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Brexit: Is Equivalence a Solution for Derivatives Clearing?

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We have considered in a broader context whether the European Union (“EU”) equivalence framework provides an appropriate basis for the future relationship between the EU and the United Kingdom (“UK”) – see our paper “**Brexit – Is Equivalence a Solution for Financial Services?**”. In this section, we consider whether equivalence offers adequate solutions for the derivatives market in the context of central clearing (both voluntary and mandatory). With the prospect of no agreement being reached by the end of the transition period becoming increasingly likely, our view (as outlined in the above paper) is that the current equivalence position does not provide a long-term, sustainable solution for the UK-based financial services industry as a whole to access EU markets. Predictability, stability and transparency in respect of the applicable regulatory requirements are key conditions to enable financial services firms to implement their distribution, marketing and growth planning in the medium to long-term. The current equivalence position intended to provide temporary permission for EU parties to clear derivatives in the UK following Brexit does not offer those key conditions.

As for many other sectors, Brexit presents various challenges for derivatives clearing. We have also prepared papers summarising the expected legal impacts arising from no agreement on financial services being reached by year end for each of the areas of: **insurance, banking, investment funds, MiFID firms, and fintech and payments**; together with an analysis of equivalence as a viable or relevant mechanism in each case.

Introduction

In July 2020, the European Commission (“**Commission**”) published a **communication** (the “**July Communication**”) giving an update on progress and indicating that it was considering a time-limited equivalence decision with respect to UK central counterparties (“**CCPs**”) and was conducting its assessment of the UK’s data privacy regime. On 21 September 2020, as contemplated in the July Communication, the Commission adopted a **decision** to give financial market participants 18 months to reduce their exposure to UK CCPs. On 28 September 2020 the European Securities and Markets Authority (“**ESMA**”) announced¹

¹ <https://www.esma.europa.eu/press-news/esma-news/esma-recognise-three-uk-ccps-1-january-2021>

the temporary recognition of three CCPs established in the UK as eligible to provide their services in the EU until June 2022.

The Commission has also published **notices** to stakeholders that indicate the Commission’s assessment of the UK’s equivalence in some other areas. However, the July Communication identifies a number of areas where the Commission does not plan to adopt an equivalence decision in relation to the UK “*in the short or medium term*”, including the equivalence decisions under Article 47(1) of the Markets in Financial Instruments Regulation (“**MiFIR**”) (for investment firms providing investment services to EU professional clients and eligible counterparties) and Article 17(2) of the Short Selling Regulation (exemption for market making). The July Communication and the notices to stakeholders are also silent on the Commission’s intentions regarding equivalence decisions in some areas.

Clearing

UK CCPs are seen as a critical element of European derivatives infrastructure; a substantial volume of Euro denominated derivatives transactions are currently cleared through UK CCPs. While there are CCPs located in the EU that provide clearing services for Euro denominated derivatives transactions, there has long been a concern that a ‘cliff-edge’ Brexit (leaving EU counterparties unable to clear derivatives on UK CCPs) would be highly disruptive for the derivatives markets. Many feared that EU CCPs may struggle to cope with the volume of trading that would need to migrate from UK CCPs, and the operational challenges and costs involved in migration would be significant.

To mitigate these concerns prior to the entry into force of the Withdrawal Agreement the Commission had implemented a number of temporary recognition decisions stating that, in the event of a no-deal Brexit, three UK CCPs (LCH Limited, ICE Clear Europe Limited and LME Clear Limited) would be recognised to provide their services in the EU. However, these decisions were contingent on a no-deal Brexit and therefore lapsed when the transition period under the Withdrawal Agreement commenced.

Partly as a result of Brexit, the European Market Infrastructure Regulation (“**EMIR**”) (which regulates derivatives trading in the EU) was amended to introduce a new framework for recognition of third-country CCPs (“**TC CCPs**”) (these amendments are known as EMIR 2.2). EMIR 2.2 entered into force in January 2020. Significantly, equivalence under EMIR 2.2 requires not just an assessment on the regulatory environment in the third-country, but also provides that TC CCPs may be fined by ESMA and on-site inspections may be conducted by ESMA (meaning ESMA performs a qualitative assessment of the business of the relevant TC CCP; effectively a limited form of regulation of the TC CCP).

Under EMIR 2.2 TC CCPs recognised by ESMA are divided into Tier 1 TC CCPs (non-systemically important) and Tier 2 TC CCPs (systemically important and subject to more stringent regulation). Importantly under EMIR 2.2 there is a procedure for a Tier 2 TC CCP to be recognised as of ‘such substantial systemic importance’ that it should not be recognised to provide clearing services in the EU. This would effectively require that CCP to relocate to the EU if it wants to service EU clients.

On 28 September 2020 ESMA announced the temporary recognition of three UK CCPs – ICE Clear Europe Limited, LCH Limited, and LME Clear Limited – as TC CCPs as of 1 January 2021 (ie, effective as of the end of the Withdrawal Agreement transition period). LME Clear Limited was assessed as a Tier 1 CCP and ICE Clear and LCH Limited were assessed as Tier 2 CCPs. This recognition applies until 30 June 2022.

The 18 month temporary recognition is intended to give ESMA an opportunity to comprehensively review the systemic importance of UK CCPs and to take appropriate measures to address financial stability risks, including considering whether any UK CCPs are of such substantial systemic importance that they should not be permitted to provide services in the EU from outside the EU.

Mitigating 'Cliff-Edge' Risks

While the temporary 18 month recognition of certain UK CCPs is welcome, it does not remove the 'cliff edge' risks for the market. The temporary recognition merely postpones the 'cliff-edge' to June 2022. The uncertainty over the status of UK CCPs post-June 2022 means counterparties will have almost two years during which they have to maintain and update contingency plans with no clear indication as to the final role UK CCPs will have within the European derivatives clearing infrastructure. Given the volume of derivatives trades cleared through UK CCPs, many in the market see a real prospect that one or more may be declared of substantial systemic importance, requiring EU clients to move clearing to an EU CCP or another TC CCP.

Other Potential Adverse Impacts on Derivatives

While this paper has focused on the impact of the end of the transition period on derivatives clearing, there are numerous other potential adverse impacts for EU derivatives users, including:

- some national competent authorities (including the Central Bank of Ireland) interpret the EMIR intra-group reporting exemption as only applicable if the relevant parent company is established in the EU. Under this interpretation EU subsidiaries of UK parent companies will need to begin reporting intra-group derivatives trades under EMIR following the end of the transition period;
- (absent an equivalence decision) exchange-traded derivatives traded on UK regulated markets will nonetheless be considered OTC derivatives for the purposes of EMIR and must be counted towards the EMIR thresholds for determining whether an entity is subject to mandatory clearing obligations;
- EU counterparties may lose their ability to rely on the exemption from clearing requirements for OTC derivatives transactions with UK pension funds;
- EU counterparties must report transactions to EMIR authorised trade repositories. Where a counterparty is currently reporting to a UK based trade repository such reporting will need to be migrated to an EU based trade repository;
- as the UK has 'on-shored' EMIR, when an EU counterparty trades with a UK counterparty the trade could be subject to reporting, risk-mitigation and clearing requirements under EMIR and the UK's domestic version of EMIR, which could cause operational issues;
- the application of the Bank Recovery and Resolution Directive ("BRRD") will require in-scope EU institutions to include bail-in recognition clauses in all derivatives trading documents governed by English law; and
- EU members of UK CCPs designated under the Settlement Finality Directive may need to consider whether domestic UK law will provide equivalent protections from loss as those provided under the Settlement Finality Directive.

In conclusion, Brexit presents many significant challenges to financial services providers wishing to operate from the UK yet maintain a central role in the trading and operational aspects of EU derivatives markets. The recently announced time-limited equivalence decision in relation to three UK based CCPs will support the continued use of those UK CCPs until June 2022. However, the significant uncertainty as to the medium and long-term regulatory outlook in relation to the UK's ability to offer derivatives market related services to EU clients is likely to result in many market participants and service providers moving to EU based alternatives before June 2022.

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Please get in touch with your usual Matheson contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this paper.

Full details of Matheson's Finance and Capital Markets Department, together with further updates, articles and briefing notes written by members of the team, can be accessed at www.matheson.com. Further Brexit-related updates, articles and briefing notes may be accessed on our [Brexit Forum](#).

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