Lex et Brexit — The Law and Brexit

Davis Polk

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Contents

On June 23, 2017, we passed the one year mark since the referendum on the UK's membership of the EU. Although certainty on the eventual consequences of that decision is in short supply, the UK and the EU finally began the Brexit negotiation process last week in Brussels. The unexpected result of the June general election in the UK (where the ruling Conservative Party lost its majority in the House of Commons) means that the UK negotiating team begins the Brexit process without the clear mandate that had been sought by the UK Prime Minister. It is not yet apparent how the consequent lack of political stability in the UK will affect the UK's position in the negotiations. In this issue, however, we focus on the EU side of the negotiating table in relation to financial services.

First, we look at an opinion published by the European Securities and Markets Authority ("**ESMA**") on supervisory convergence in the context of firms relocating from the UK following Brexit. The opinion addresses regulatory and supervisory arbitrage risks that may arise from such relocations and sets out general principles for a common supervisory approach across the remaining EU Member States. We also look at comments by senior officials from the European Central Bank ("**ECB**") that indicate that the ECB shares ESMA's concerns about regulatory standards in respect of UK banks moving to the EU.

We then look at a recent legislative proposal by the European Commission to amend the European Market Infrastructure Regulation. The proposed Regulation amends, inter alia, the procedures involved for the authorization of central counterparties and requirements for the recognition of third country (non-EEA) central counterparties ("**CCPs**"). Despite ESMA suggesting that the reforms are consistent with the goal of ensuring the robust supervision of CCPs as systemically important institutions, the proposals have been criticised by some UK policymakers who view them as a means of forcing the clearing of euro-denominated financial instruments from the UK to the EU.

Supervisory Convergence in Financial Services

Background

On May 31, 2017, ESMA published an opinion (the "**Opinion**") on general principles to support supervisory convergence in the context of authorized firms relocating from the UK[1], following the decision of the UK to leave the EU. As the UK withdraws from the EU, market particpants may seek to relocate to Member States that will remain in the EU (the "**EU27**") in order to maintain access to the EU financial markets. The Opinion addresses regulatory and supervisory arbitrage risks that may arise from such relocations and sets out general principles (the "**Principles**") for a common supervisory approach across the EU27. Senior officials from the ECB have recently explained in a number of fora that they share ESMA's concerns about regulatory standards in respect of UK banks moving to the EU.

The Opinion is underpinned in the EU by a concern that a regulatory "race to the bottom" may occur among the regulators in the EU27 (known as national competent authorities ("**NCAs**") in EU jargon), in a bid to win business post Brexit. To guard against such arbitrage, the Opinion encourages progress in supervisory convergence to improve integration and ensure financial stability accross the EU.

The Opinion is addressed to the NCAs of the EU27 and focuses on entities subject to the AIFMD, UCITS and MiFID regimes[2]. Although the Opinion assumes that the UK will become a third country (i.e. a non-EU and non-EEA country) after its withdrawal from the EU, both ESMA in the Opinion, and the ECB in its recent commentary, make it clear that equivalence available to third countries under under certain EU legislation is not a "blank cheque".

> "As many firms reconsider how to structure their business across Europe to prepare for the UK's departure from the internal market, we are reminded once again about the risks of a race to the bottom among supervisors to win over business, at the expense of financial stability. We must confront any such allegations. Different supervisors within the internal market must work together, converge their supervisory practices, and establish strong mutual trust." **Commission Vice President Valdis Dombrovskis, speech at the European Business Conference: Challenges for EU financial services policy, April 25, 2017.**

The Principles

No automatic recognition of existing authorizations

Existing authorizations will not be recognized by the NCAs of the EU27 as there is no basis for automatic recognition of authorizations granted by third country authorities, such as the UK regulator, in EU law. ESMA encourages relocating entities to contact the NCA in the Member State where it wishes to relocate as soon as possible.

1. **No automatic recognition of existing authorizations.**
2. **Authorizations granted by the EU27 should be rigorous and efficient.**
3. **NCAs should be able to verify the objective reasons for relocation.**
4. **Special attention should be granted to avoid "letter-box" entities in the EU27.**
5. **Outsourcing and delegation to third countries is only possible under strict conditions.**
6. **NCAs should ensure that substance requirements are met.**
7. **NCAs should ensure sound governance of EU entities.**
8. **NCAs must be in a position to effectively supervise and enforce EU law.**
9. **Co-ordination to ensure effective monitoring by ESMA.**

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[1] ESMA 42-110-443.

[2] These acronyms refer to the three key pieces of legislation applicable to asset managers and investment firms in the EU: the Alternative Investment Fund Managers Directive ("**AIFMD**"), Undertakings for Collective Investment in Transferable Securities ("**UCITS**") Directive and the Markets in Financial Instruments Directive ("**MiFID**"). MiFID will be replaced by a new Directive and a Regulation (known as "**MIFID II**" and "**MiFIR**"**)** from January 3, 2018.

Authorizations granted by the EU27 should be rigorous and efficient

NCAs must ensure that the conditions set by the relevant legislation and ESMA guidance are met from the point of authorization.

Although NCAs could take into account aspects of assessments carried out by UK regulators previously, for example in relation to fit and proper requirements, they must apply strong scrutiny to at least the following elements: the governance structure of the entity; human and technical resources; geographical distribution of activities; and outsourcing and delegation arrangements.

NCAs should be able to verify the objective reasons for relocation

ESMA requires NCAs to ensure, by reference to the entity's program of operations, that the applicant has an "objective reason" for relocation. The desire to relocate should be driven by the entity's planned activities within the EU. NCAs should attain a clear view of the applicant's planned activities by obtaining information on: (i) prospective investors or marketing and promotional arrangements; (ii) location of development of products and services; and (ii) other jurisdictions where the entity has engaged a local NCA. ESMA warns against the risk of regulatory arbitrage and encourages NCAs to only grant authorization where they are fully satisfied that their Member State was not chosen to evade the stricter standards of other Member States.

Special attention should be granted to avoid "letter-box" entities in the EU27

To minimize the transfer of business activities and personnel from the UK, entities might attempt to outsource or delegate certain functions to UK based entities so that the effective performance of certain activities remains in the UK, while a lightly staffed and resourced licensed entity is established in the EU. ESMA expects NCAs to reject authorization requests creating such "letter-box" entities where: (i) extensive use of outouring and delegation is foreseeable; (ii) the intention is to benefit from an EU passport; and (iii) all substantial activities or functions are performed outside the EU.

Outsourcing and delegation to third countries is only possible under strict conditions

An EU market participant must ensure that it retains the ability to direct and control outsourced or delegated functions and cannot outsource or delegate its responsibilities. ESMA also notes that under certain EU legislation, such as the outsourcing of critical or important functions under MiFID II, outsourcing or delegation arrangements to a third country entity are conditional on prior co-operation agreements between the EU NCA and the third country authority.

NCAs should ensure that substance requirements are met

NCAs should ensure that: (i) outsourcing or delegation arrangements do not hinder the ability of the NCA to effectively supervise the entity; (ii) they have access to data relating to the arrangements and to the business premises of the outsourcee and the delegate; and (iii) the arrangements do not impact business continuity, confidentiality and conflicts of interest, which should be appropriately managed.

ESMA also states that some important activities and functions require special scrutiny and in certain circumstances cannot be outsourced or delegated without threatening the activity of the regulated entity and the ability of the NCA to effectively supervise the entity. ESMA provides several examples of these important activities and functions including: internal control functions; IT control infrastructure; key management functions; and sector specific functions.

NCAs should ensure sound governance of EU entities

Key executives and senior management should be located in the Member State of establishment and work there to a degree proportionate to their role, if not on a full time basis. In smaller companies, where the functions may not constitute a full-time job, the NCA may, on a case-by-case basis, employ some flexibility in its assessment.

NCAs should be satisfied that board members and senior management in the Member State have effective decision making powers to ensure compliance with EU laws. The quality and the presence of executive board members and/or senior management should be assessed to ensure that they can effectively carry out their responsibilities, which include having sufficient knowledge and relevant experience, and dedicating sufficient time to carrying out their duties.

In relation to risk management, entities applying for authorization should have readily available and sufficient capital and liquidity resources.

NCAs must be in a position to effectively supervise and enforce EU law

NCAs should have the resources and the capacity to effectively monitor the application of legislation and to ensure proper supervision of entities. In particular, NCAs should ensure that conditions are met on a continuous basis and should have the capacity to conduct on site investigations of outsourced or delegated activities without any prior third party authorization.

ESMA emphasizes the importance of co-operation between the various NCAs and with third country authorities, such as the Prudential Regulation Authority and the Financial Conduct Authority in the UK, to help ensure the effective supervision of entities.

Co-ordination to ensure effective monitoring by ESMA

ESMA intends to establish a new Supervisory Coordination Network to promote consistent decision making by NCAs. This forum will allow NCAs to discuss relocation cases to help ensure a consistent approach across the EU27. ESMA is prepared to go further to ensure supervisory convergence and is considering using its powers to bring cases for discussion before the Supervisory Coordination Network, provide opinions to NCAs, conduct peer reviews and investigate possible breaches of EU law.

Observations

Although much of the Opinion simply reflects powers and obligations that already apply to NCAs under existing law, it provides a number of useful indications of ESMA's thinking on the shape of post-Brexit regulation:

- The Principle that there is no recognition of existing authorizations reflects the existing position under EU law for third countries; firms from such countries wishing to establish themselves in an EU Member State are required to go through the relevant national authorization process. This is in contrast, of course, to the passporting regime available to EU firms, which allows for business to be conducted in a host Member State without the need for full authorization by the NCA in that host Member State.

- The Principles also reflect the existing position regarding authorization processes in EU law. The key point here is one of emphasis and tone; ESMA is signalling that it will not tolerate NCAs applying a "light-touch" authorization process for UK firms because of the UK's prior EU membership. This Principle sits rather uneasily with a French regulatory initiative launched in September 2016 to allow a "fast-track" authorization process for some UK firms aiming to relocate as discussed in the **seventh issue of Lex et Brexit**.

- Given ESMA's role as the body responsible for ensuring supervisory harmonization within EU financial markets, it is unsurprising that it should warn against regulatory arbitrage. That said, it seems slightly at odds with the ethos of the single market that a firm should not be able to choose any EU Member State as its Home State and then provide services in any such Member State using the passporting regime. The reference to "stricter standards" is, of course, open to interpretation; many UK financial services firms might regard a move to a jurisdiction with higher levels of regulatory capability, engagement and interaction as a bonus rather than a problem.

- The existence of potential "letter-box" entities has been a long-standing concern of ESMA, particularly in the context of asset management. This Principle overlaps considerably with the requirements on substance referred to in the other Principles, and the restrictions on delegation and outsourcing, which will be of particular concern to asset management firms. In practice, this can be seen as ESMA firing a shot across the bows at those NCAs who might be tempted to permit substantial internal control, IT and management functions to be retained in London post-Brexit. Firms may face increased costs in maintaining duplicative roles and infrastructure in the UK and the EU (to the extent those firms plan to maintain substantive authorized firms and business in both jurisdictions).

- Another key concern for ESMA is to ensure that NCAs have senior personnel in the EU jurisdiction to whom any enforcement action can be addressed. It is evident from the Principles that the flexibility of management structures in EU financial services groups may be constrained by this requirement.

- The Supervisory Co-ordination network is an interesting new development. The European Supervisory Authorities such as ESMA already have the power to require NCAs to "comply or explain" in relation to certain regulatory standards, but the creation of a new body implies that ESMA wishes to be a more powerful voice in directing the activities of NCAs in the authorization process.

Next Steps

ESMA has encouraged NCAs to ensure they are adequately staffed and resourced to manage an increase in authorization and supervision activities from UK financial market participants seeking to relocate within a short period of time. ESMA also intends to develop sector specific opinions for asset managers, investment firms and secondary markets.

ECB

The ECB has taken a similar view on regulatory arbitrage as that put forward by ESMA, noting that divergent supervisory practices pose a risk to effective oversight. Following approaches by banking groups about supervision requirements for banks relocating business in the context of Brexit, the ECB organised a technical workshop for institutions considering relocating banking activities to the euro area on May 4, 2017.

In the introductory remarks to the workshop, the vice-chair of the supervisory board of the ECB, Sabine Lautenschläger, provided general guidance on the ECB's supervisory expectations for relocating banks, and emphasized the importance of both banks and NCAs putting in place significant and efficient planning resources.

The concerns of the ECB mirror those of ESMA, for example: "letter-box" entities are prohibited; material risk management at the local level is encouraged; and outsourcing and delegation is prohibited where it might interfere with the operational independence of the entity.

Conclusion

ESMA's concern that regulatory arbitrage may ensue as a result of Brexit echoes the concern of the ECB who have emphasised that they will "resist any supervisory or regulatory race to the bottom". The proposals to enhance supervisory convergence across the EU27 are intended to ensure that intense competition between Member States in the race to lure post-Brexit business does not undermine the stability of the EU financial system. We are also aware that the European Insurance and Occupational Pensions Authority (the insurance equivalent of ESMA) is likely to produce a similar set of standards or recommendations in the coming weeks.

An interesting feature of the Opinion is that it clearly envisages UK financial services firms being treated in the same way as those from any other third countries. In the absence of any sign of the bespoke (and complex) financial services arrangements currently being contemplated on the UK side, it is clear that EU27 regulators are planning for a post-Brexit world where UK firms will not get any special treatment (for example, no special recognition of the value of a previous FCA authorization).

Furthermore, there is a clear direction of travel to give the ESMA and the ECB more direct supervisory powers in relation to the UK post-Brexit, and more powers of direction generally in relation to NCAs. Although the clear focus of these proposals is in relation to UK firms, it is certainly plausible that tougher standards might well be applied to third country firms more generally, including U.S. financial services groups. This new direction can be seen in other EU initiatives such as the evolution of the "equivalence" standard for third country access, proposals to require an EU intermediate holding company for some banking groups (see the **ninth issue of Lex et Brexit** for more detail) and the euro-clearing proposal discussed below.

Firms will therefore need to be aware of this evolving environment. When applying for authorization in an EU27 jurisdiction, investment firms and asset managers should expect the relevant NCAs to import, implicitly or explicitly, the Principles into their authorization requirements. Such firms may do well to do the same in terms of demonstrating why their authorization application and accompanying business plan fits with the model envisaged in the Principles and recent statements by EU policymakers.

"ESMA's focus has shifted markedly from the single rule book to supervisory convergence, but the experience indicates that stronger powers to ensure consistency across the EU are needed. Stronger tools would allow more effective and timely intervention to promote convergence of practices across the EU."
Steven Maijoor, Chair of ESMA

Proposals to amend the EMIR Supervisory Regime

Background

On June 13, 2017, the European Commission published a **proposed Regulation** amending the ESMA Regulation (*Regulation 1095/2010/EU*) and the European Market Infrastructure Regulation (the Regulation on OTC derivative transactions, central counterparties and trade repositories) (*Regulation 648/2012*) ("**EMIR**"). This proposed Regulation amends, inter alia, the procedures involved for the authorization of CCPs and requirements for the recognition of third country CCPs. The proposal aims to address challenges in derivatives clearing as it grows in scale and seeks to reflect a pan-EU approach to the supervision of EU CCPs, in order to ensure further supervisory convergence and to enable closer co-operation between supervisory authoritities and central banks in the EU and in third countries.

Despite ESMA suggesting that the reforms are consistent with the goal of ensuring the robust supervision of CCPs as systemically important institutions, the proposals have been criticised by some UK policymakers who view the reforms, in a post-Brexit context, as a means of forcing the clearing of euro-denominated financial instruments from the UK to the EU.

What is EMIR?

Following the financial crisis, EMIR was introduced to increase transparency in the financial markets. London is a global hub for derivatives trading and, as an EU Member State, the UK has been subject to EMIR, which for trades involving an EU counterparty, requires the clearing and collateral exchange for certain types of standardized OTC derivative contracts and the reporting of all derivative contracts to trade repositories. As discussed in the **sixth issue of Lex et Brexit**, EMIR can be considered to be the EU counterpart of the regime regulating the swaps market in the US under the Dodd-Frank Act, although there are significant differences in the scope, detail and application of the rules.

The key benefit of clearing via a CCP is the reduction in counterparty risk. The CCP, as a regulated financial infrastructure provider, acts as the "buyer to every seller and the seller to every buyer" in securities or derivatives transactions where the parties have agreed to clearing; in other words, the clearing entity interposes itself between the two parties so that one transaction becomes two matching contractual obligations.

Appetite for Change

CCPs have helped reduce reliance on bilateral OTC trading of derivatives and are effective vehicles for reducing both counterparty and systemic risk. However, with: (i) the increased reliance on CCPs; (ii) the increased scale of CCPs; (iii) the interconectedness of CCPs; and (iv) the concentrated nature of the CCP market, the failure of a CCP could destabilize the financial system.

In this context, the Commission has conducted a broad assessment of EMIR, assessing supervisory arrangements for CCPs and, taking into account feedback from a series of Commission consultations, has proposed that further amendments to the supervisory arrangements for EU and third country CCPs under EMIR are necessary because:

- the main supervisory decisions for EU CCPs are currently taken at the national level (by national authorities in the Member State in which the relevant CCP is established). Due to the increased volume of cross-border CCP activity, this Commission believes this is no longer appropriate and exposes the EU financial system to risks whilst not reflecting the important role played by central banks in determining monetary policy and payment systems used by CCPs; and

- although financial instruments denominated in Member State currencies (including the Euro) can be cleared by recognized CCPs in non-EU countries due to the equivalence regime of EMIR, the current EMIR rules on equivalence and recognition have gaps in relation to ongoing supervision in third countries. This, according to the Commission, exposes the EU to further risk which could harm the financial stability of Member States or of the EU as a whole.

As noted in previous editions of Lex et Brexit, London is one of the most important centers for the clearing of all types of derivative, dominating the clearing of euro-denominated derivatives. Although not explicitly stated in the Commission proposal, Brexit throws into stark relief the fact that UK based CCPs are not subject to regulatory control by the ECB, and, following Brexit, will not be directly subject to prudential and authorization requirements applicable to CCPs under EMIR. The Commission has made clear its view that the current system would struggle to cope with CCPs which could pose a systemic risk to the functioning of the Eurozone operating from outside the EU.

The Proposed Amendments: EU CCPs

The proposal envisages NCAs, the ECB and ESMA together exercising supervision of CCPs established in the EU. It is proposed that a new CCP Executive Session will be set up within ESMA for this purpose, with responsibility for providing more coherent and consistent supervision of EU CCPs.

To ensure consistency, the head of the new CCP Executive Session will chair the existing colleges of national supervisors established under EMIR for each EU CCP. The CCP Executive Session will comprise: newly-appointed independent members; the relevant national authorities; the relevant central banks; and the Commission as non-voting members.

The Proposed Amendments: Non EU CCPs

The proposal envisages a new two-tier system for third country CCPs whereby:

- **non-systemically important CCPs** continue to operate under the existing EMIR equivalence framework; and

- **systemically important CCPs** will be subject to stricter requirements.

A limited number of CCPs (so called “**substantially systemically important CCPs**”) may be of such systemic importance that the additional requirements for systemically important CCPs would be insufficient to mitigate risk and the Commission, at the request of ESMA and in agreement with the relevant central bank, could prevent a CCP from providing services in the EU without establishing itself in the EU (by applying for authorization in the relevant Member State in accordance with EMIR).

What is a systemically important CCP?

ESMA will be tasked with determining if a third country CCP is systemically important. When considering an application for recognition, ESMA will need to consider the degree of systemic risk presented by a third country CCP, which will depend on their scope, the type of transactions cleared and the volume of their clearing activity.

Four objective criteria are provided for to enable ESMA to determine whether a third country CCP is systemically important[3]:

- the nature, size and complexity of the third country CCP's business;
- the effect that the failure of, or a disruption to, the third country CCP would have on critical markets, financial institutions, or the broader financial system and on the financial stability of the EU;
- the third country CCP's clearing membership structure; and
- the third country CCPs relationship, interdependencies, or other interactions with other financial market infrastructures.

CCPs that have already been recognized under the current EMIR regime will continue to be recognized as 'non-systemically important' CCPs until ESMA has determined whether such third country CCPs are systemically important.

Requirements for systemically-important CCPs

Systemically important CCPs will have to comply with additional requirements, including:

- ongoing compliance with the necessary prudential requirements for EU CCPs (including capital requirements, conduct of business rules, margin, default, financial resources, stress tests, default fund and internal organization management rules);
- compliance with additional requirements set by the relevant EU central bank (likely to be the ECB in most cases), including written confirmation of compliance. This may include, for example, additional requirements to address risks for liquidity, payment or settlement arrangements in the EU or Member States;
- providing ESMA with relevant information to enable it to exercise its supervisory responsibilities including enabling on-site inspections; and
- having all necessary measures and procedures in place to be able to comply with the first and third condition above.

A new system of 'comparable compliance', similar to the system applied by the US authorities, is proposed whereby ESMA may determine that the application of the rules in a third country are comparable to compliance with EMIR and waive the application of the corresponding EMIR provision.

In short, the proposals for systemically important CCPs amount to joint supervision between the third country supervisor and the EU.

Implications of Proposed Changes

Advantages

- **Ease of Implementation:** operationally, clearing parties with CCPs established in the EU will be minimally affected by the proposals.
- **Safer CCPs:** according to the Commission the probability of importing financial stability risks into the EU would be reduced and a safer clearing market in the EU should benefit all market participants and Member States by creating strong and stable global markets.

[3] These criteria will be further specified by the Commission in secondary legislation within six months of the adoption of the Regulation.

- **Funded from outside of the EU**: any additional resources required should be funded via the collection of supervisory fees from third country CCPs.

- **Greater harmonization**: Under these proposals, ESMA will be granted a range of additional direct supervisory powers and resources. This may result in a more uniform application of EMIR rules more generally and a more transparent system for the assessment of equivalence and the treatment of third country CCPs.

Disadvantages

- **Cost of supervisory fees:** third country CCPs will face additional supervisory fees which may be passed on to clearing members.

- **Other costs and market fragmentation:** UK and other third country CCPs may have to establish supervised entities in the EU leading to financial costs and operational impacts including the potential higher costs of trading due to market fragmentation, impacts on the liquidity of the instruments cleared and potential higher costs of clearing due to losses in margin efficiencies.

Impact on existing equivalence decisions with non-EU jurisdictions

Existing equivalence decisions adopted under EMIR to date remain in force and will not be called into question unless there are regulatory or supervisory changes in the third country or changed market conditions. The equivalence assessment in relation to the US in particular was cited in the **fact sheet** on the proposed Regulation as proving fit for purpose and facilitating transatlantic derivative activities, whilst not jeopardizing financial stability.

The interplay between the proposal and Brexit

If, as increasingly seems likely, the UK will not retain EEA membership following Brexit, UK CCPs will no longer be authorized as EU CCPs under EMIR. As discussed in the **sixth issue of Lex et Brexit**, there is a process by which the Commission could make an equivalence decision in respect of a third country jurisdiction.

After the Commission has decided that a third country jurisdiction is equivalent, counterparties entering into transactions within the scope of EMIR shall be deemed to have complied with the provisions of EMIR if at least one of the counterparties is established in that third country.

As mentioned above, EMIR provides for third country CCPs and trade repositories to provide services through an ESMA recognition process. Under the Commission's proposal, ESMA, in determining an application for recognition of a UK based CCP, will now additionally be tasked with determining the systemic risk profile of a UK CCP. ESMA could deny recognition to a CCP that it considered to have "substantial systemic significance" for EU financial stability, thereby requiring the UK CCP to establish itself in the EU in order to provide clearing services in the EU.

The proposal has faced criticism from UK policy makers who view it as a potential method of forcing the clearing of euro-denominated derivatives from the UK. into the EU. The category of "substantially systemically important CCPs" seems to be aimed squarely at the activities of London based CCPs, which currently clear around three quarters of euro-denominated derivatives.

However, the proposal is not a simple re-casting of the ECB's 2011 proposal to impose a "location policy" in respect of CCPs clearing euro-denominated instruments above a certain simple quantitative threshold; such a move would have been far more controversial and potentially damaging in terms of market fragmentation. The "substantially systemically important" categorization is nonetheless viewed by some as a relocation weapon being held in reserve by the EU. If the political and regulatory relationship between the UK and the EU deteriorates after Brexit, it is possible that this weapon could be employed to damage the position of London as a global financial center, although such use would not be without collateral damage to the EU side.

On a more positive note, it is also worth noting that the 'comparable compliance' approach means that UK clearing houses may theoretically be released from EU requirements provided that they comply with local rules which EU regulators determine to be equivalent. In practice, however, we expect the UK regulatory regime for CCPs and derivatives trading to be the same as that under EMIR in the short to medium term.

The ECB

The ECB has defended the proposal noting the importance of the major clearing houses in the UK (who provide a large proportion of the euro-denominated interest rate swaps of euro area banks and euro-denominated credit default swaps) to the stability of the euro, and emphasizing that the current regime was not designed to cope with major systemic CCPs operating outside the EU and therefore requires reform in the context of Brexit to uphold the stability of the financial system.

On June 23, 2017, the governing council of the ECB proposed an amendment to their statute to provide the ECB with increased competence in relation to central clearing oversight, in accordance with the proposed amendments to EMIR. Formerly the ECB did not have the necessary competence to regulate the clearing system[4].

The proposed amendment comes off the back of the proposed Regulation of 13 June, and reflects the aforementioned worries about the potential impact on European liquidity of a significant disturbance affecting a major UK CCP in the context of Brexit, and the recognition that central clearing has become increasingly cross-border and systemically important in nature whilst CCPs have evolved and are now a critical part of the European financial markets infrastructure. The proposed amendment aims to ensure that the Eurosystem can perform the role envisaged by the proposed Regulation and that the ECB has the necessary powers, under the Treaty on the Functioning of the European Union and under its statute, to do so. Notably, the ECB will have regulatory powers to: (i) adopt binding assessments, (ii) require remedial action, in co-operation with other EU authorities, to respond to risk affecting the European financial system; and (iii) adopt additional requirements for CCPs involved in the clearing of significant amounts of euro-denominated transactions.

In accordance with the simplified amendment procedure, the recommendation was sent to the European Parliament and the Council for the adoption of a decision to amend the statute. The European Commission will issue an opinion on the proposed amendment.

Conclusion

To the extent that the proposal seeks to address challenges in derivatives clearing as it grows in scale by encouraging pan-European supervisory convergence in the form of a CCP Executive Session with responsiblility for providing more consistent supervision of EU CCPs, it is welcome.

However, the addition of a systemic risk based criteria for third country CCPs may further obfuscate procedures around third country recognition. The proposed ability of the Commission to deny recognition to a CCP in particular angered certain UK commentators who have interpreted it as the EU driving the clearing of euro-denominated derivatives from the UK. Nonetheless, the direction of travel for the UK derivatives market in the context of Brexit is more benign than might otherwise have been the case. The EU appears willing to tolerate London as a euro-denominated derivatives center, as long as UK regulation is maintained in line with EU regulation. There remains a material risk, however, that political considerations in the EU may still ultimately determine whether the power of relocation of large UK CCPs is ultimately invoked.

It is important to note that in the current draft of the proposal, there would be a substantial degree of regulatory and political discretion to be applied by the Commission when deciding whether to require a CCP to establish itself in the EU.

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[4] See the *United Kingdom of Great Britain and Northern Ireland v European Central Ban*k, ECLI: EUT2015:133.

The proposal also does not deal with transitional arrangements for derivatives trading in the context of Brexit which will need to be put in place to ensure that UK CCPs maintain the right to provide services to EU counterparties in any transitional period.

"We are aware that Brexit is a cause for concern in the future regulatory treatment of central clearing. In this regard, we know that there has been significant focus on one aspect of the recent Commission proposal, namely the ability of the Commission to deny recognition to a CCP that poses excessive risks to the financial stability of the EU, and to require it to establish itself in the EU if it wishes to provide clearing services in the Union. This would be just one of the tools available to EU authorities under the revised EMIR proposal. I believe that such an approach will be justified in case EU authorities are unable to adequately control risks and fulfil their mandates through other means. Ultimately, however, it will be up to the Commission and the EU legislators to decide on the specific conditions for triggering such a requirement, in the context of the forthcoming legislative discussions. The ECB and other central banks of the EU are, of course, carefully examining the Commission's proposal and the ECB will issue an opinion on it in the coming months."
Benoît Cœuré, Member of the Executive Board of the ECB, at the Global Financial Markets Association, Frankfurt am Main, June 20, 2017.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Thomas J. Reid	**+1 212 450 4233**	tom.reid@davispolk.com
John D. Amorosi	**+1 212 450 4010**	john.amorosi@davispolk.com
John Banes	**+44 20 7418 1317**	john.banes@davispolk.com
Leo Borchardt	**+44 20 7418 1334**	leo.borchardt@davispolk.com
Will Pearce	**+44 20 7418 1448**	will.pearce@davispolk.com
Simon Witty	**+44 20 7418 1015**	simon.witty@davispolk.com
Michael Sholem	**+44 20 7418 1027**	michael.sholem@davispolk.com
Helen Mc Grath	**+44 20 7418 1321**	helen.mcgrath@davispolk.com

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