EMIR 3.0 has not been adopted yet and it is unclear what (and if) thresholds are envisaged. However, Recital (10) of the EMIR 3.0 proposal provides some idea of current thinking; it states that the active account requirement should

> reduce the provision of those clearing services by those Tier 2 CCPs to a level where such clearing is no longer of substantial systemic importance.

While doing this, ESMA should also, among other things, take into account the costs, risks and impact on competitiveness, as well as amend these thresholds in the future when this is required by changing circumstances.

The European Commission has emphasised that the active account requirement should not be regarded as a location policy, because there is no intention to force all clearing activity to migrate to the EU, and clearing in other jurisdictions is not forbidden, as only a proportion thereof would need to be cleared in the EU in order to address financial stability risks.[46] This explanation appears fairly semantic: in practice, market participants will regard an obligation to clear a portion of derivatives in the EU as a partial location policy. The fact that the EU wants to force certain clearing activities to take place in the EU implies that the EU's concerns regarding overreliance on third-country CCPs are not solely focused on one or more specific non-EU CCPs. and cannot be resolved by transferring clearing activities to a number of other non-EU CCPs. At the time of publishing this article, the EU trilogue was still ongoing. So it remains to be seen what the final wording will look like.

Another newly proposed provision is Article 7b EMIR, which requires CMs to inform their clients in the context of each proposed transaction that there is a possibility of clearing with a CCP formally authorised under Article 14 EMIR. Some scepsis on the effectiveness of this provision seems justified. In order to ensure that the active account requirement is properly applied and effectively monitored, CMs and clients also have to provide their regulators with an annual report, informing them about their clearing activity in third-country CCPs, thus adding to the ever-increasing burden of reporting requirements.

7.2 Active Account Requirement Versus Temporary Recognition

How does the active account requirement relate to the UK's temporary equivalence regime, which is due to expire in 2025? If temporary equivalence is actually revoked, EU market participants will already be forced to relocate their clearing activities to the EU (or another equivalent jurisdiction), making an active account

[45] European Commission (2022a), Arts. 7a(2) and 7a(6) and 25(2c) apparently only refer to instruments subject to the clearing obligation.

[46] European Commission (2022c), p 3.

requirement superfluous. This raises the question why the EU is pursuing an active account requirement. Possible scenarios are as follows:

(i) The temporary equivalence decision will be revoked in 2025. The active account requirement will be adopted and implemented.
(ii) The temporary equivalence decision will be further extended but eventually revoked, thus giving the EU more time to enforce its active account requirement and build sufficient clearing capacity.
(iii) The UK will eventually be deemed equivalent but the temporary equivalence will first be extended, thus giving the EU more time to enforce its active account requirement and build sufficient clearing capacity.

A further extension seems likely, also given the fact that the reasons for previously extending the temporary equivalence decision will most likely still be relevant in 2025 (see Sect. 6.2). The third scenario seems the most plausible as it appears to be the only way to reconcile the contradictory impact of not extending the temporary equivalence regime and imposing an active account requirement.

7.3 Capital Incentives—Concentration Risks

EMIR 3.0 is accompanied by proposed amendments to the CRD, IFD and UCITS Directives[47] to encourage institutions to address excessive concentration risk to CCPs, in particular with respect to clearing services deemed of substantial systemic importance.[48] The most controversial proposals impose on credit institutions and investment firms the obligation to specifically focus on, to develop policies in relation to, and to consider the risk impact of CCP concentrations. The proposals also aim to provide competent authorities with concrete supervisory powers to address the concentration risk to third-country CCPs, by imposing additional capital requirements, and to 'require institutions to reduce exposures towards a central counterparty or to realign exposures across their clearing accounts in accordance with Article 7a', if the competent authority considers there to be an excessive risk concentration.[49]

These proposals do not specify how the active account requirement relates to the requirements under these proposals. Alignment would be helpful, since under the CRD/IFD the ECB is the prudential supervisory authority, whilst ESMA has that function in respect of CCPs.

Clearly, these proposals aim to enhance the use of EU CCPs, making it commercially less attractive for EU credit institutions and investment firms to use third-country CCPs, even if they are framed as addressing concentration risk. The exposures of larger EU banks to third-country CCPs are however considerable: BNP,

47 Directive 2013/36/EU of 26 June 2013, Directive (EU) 2019/2034 of 27 November 2019 and Directive 2009/65/EC of 13 July 2009.

48 European Commission (2022d).

49 Ibid., Arts. 2(5) and 3(4) of this proposal amending Arts. 104(1) CRD and 39(2) IFD.

Deutsche Bank and Société Générale are the top three EU CMs in SwapClear, according to the EMIR 3.0 Impact Assessment.[50]

7.4 Other Notable Amendments

In the context of equivalence, EMIR 3.0 contains a variety of other measures, including provisions that[51]

- aim to reduce bureaucracy and make authorisation procedures for expanding the CCP product offerings shorter, less complex and more predictable. ESMA is to produce technical standards in relation to these procedures. Non-objection procedures are introduced for the authorisation of additional non-material clearing services.
- permit the European Commission, 'where in the interests of the Union and considering the potential risks for the Union financial stability', to take a proportionate approach and waive the requirement for a third country to have an effective equivalent system for the recognition of third-country CCPs. The quoted proviso signifies that this proportional approach would only be applied to third countries where the CCPs concerned are not (potentially) significant, and where European CCPs would have no substantive commercial interests.
- intend to provide more legal certainty concerning the framework for intragroup equivalence decisions and, amongst others, to replace the need for an equivalence decision with a specific list of jurisdictions for which an exemption would not be granted.

8 Potential Impact of a (Partial) Location Policy

This section discusses some of the more substantive issues that would arise if location requirements were imposed on EU market participants.

8.1 Market Efficiency

Market participants have a natural tendency to look for the most efficient and cost-effective solutions. The fact that LCH and ICE Clear Europe have established such a dominant position in a number of clearing services means that the relevant CMs and end users feel that clearing with these CCPs is in their best interest. Because of strong network effects inherent to the clearing markets, the benefits of using the dominant CCPs tend to increase over time. This not only has resulted in quasi-monopolies in a number of clearing services, but, with the passage of time, makes clearing with these CCPs even more effective compared to clearing with competing, smaller EU CCPs. This market efficiency emphasises that EU market participants

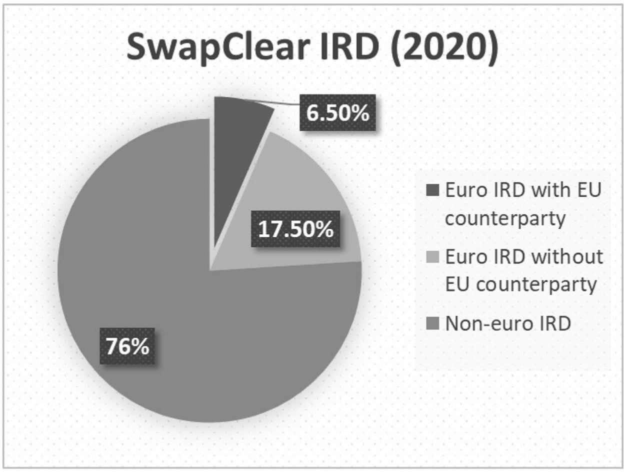
[50] European Commission (2022b).

[51] European Commission (2022a), pp 11-17, gives a concise overview of all 35 proposed amendments.

have a vested interest in the continuance of these quasi-monopolies (which is effectively in conflict with the European regulators' wish to deal with the risk of financial instability).

8.2 The EU's Relative Position

Derivatives markets are global in nature. Within these markets the EU's role is important but should not be overstated. The vast amount of interest rate derivatives is currently cleared by SwapClear, which indicated that, based on clearing volumes in 2020, only about 24% of these IRDs is denominated in euro.[52] But even with respect to euro-denominated IRDs, the powers of EU legislators should not be overestimated as these are limited to EU entities. A location policy (i) linked to euro-denominated IRDs and (ii) involving at least one EU counterparty may accordingly only cover about 6.5% of overall IRD volumes.[53]



Source: authors (based on SwapClear data)

Unless a relocation of euro-denominated IRDs would also attract a significant voluntary transfer (i.e., by non-EU firms and EU firms with respect to other products, for example, because of capital incentives), this would result in a much smaller EU market, enjoying a smaller number of participants, lower liquidity and higher costs.

8.3 Higher Costs

A forced location policy would—to some extent—break the existing (quasi-)monopolies, which would inevitably lead to market fragmentation. Splitting positions

52 Jones (2021).

53 24% * 27% = 6.5%. Only 27% of the euro-denominated IRDs involves at least one EU counterparty.

over multiple CCPs will lead to a breaking of margin sets, generally resulting in less margin efficiency for CMs and end users. It should be taken into account that the impact can be very different for specific CMs and end users, depending on their relevant positions and netting opportunities. ESMA has estimated that in case of a full relocation (including legacy portfolios) away from LCH SwapClear, margins for credit institutions and insurance companies would increase with approximately 6-7%, whereas pension fund margins would hardly be impacted.[54] However, for EU funds (39%) and EU CMs (53%) this would be very different.[55] If these estimates are correct, the margin costs would increase quite considerably for these CMs and end users.

Increased default funding costs, higher margin requirements[56] and higher CM capital charges would also result in higher costs of clearing with EU CCPs. This will have a negative effect on their competitive position, also in relation to non-EU market participants. Third-country CCPs may well exploit that disadvantage.

8.4 Default Management

In addition, the fact that all relevant CMs and end users predominantly use the UK-based CCPs may put these CCPs in a better situation when it comes to default management if one or more CMs default. This is because of the depth of these CCPs' liquidity pools, associated hedging or unwinding options and the available porting capacity, whereas smaller CCPs may face liquidity issues, or have a lack of active CMs with which hedging and porting could be realised.

8.5 Distortion of Competition and the Capital Markets Union

Relocation requirements constitute a distortion of global competition: only CMs and end users from the EU would have to clear in the EU, whereas their international competitors would enjoy freedom of choice. This would be harmful to the EU CMs' competitive position when offering market-making and client clearing services to non-EU clients. On the other hand, relocation would clearly advantage EU CCPs that have not succeeded in becoming market leaders for the impacted clearing services.

In a broader global context, the above-mentioned competitive distortion would not meaningfully contribute towards building a strong European Capital Markets Union. However, the EMIR 3.0 proposal explicitly states that it aims to (i) promote the Capital Markets Union; (ii) reinforce the EU's open strategic autonomy; and (iii) enhance the efficiency and effectiveness of EU-level supervision.[57] In relation to the

54 ESMA (2021a), p 96, because they mostly clear EU currencies and are often one-directional.

55 Ibid., pp 94-95, states that this may result in margin increases of EUR 2/10.6bn for funds/CMs.

56 Ibid., p 100, mentions that transfers to smaller CCPs may lead to higher concentrations, thus triggering additional concentration margins.

57 European Commission (2022a), p 3, provides a brief summary.

concept of 'open strategic autonomy',[58] the proposal states that it can reinforce this because 'building a strong EU central clearing system with robust capacity reduces risks stemming from excessive reliance on third-country CCPs and their supervisors'. Clearly, the European Commission attempts to base the EU's policies regarding third-country CCPs on EU financial stability concerns, but the EU's tiering policies can also be explained by reference to the open strategic autonomy (which is not necessarily the same).[59]

8.6 Financial Stability and Oversight

The European Commission has repeatedly stated that the high volume of exposures to UK-based CCPs entails risks for the financial stability of the Union and its monetary policy.[60] But even though Tier 2 CCPs need to comply with EMIR requirements and are directly supervised by ESMA, the EU considers that this may still not be enough to fully mitigate financial stability risks related to certain clearing services. In its Tier 2 Assessment Report of December 2021, ESMA stated that Tier 2 CCPs may adopt discretionary decisions that may have an impact on the EU's financial stability. In particular, ESMA focused on three types of risk scenarios:[61]

(i) Business-as-usual scenarios, whereby access to clearing services is no longer available because of operational disruptions, or because a third-country CCP uses contractual discretionary powers to restrict, suspend or terminate access of EU trading venues or CMs.[62]
(ii) Crisis management scenarios, whereby a third-country CCP uses contractual discretionary powers to increase collateral haircuts, ask for additional margins or declare an EU CM in default, could conflict with measures EU authorities wish to take to manage this crisis.[63] ESMA stated that '[p]ast experiences have shown that the risk that CCPs might not act in line with EU financial stability is not an unrealistic concern. As observed for instance in 2011 when sudden hikes in haircuts on EU sovereign collateral were applied by some CCPs.'[64] These events have apparently been one of the triggers for the EU to tighten its grip on systemically important third-country CCPs and also raises questions on the division of responsibilities between CCPs and EU supervisors. While

[58] Which is a somewhat hazy concept, elaborated in European Commission (2021).

[59] Ibid., pp 12-13, also mentions that third-country sanctions could expose EU entities to being punished 'through the unlawful extra-territorial application of unilateral sanctions'.

[60] Ibid., p 13.

[61] ESMA (2021a), pp 34-41 (SwapClear) and pp 68-73 (ICE Clear Europe).

[62] Ibid., p 38 (under 86, n. 37). Tier 2 CCPs do not have to comply with Arts. 7-8 EMIR (access to CCPs /trading venues).

[63] Turing (2023) states that during a crisis the ECB may be inclined to lower collateral standards, while the CCP might want to increase them.

[64] ESMA (2021a), pp 38-39, refers to some alarming occurrences during the financial crisis, which caused LCH to increase sovereign bond haircuts for Ireland, Portugal, Spain and Italy, resulting in a dramatic value decrease of these bonds, requiring immediate intervention by the ECB. Reportedly, the Bank of England and the UK Chancellor then refused to intervene in LCH.

ESMA appears to be mainly worried about actions of CCPs, politically motivated supervisory interventions may not be an unrealistic scenario.[65]

(iii) Third-country recovery and resolution scenarios, which may not adequately address EU financial stability risks. During the recovery phase, CCPs and/or their supervisors may use discretionary powers which may have a substantial impact on EU CMs without ESMA having any supervisory control over the CCP's recovery plan.[66]

The analysis of these scenarios has led ESMA to the conclusion that certain clearing services of LCH and ICE Clear Europe are of substantial systemic importance (see Sect. 6.1).

8.7 Experiences with Location Policies Abroad

The idea of implementing a location policy is not unique but in general, most jurisdictions have decided against implementing such an obligation because it would be harmful to their own financial institutions, from both a cost and a risk perspective.[67] An important exception is Japan, where the regulator has only provided licenses to foreign CCPs for clearing services related to non-yen-denominated derivatives. This has resulted in a *de facto* location policy which appears to be fairly successful.[68]

In the US, there are no location requirements in the strict sense of the term, but the Commodity Futures Trading Commission ('CFTC') extends its regulatory jurisdiction to any entity, regardless of its domicile, that engages in activities affecting US commerce. This agency's jurisdiction covers not only the activities of CCPs, but also those of other market participants (swap dealers, etc.). As a consequence, EU CCPs extending services to US customers must be registered and will then be fully subject to CFTC requirements, supervision and enforcement measures, thus creating significant entry barriers.[69]

65 Lehmann (2022), p 7, rightfully points out that both CCPs and supervisors may have skewed incentives. See also ESMA (2021a), pp 38-39, stating that direct supervision should give ESMA more control over CCPs' collateral policies and the authority to amend them if they are discriminatory or increase procyclicality. ESMA also mentions that it has no powers to oppose supervisory interventions in the UK which are detrimental to the EU. See also European Commission (2022a), pp 16, 55-56.

66 ESMA (2021a), pp 35, 41 and 46, mentions that this could cause losses, that alternative clearing opportunities may not be available and that the current UK R&R toolbox is fairly limited. See also Sect. 3.4.

67 Thomadakis and Lannoo (2021), pp 47-50.

68 Ibid., p 52, stating that >60% of yen-denominated interest rate swaps are cleared in the Asia Pacific region. See also Clancy and Davies (2023).

69 See, *inter alia*, Saguato et al. (2021), pp 64 ff.; Pearson (2023).

9 An International Order?

9.1 General

It can be argued that there is an 'international legal order' embodying principles that govern, or should govern, the manner in which regulatory authorities deal with cross-border activities, more in particular CCPs, including principles of mutual recognition, reciprocity and proportionality. In this section, we will examine the extent to which the EU's approach to third-country CCPs applies these principles.[70]

The equivalence regime as implemented in EMIR in 2012 was based on mutual recognition and deference to the local regulators. Because many other (major) countries applied a similar approach, this regime could be deemed to reflect the international legal order described above.

At the G-20 summit in Saint Petersburg in 2013, the final statement included the following wording:

> Jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes.[71]

The preferred outcome of this approach should be that the major economic blocs do not impose their own regulations on foreign CCPs, but rely on the application of foreign law and supervision, based on the notion that these are deemed broadly equivalent. However, even if this approach is generally agreed, circumstances may justify a deviation from this preferred outcome, provided that such measures should in principle only be applied if fundamental policy issues so require.

Over time, the EU regime has evolved (and is still evolving) into a rather complex set of rules, whereby Tier 2 CCPs are forced to comply with EU law and are subjected to direct EU supervision. Furthermore EMIR 2.2 and the EMIR 3.0 proposal provide the EU with the authority to impose a (partial) location policy. Can the said deviations from the preferred international order be justified?

Although granting equivalence ought to be predicated solely upon objective criteria, a political dimension is evidently involved, and proportionality and reciprocity are required for the international order to flourish. Below, we briefly describe these two principles and how these have been applied within the EU regulatory framework regarding CCP equivalence.

9.2 The Principle of Proportionality

Application of the principle of proportionality implies that—if fundamental policy issues so require—more stringent rules may be applied to systemically important

[70] Callens and Löber (2023), for an insightful description of the challenges which the 'international legal order' faces.

[71] G20 Leaders' Declaration (2013), p 71.

CCPs. This makes sense, since the underlying idea of equivalence is to ensure that third-country CCPs do not pose unacceptable levels of systemic risk in the EU. Conversely, this principle also entails that less stringent rules should be applied to CCPs that have little systemic importance. The principle of proportionality is closely interlinked with the concept of subsidiarity, which means that it should be investigated if (less harmful) alternatives are available.

The principle of proportionality is applied throughout the EMIR regulatory framework. A few notable examples:

- A less stringent equivalence approach, in practice, towards smaller Tier 1 CCPs;
- A more stringent approach towards systemically important Tier 2 CCPs, whereby these CCPs have to comply with core EMIR provisions and are subject to direct ESMA supervision;
- An even more stringent approach by (potentially) enforcing a location policy with respect to substantially systemically important CCPs;
- A detailed set of (proportionate?) criteria in order to establish whether a CCP is systemically important (Tier 2) or substantially systemically important;
- The concept of comparable compliance, which may provide some leeway to Tier 2 CCPs to avoid full EMIR compliance;
- The fact that the substantial systemic importance determination does not necessarily apply to a CCP as a whole, but may address certain specified clearing services only;
- Imposing an active account obligation on larger market participants, as proposed in EMIR 3.0, based on proportionate thresholds.

Of course, it can be argued that certain CCPs (or market participants) did not receive proportionate treatment in EMIR's regulatory framework. This is open to discussion. Clearly, though, proportionality is one of the leading principles.[72]

9.3 The Principle of Reciprocity and Mutual Benefit

This principle entails that countries expect to receive a similarly beneficial regulatory treatment as they themselves apply to the relevant third country. The EU certainly expects a certain level of reciprocity, as reflected in Recital (60) of EMIR:[73]

> On 16 September 2010, the European Council agreed on the need for the Union to promote its interests and values more assertively and, in a spirit of reciprocity and mutual benefit, … to secure greater market access for European business and deepen regulatory cooperation with major trade partners.

The principle was later codified in Article 25(6c) of EMIR, stating that the European Commission may adopt an implementing act relating to the equivalence of a

[72] European Commission (2022b), pp 4-5, also refers to the concepts of subsidiarity and proportionality.

[73] The Recital refers to the 'spirit of reciprocity', which may give the European Commission a bit more leeway on how to interpret this principle.

third-country regulatory regime where 'the legal framework of that third country provides for an effective equivalent system for the recognition of CCPs authorised under third-country legal regimes'. Apart from reciprocity, reference is made to equivalence decisions being mutually beneficial to both the EU and third countries in order to protect the EU's interest. In 2021, the European Commission re-confirmed this position by stating the following:

> The EU is open to global financial markets but is ready to protect its interests. In this context, equivalence decisions in financial services are mutually beneficial for the EU and for third countries … .[74]

9.4 The International Order at Risk?

Based on the principles of proportionality and reciprocity mentioned above, the EU is arguably well justified in its approach whereby more equivalence is not granted, or other measures are taken, in order to protect the EU's interests. However, this should only be done if fundamental policy issues require such actions.

If third countries perceive that the EU exercises these powers too liberally, this could be construed as a violation of the international order. For the time being, EMIR 2.2 as well as the proposed EMIR 3.0 may be regarded as a – logical – corollary of Brexit, and, for now, only two UK-based CCPs are impacted by this new approach towards CCP equivalence. But this may change over time, if the temporary UK equivalence is not extended, if CCPs from other third countries are impacted and/or a (partial) location policy is implemented. Exercise of these powers would be defendable when based on legitimate financial stability concerns, but could also be harmful to EU market participants, and the EU's Capital Markets Union. Moreover, it could open a Pandora's box as the EU could be subjected to a degree of retaliation risk.

10 Conclusion

The road to EU economic and financial independence is, as far as clearing services are concerned, long, winding and bumpy. The consequences of forcing (re)location upon EU market participants are, for the time being, unfavourable for the EU clearing industry, and it is doubtful whether EU-based CCPs and market participants will be able to (cost-)effectively absorb these consequences in the near future. The McGuinness pre-announcement of an end to the equivalence regime in 2025 either seems unduly optimistic or might be interpreted as an indication that the EU is willing to trade off better control over its financial stability against the disadvantages of (re)location. If and when EMIR 3.0, with an imbedded active account requirement, is introduced before 2025, this can perhaps be seen as the EU's preferred compromise solution: a somewhat veiled, very real but prudently gradual location requirement.

The recently signed Memorandum of Understanding between the UK and the EU could be seen as a sign that the EU and the UK are making a first cautious effort to

[74] European Commission (2021), p 12.

find workable solutions for the financial market sector. However, for now, the market should not get its hopes up that full-fledged mutual recognition is back on the table.[75]

The political and commercial drivers underlying the EU's approach are undeniable, and this could lead to friction with the US and UK. Would the outcome of such friction ultimately be beneficial to the EU financial infrastructure landscape? The existing 'international order' described in Sect. 9 above would be replaced by a new 'international order' of uncertain parameters and consequences. The question of whether the price the EU would likely have to pay is worth the advantages of added supervisory control and perhaps better macro-economic containment of financial stability risks remains extremely difficult to answer.

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