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# Supervisory systems after Brexit: coordination between EU and UK on a daily basis. Dispersed vs. single supervisor (systemic risk aspects).



## I – General background on the existing supervisory architecture and its proposed reform.

### 1. - An introductory overview.

1. To reduce systemic risk linked to the extensive use of derivatives the EU adopted, in accordance with the G-20 Pittsburgh agreement, the European Market Infrastructure Regulation (EMIR) no. 648/2012. EMIR requires that standardised OTC derivatives contracts be cleared through a central counterparty (CCP). According to data published by the European Commission, in the five years since the adoption of EMIR "the scale and scope of centrally-cleared transactions has expanded, [whilst] the number of CCPs has remained relatively limited. There are currently 17 CCPs established in the EU, all of which are authorised under EMIR (Article 14) to offer their services within the Union, although not all CCPs are authorised to clear all assets. An additional 28 third-country CCPs have been recognised under EMIR's equivalence provisions, allowing them to offer their services in the EU".[1] According to a recent study[2] "interest rate derivatives account for the greatest

[1] Explanatory memorandum to the Proposal for a regulation amending Regulation No 1095/2010 and Regulation No 648/2012, SWD (2017) 246 final, p. 3-4.

[2] V. Brühl, 'Clearing of euro OTC derivatives post Brexit – an anlysis of the present cost estimates', *CFS Working Paper Series,* No. 588, 29 November 2017, p. 2.

proportion, at around 75%" of the derivatives trades cleared worldwide (overall, over USD 400 Trillion); "around 30% of the interest rate derivatives are euro-denominated, and around 97% of these are cleared via LCH Clearnet (LCH), the clearing subsidiary of the London Stock Exchange. Eurex currently has a market share of around 1% for the clearing of euro-denominated interest rate derivatives; CME controls around 2% of the market; the importance of other clearing houses is negligible". No surprise that, as rightly noted[3], "the location of systemic clearing facilities has become by far the most contentious issue in Brexit finance discussions. Just one day after the no-vote in the referendum, French President Francois Hollande stated that euro clearing facilities could no longer be based in London if the UK left the EU".

**2.** Under EMIR, EU CCPs are supervised by their home country competent authorities, with the assistance of colleges composed (Article 18) of (i) national supervisors, (ii) ESMA, (iii) relevant members of the ESCB; (iv) other relevant authorities (like supervisors of the largest clearing members, of certain trading venues and of central securities depositories). The colleges can include as many as 20 member authorities, under the chair and coordination of the home-country competent authority. EMIR details the role entrusted to colleges, which are meant to "facilitate the exercise of the tasks" referred to authorisation, extension of activities and services, validation of models, stress testing and back testing of its risk control mechanisms, approval of interoperability arrangements. Three main concerns have been raised in respect of the current architecture for EU CCPs: (1) due to concentration of clearing services in a small number of Member States, supervisory decisions adopted mainly by the home-country supervisor (despite college's assistance) have significant cross-border implications and may affect the EU financial system as a whole; (2) there are diverging supervisory practices (different authorisation conditions and different model validation processes) across the EU and they can create risks for arbitrage; (3) the role of central banks – as issuers of the currency – is not adequately reflected in the colleges (nor in the ESAs).

**3.** Under EMIR third-country CCPs can be recognised by ESMA and can thus provide clearing services to clearing members or trading venues established in the European Union (Article 25). *This recognition is very important for EU-based clearing members: they can reduce their regulatory capital on exposures to the recognised CCP from 100% to just 2%.*[4] The conditions for third-country CCPs' recognition are set out in Article 25(2). The most important of such conditions relates to the adoption by the European Commission of an implementing act "determining that the legal and supervisory arrangements of a third country ensure that CCPs authorised in that *third country comply with legally binding requirements which are equivalent to the requirements laid down in Title IV of [EMIR] Regulation, that those CCPs are subject to effective supervision and enforcement in that third country on an ongoing basis* and that the legal framework of that third country provides for an effective equivalent system for the recognition of CCPs authorised under third-country legal regimes" (Article 25(6)). A significant amount of financial instruments denominated in the currencies of the Member States are currently cleared by recognised third-country CCPs[5] and they will become virtually (almost) all once the United Kingdom will leave the UE. Thus, as it has been noted[6], "there is a perceived risk a politicised European Commission might withhold an equivalence determination for UK supervisors regardless of the quality of UK authorisation and supervision. Without the equivalence determination the capital cost of clearing in London for EU-banks would become

[3] K. Lannoo, 'Derivatives Clearing and Brexit. A comment on the proposed EMIR revisions', *ECMI Policy Brief* No. 25, November 2017, p. 9

[4] K. Tyson, 'Brexit and Clearing', in *Brexit and the implications for financial services,* ed. P. Jackson, Larcier - Suerf Conference Proceedings, 2017/1, p. 102

[5] Explanatory memorandum to the Proposal for a regulation amending Regulation No 1095/2010 and Regulation No 648/2012, p. 5.

[6] K. Tyson, *cit.*, p. 102

prohibitive". *This is what makes the TCE regime under EMIR central stage in the Brexit negotiations.* Once recognised, third-country CCPs operate under the third-country competent authority supervision, but *a cooperation arrangement must be in place with ESMA* to ensure exchange of information, prompt notification of specified events (breach of conditions of authorisation or breach of law; grant of right to provide services to EU clearing members of clients) and coordination of supervisory activity, including on-site inspections (article 25(7)). However, after the first five years of implementation, concerns have been raised, as to third-country CCPs, on (1) the effectiveness of ongoing supervision, because ESMA encountered difficulties (i) in accessing information from CCPs, (ii) in conducting on-site inspections and (iii) in sharing information with other authorities; (2) possible misalignments between supervisory and central-bank objectives and (3) possible changes in the regulatory and supervisory framework, because there is currently no mechanism to ensure that the EU is automatically informed of such changes.

**2.- The ECB failed attempt to impose Eurosystem central bank supervision (and relocation).**

**4.** Since euro-denominated derivatives trades are cleared out of the Euro zone, the central banks of the financial centres (mainly New York, Chicago and London)[7] where the relevant CCPs are established need to secure liquidity swap arrangements with the ECB to manage any potential euro liquidity demands that might arise during a crisis in their jurisdiction. *This calls into question the need for the ECB to satisfy liquidity demands that may have monetary policy implications*. To be true, this is not the only connection with monetary policy and financial stability. Indeed, the default of a systemically relevant third-country CCP clearing euro denominated trades in New York or London could have far-reaching financial stability consequences (and hence monetary policy implications due to possible disruptions or serious disturbances of the transmission channels) in the euro zone, because it may trigger domino effects with major dealers. This is why on 5 July 2011 the ECB published on its website the *Eurosystem Oversight Policy Framework*, describing the role of the Eurosystem in the oversight of 'payment, clearing and settlement systems'. The ECB claimed, under Article 127(2) TFEU, Article 3.1. Protocol No 4 and Article 22 of its Statute, that as a matter of principle infrastructures that settle euro-denominated payment transactions should settle these transactions in 'central bank money' and should be legally incorporated in the euro area, with full managerial and operational control and responsibility, over all core functions, exercised from within the euro area. As to CCPs in particular, the ECB pointed out that there was a need for at least one European CCP for credit derivatives and that given the potential systemic importance of securities clearing and settlement systems, this infrastructure had to be located within the euro area. The rationale for claiming such a re-location was, in the ECB reasoning, that any serious malfunctioning on the CCPs participating in the settlement or clearing of euro-denominated transactions may have *adverse effects on payment systems located in the euro area* (the 'securities leg' of the transaction has implications for the 'cash leg' of the same transaction cleared through the CCP) and that cooperative oversight arrangements at international level can only mitigate the lack of direct influence and not offset it entirely.

**5.** The United Kingdom challenged before the GCEU this ECB *Policy Framework*, submitting, that the ECB lacked competence to lay down a location requirement in respect of CCPs and that the ECB's location policy infringed the provisions of the TFEU relating to freedom to establish, freedom to provide services and the free movement of capital and well as the principle of non-discrimination in Article 18 TFEU.

[7] C.Chen, 'Extraterritoriality of the regulations and interconnections of the derivatives market: legal implications for East and Southeast Asia, *Masaryk University Journal of Law and Technology* (2017), vol. 11, issue 2, p. 332.

6. The GCEU, with judgment 4 March 2015 in case T-496/11 annulled the ECB Policy Framework finding that, *in the absence of an explicit reference to the clearing of securities in Article 22 of the Statute* (point 101), the definition of payment system includes the cash leg of clearing operations but not the securities leg: while such securities "may be regarded as being the subject-matter of a transaction giving rise to the transfer of funds, they do not, however, in themselves constitute payments" (point 97). The General Court also noted that, despite implicit powers are recognised by case-law if they are necessary to ensure the practical effect (effet utile) of a provision of the Treaty or of the regulation at issue, this is an exceptional derogation from the principle of conferral laid down by Article 13(2) TEU and must be appraised strictly (point 105). In the case of CCPs, in the Court's view, "the existence of very close links between payment systems and securities clearing systems cannot be denied nor can the possibility that disturbances affecting securities clearing infrastructures will have repercussions for payment systems and be injurious to their smooth functioning" (point 106); nevertheless, this is not enough to accept the ECB has implicit powers, since the TFEU "envisages the possibility of such powers being conferred explicitly upon the ECB" (point 107). The Court concluded therefore that it would be for the ECB "to request the EU legislature to amend Article 22 of the Statute, by the addition of an explicit reference to securities clearing systems" (point 109).

**3.- The current legislative initiative to amend Article 22 of the ECB statute.**

7. Whilst case T-496/11 was still pending, EMIR was adopted. Its recital (11) posits that "one of the basic tasks to be carried out through the European System of Central banks (ESCB) is to promote the smooth operation of payment system. In this respect, *the members of the ESCB execute oversight by ensuring efficient and sound clearing and payment systems, including CCPs. The members of the ESCB are thus closely involved in the authorisation and monitoring of CCPs, recognition of third-country CCPs and the approval of interoperability arrangements*. In addition, they are closely involved in respect of the setting of regulatory technical standards as well as guidelines and recommendations. This Regulation is without prejudice to the responsibilities of the ECB and the NCBs to ensure efficient and sound clearing and payment systems within the Union and with other countries. Consequently, and in order to prevent the possible creation of parallel sets of rules, *ESMA and the ESCB should cooperate closely* when preparing the relevant draft technical standards. Further, the access to information by the ECB and the NCBs is crucial when fulfilling their tasks relating to the oversight of clearing and payment systems as well as to the functions of a central bank of issue". This recital (11) was not enough to convince the General Court (which addressed it expressly in point 102 of its judgment) that the ECB had competence to regulate the clearing of the securities leg of the transaction lacking an express reference to such powers in Article 22. *It was important, nonetheless, to signal that CCPs supervision must be a shared competence between financial supervisors and central banks. CCPs are indeed at the intersection of capital markets, payment systems and monetary policy and they call into action the remits of both authorities.* This finding is relevant for the following discourse. Indeed, it seems odd, from this perspective, that CCPs are currently exclusively in the remit of securities' supervisors and the proposed change in the supervisory architecture to favour a shared competence with central banks (as it will be discussed below) is not surprising.
8. Following the clear indications of the General Court (points 108-109), and in parallel with the proposals put forward by the European Commission to amend EMIR, the ECB submitted on 22 June 2017 a Recommendation (ECB/2017/18) for a decision of the European Parliament and of the Council amending Article 22 of the Statute, according to the simplified procedure laid down in Article 129(3) TFEU. On 3 October 2017 the

Commission rendered its positive opinion on such recommendation, noting at the same time that – once adopted the proposed amendment to Article 22 of the Statute – "while the ECB's participation in decision-making regarding Union and third-country CCPs and the exercise of its regulatory powers to impose requirements on CCPs in relation to its basic tasks would be undertaken independently pursuant to Article 130 TFEU to the extent necessary to achieve the ESCB's primary objective, *its newly granted responsibilities should be exercised in a manner which is consistent with the general framework for the internal market"* (point 15) and thus "in a manner which is consistent with any acts adopted by the European Parliament and the Council (...) and with delegated acts adopted by the Commission" (point 16).

**4.- The current proposal for a Regulation on an institutional framework for recovery and resolution of CCPs**

**9.** The success of EMIR in taking derivatives clearing and settlement within CCPs strengthened systemic stability overall, *but at the same time was a source of concentration of risk at the CCP "node" , thereby making the failure of a systemically relevant CCP a low-probability but potentially high impact event* (CCPS are often mammoth financial institutions). Moreover, CCPs, as banks, are (i) susceptible to "runs" if clearing members lose confidence in their solvency and (ii) interconnected directly and via clearing members and clients. Nonetheless they are not necessarily subject to the prudential requirements set for banks by CRD and CRR, although Article 14(5) of EMIR specifies that the authorisation under EMIR "shall not prevent Member States from adopting or continuing to apply, in respect of CCPs established in their territory, additional requirements including certain requirements for authorisation under Directive 2006/48/EC (now superseded by CRD IV and CRR). Also BRRD does not apply (unless the CCP is authorised as a bank). But, as it has been noted[8], "a default of a CCP could have far-reaching financial stability consequences [and] hence liquidating a CCP would not be an option, but rather resolving it". This led the Commission to adopt in November 2016 a proposal for a regulation on CCP Recovery and Resolution. The proposal envisages *a set up of resolution authorities for CCPs working in colleges, equipped with a harmonised armoury of powers to prepare and adopt resolution measures.* Resolution authorities can be central banks, competent ministries (in particular where the resolution decision has a direct fiscal impact: Article 3(7)), the competent authorities of CCPs or other public administrative authorities (article 3(1)) at the choice of the relevant Member State. If resolution remits are allocated to an existing authority (with other responsibilities), segregation of duties and appropriate operational independence must be ensured (Article 3(3)). As mentioned, CCPs resolution authorities are in turn required to set up resolution colleges (Article 4), chaired by the home-country resolution authority, largely mirroring the supervisory colleges under EMIR. This translates in this context the problems which were experienced in the past with banks' resolution colleges which led to the establishment, within the Banking Union, of the SRB.

**10.** Resolution authorities presiding over a EU CCP are also required to enter into cooperation arrangements with relevant third-country authorities (Article 77), because for any given CCP there may be several countries, EU and non EU, where clearing members could be located or under whose laws relevant assets or contracts could be governed. ESMA shall issue guidance on the relevant content of such arrangements. But in accordance with Article 218 TFEU, the Commission may also submit to the Council recommendations for the negotiations of agreements with one or more third countries regarding the means of cooperation between resolution authorities and the relevant third-country authorities in

[8] K. Lannoo, *cit.*, p. 4

connection with recovery and resolution (a) where a third country CCP provides services or has subsidiaries in one or more Member States or (b) where a CCP established in a Member state provides services or has one or more subsidiaries in a third country (article 74). Such agreements shall seek to ensure establishment of the cooperation arrangements mentioned above (those under Article 77). Lacking such agreements with third countries, recognition and enforcement of third-country resolution proceedings is regulated by Articles 75-76 and cooperation between competent and resolution authorities of Member States and of third countries are regulated by Article 77 (in particular Articles 77(3) and 77(4) detail processes and arrangements, exchange of information, consultation and cooperation as well as early warnings).

**5.- The current intervention-based ESMA role on EU and third-country CCPs and the role of MoU**

**11.** Currently the ESMA role on both EU and third-country CCPs reflects an "intervention based model": *it leaves day-to-day supervision at the level of the home supervisor and, at the same time, it allows ESMA to monitor and intervene when necessary in exceptional circumstances*. As a matter of fact:

a) EU CCPs are subject to "supervision and oversight" by their home competent authority as designated under Article 22(1) EMIR. Such competent authority shall however "establish, manage and chair a college to facilitate the exercise of the tasks referred to in Article 15, 17, 49, 51 and 54 EMIR" (Article 18(1)) and the college is composed as indicated in Article 18(2). Articles 18 and 19 set out the rules governing the functioning of the college. ESMA displays the role specified in Article 21 of Regulation No. 1095, and namely "shall contribute to promoting and monitoring the efficient, effective and consistent functioning of the colleges" and "shall lead in ensuring a consistent and coherent functioning of colleges of supervisors for cross border institutions across the Union, taking into account of the systemic risk posed by financial market participants", as set out in Article 23. It is noteworthy that under Article 23 of Regulation No. 1095 ESMA shall, in consultation with the ESRB, develop criteria for the identification and measurement of systemic risk and an adequate stress testing regime.

b) Third-country CCP are recognised by ESMA under Article 25 provided that cooperation agreements are in place with the home competent (Article 25(2) letter c) and 25(7). In particular Article 25(7) sets out that these arrangements shall specify at least: (i) the mechanism for the exchange of information with ESMA; (ii) the mechanism for prompt notification to ESMA ; (iii) the procedures for coordination of supervisory activities, including, where appropriate, on-site inspections.

**12.** To duly implement Article 25(7) EMIR ESMA entered into several MoU "related to ESMA's Monitoring of the Ongoing Compliance with Recognition Conditions by CCPs": examples are those MoU adopted with the US CFTC, with the Swiss Finma and National Bank, with Federal Bank and the Financial Markets Authority of New Zealand, the one adopted with the Securities and Commodities Authority of United Arab Emirates.

**13.** The structure of these MoU is basically the same. MoU acknowledge, first, that "ESMA does not have direct supervision or enforcement powers over the covered CCPs and relies on the supervision and enforcement capabilities of the Local Authorit(y)(ies) , which supervise and enforce compliance with the Local Authority(ies) laws and regulations" (Article 2(1)). This means that, once the third-country CCP is recognised, recognition allows for substituted compliance[9] and compliance of the CCP with third country equivalent provisions prevents the need of double compliance. The MoU is not bidirectional, though, and does not

[9] On substituted compliance for OTC derivatives in Singapore and Hong Kong, see C.Chen, *cit.*, p. 340-341.

cover cooperation with regards to CCPs established in the European Union "because ESMA does not have direct supervisory powers in respect of such CCPs". Second, the MoU is "a statement of intent to consult, cooperate and exchange information" but does not create legally binding obligations nor confer any rights or supersede any domestic laws. It is not intended to limit or condition the discretion of the competent supervisory authority either (Article 2(5)). MoU then define the scope of cooperation, both at the level of "cooperation", "notification" and "exchange of information".

**14.** *Cooperation* is expected "in circumstances where issues of regulatory concern may arise, including but not limited to: (a) the initial application for recognition in the EU, pursuant to Article 25; (b) changes in CCPs internal rules, policies and procedures that could affect the way it complies with the recognition conditions; (c) regulatory or supervisory actions or approvals taken by the Local Authority(ies) or ESMA in relation to a CCP, including changes in the relevant obligations and requirements to which CCPs are subject that may impact the CCP's continued compliance with the recognition conditions".

**15.** *Notification* shall occur "as soon as practicable" after a (a) "known material event that could adversely impact the financial or operational stability of a CCP"; (b) "after enforcement or regulatory actions or sanctions"; (c) after "any permission or approval are granted"; (d) after " a request to observe a measure that ESMA has adopted to ensure compliance with recognition conditions or to cease a practise that ESMA determines is contrary to the recognition conditions"; (e) after "any material extension of the range of activities and services a CCP provides"; (f) after "material changes to the laws and regulations to which CCPs are subject". Reasonable discretion is granted to the competent authority in the determination of the prerequisites of notification set out above. (Article 3(4)).

**16.** *Exchange of information* shall occur in order to "endeavour to obtain information not otherwise available to the requesting authority" so to enable the requesting authority to assess compliance with the law and regulations to which the CCP is subject. An indicative list of such information is offered by Article 3(5), letters a) to f). Article 4(2) supplements this ordinary "exchange of information" with a special provision on emergency situations, where authorities shall "endeavour to notify each other of the emergency situation and communicated information between each other as deemed appropriate in the particular circumstances, taking into account all relevant factors, including the status of efforts to address the emergency situation".

**17.** Finally, *on-site inspections* are also addressed by MoU. Article 5 spells out the principle that "ESMA does not intend to conduct any on-site inspection as part of its monitoring of the ongoing compliance by the CCP with the recognition conditions, since under Article 25(6) EMIR local requirements are recognised equivalent. Nonetheless, under Article 5(2), "on-site inspections by ESMA officers can occur in exceptional circumstances, subject to the prior agreement of the local authorities. Article 5(3) specifies the content of such prior agreement.

## 6.- The legislative initiative to amend EMIR and ESMA regulations as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs.

**18.** It is against this backdrop that the European Commission put forward its proposal for a regulation amending EMIR and ESMA regulation of 13 June 2017, further to its Communication of 4 May 2017, as regards the procedures and authorities involved in CCPs supervision. The proposal is aimed to "establish clear and coherent supervisory arrangements both for EU and third-country CCPs" and is motivated by concerns over the "expanding role of CCPs" and "the need to upgrade supervisory arrangements under EMIR, also in light of the establishment of the Capital Market Union" (explanatory memorandum.

P.3). The new proposal is expressly justified by the need to better address efficiency and effectiveness concerns. As to the latter in particular, the explanatory memorandum clarifies that:

a) *as to EU CCPs' supervision*, while during the CCP authorisation process, "colleges facilitated two-way cooperation" (necessary to vote on the joint opinion), "a reduced level of cooperation occurs where there is no need of such an opinion" (after the granting of the authorisation) and cooperation becomes a mere exchange of information, "rather than an effective supervisory tool"; different college members participate to different degrees in college discussions; supervisory approaches by national competent authorities vary to a significant extent even in cases involving comparable CCPs and common templates provided by ESMA failed to achieve the desired convergence;

b) *as to third-countries' CCPs supervision,* "EMIR equivalence has *de facto* created a situation where the requirements for CCPs established in the EU are possibly stricter than for third-country CCPs, leading to an unlevel playing field. Moreover no effective reciprocity seems to apply when the third country has to recognise a CCP established in the EU.

**19.** The impact assessment considered therefore options for targeted amendments of the existing supervisory arrangements of EMIR: a) a centralisation of EU-based CCPs's supervision through the establishment of a European supervisory mechanism; b) "a sliding scale" of additional supervisory requirements by ESMA and relevant Central Banks for third-country CCPs, based on objective criteria and thresholds. In particular Tier1 CCPs would be subject to essentially a continued implementation of the EMIR equivalence and recognition regime, while Tier2 CCPs would be subject to a sliding scale of additional supervisory requirements, including at the end of the spectrum a possible EU authorisation and establishment requirement for third country CCP that would pose substantial exposure risk to the EU and the stability of its financial system, should the system of "full application of EMIR via equivalence" provided for for Tier2 CCP prove insufficient (explanatory memorandum, p. 14). Option b) was eventually adopted by the proposal.

**20.** The proposal puts forward the idea of establishing a CCP Executive Session within ESMA in the field of supervision of both Union and third-country CCPs (new Articles 44a, 44b and 44c). The Chair of such Executive Session will also chair any college (new Article 18 EMIR) and the members of the Executive Session shall have one vote each in the college (new Article 19 EMIR). ESMA may request information directly from an authorised or recognised CCP where information is not available (new Article 35 ESMA regulation).

**21.** Supervision of CCPs established in the EU shall be carried out by national competent authorities, *but proper consent of ESMA and where appropriate of the competent Central Bank is required for several important supervisory decisions (new Article 21a as to the role of ESMA and new Article 21b as to the role of the competent Central Bank).*

**22.** Supervision of third-country CCPs shall continue to rest on the European Commission's determination of equivalence. However ESMA will be tasked with the monitoring of the regulatory and supervisory developments in third-countries CCPs regimes deemed equivalent (New Article 25(6b) EMIR). *ESMA will also be tasked with the determination on whether a third-country CCP is systemically important or not, taking into account the criteria set out in new Article 25(2a).*

**23.** For Tier2 CCPs additional requirements must be fulfilled to obtain recognition (so called "system of full application of EMIR via equivalence"). ESMA shall be responsible for the supervision on an ongoing basis of the compliance of recognised Tier2 CCPs with EMIR requirements (Article 25b(1)) and shall "obtain the consent of the relevant central bank of issue in respect of any aspect of those supervisory decisions relating to the carrying out of their monetary policy tasks" (Article 25b(2)). To carry out its duties, ESMA may conduct necessary investigations of Tier2 CCPs with a suite of powers detailed in Article 25(d)

**24.** If, despite these additional requirements, Tier2 CCPs are considered posing a risk to the Union's financial stability that cannot be sufficiently mitigated by a system of full application of EMIR via equivalence, ESMA, in agreement with the relevant EU central banks, has the power to recommend to the European Commission, that the CCP is not recognised and that, therefore, if it wishes to provide clearing services in the Union, should be authorised and established in one Member State (new Article 25(2c). In this context, ESMA powers in the implementation of EMIR recognition are proposed to be enhanced (new Articles 25b) to m)

**7.- The current legislative initiative to amend ESAs regulations and in particular ESMA remits**

**25.** A few months later, with its proposal for a regulation amending Regulations 1093, 1094 and 1095/2010 presented on 20 September 2017, the Commission stated that "to strengthen and integrate [the financial] supervisory framework is a priority"[10] and that "strong and increasingly integrated financial supervision will play a key role" to deliver an integrated EU capital market and to prevent that "inadequate supervision in one Member State [become] a source of risk for financial markets participants and consumers in other Member States"[11]. The establishment of a single European capital markets supervisors remains, however, a longer term objective; nonetheless the Commission noted that "the decision of the United Kingdom to leave the EU reinforces the case for more integrated supervision within the EU 27 and a reassessment of supervisory relations with third countries, so as to ensure proper management of all financial-sector risks".[12]

**26.** The proposal puts forward several amendments to the existing supervisory framework, starting from a new and more solid governance structure (inspired from the SRB) and changes to funding and proposes for ESMA additional day-to-day supervisory remits as follows:

*Prospectuses: Approval of certain categories of prospectuses by EU issuers Approval of all prospectuses drawn up under EU rules by third country issuers*

*Harmonised collective investment funds (EuVECA, EuSEF and ELTIF): Authorisation and supervision of funds which are regulated at the EU level*

*Central Counterparties (CCPs) Supervisory powers in relation to CCPs (Commission proposal of June 2017) Recognition and supervisory powers for third country CCPs (already existing; reinforced in Commission proposal of June)*

*Data reporting services providers Registration and supervision of data reporting service providers*

*Benchmarks Supervision of critical benchmarks Endorsement and supervision of third country benchmarks.*

It can only be added that, also the forthcoming European Commission proposal for a Regulation on crowdfunding will make a further addition of a new direct supervisory competence to ESMA's remits.

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[10] Communication 'Reinforcing integrated supervision to strengthen CMU and financial integration in a chaning environment', COM(2017) 542 final, p. 3

[11] Ibidem, p. 3

[12] Ibidem, p. 4

**27.** Clearly this is not the end of the road, but another step (not a leap) forward in the establishment of a centralised EU capital markets supervisor tasked with day-to-day supervision over EU-wide financial activities and market players. It is not surprising that the ECB, in its contribution to the European Commission's consultation on the operation of the European supervisory authorities, supported the view that "the aim of the review should be to strengthen the EU dimension of supervision", noting that "*a European approach is justified when major financial market infrastructures have systemic implications for the entire EU market" and that, in the long run, a strong CMU requires the creation of a single capital markets supervisor.*

**II - A first preliminary assessment of the supervisory practice: how different models of supervision were expected to work in an ideal state of the world and how they delivered in real markets.**

**1.- EU day-to-day supervision v. intervention-based supervision: the academic view.**

**28.** Literature[13] has discussed, in the past (since the Lamfalussy report), merits and demerits of the two competing models of (i) EU day-to-day supervision and (ii) EU intervention-based supervision. EU has traditionally relied on Member States' home country control, whereby "home competent are meant to enforce the rules for the benefit of domestic actors and host Member States".[14] *Despite its "blind spots" in cross-border situations – due to sub-optimal capacity and sub-optimal interest for a national competent authority to supervise host operations or to control spill over effects – the model is still the prevailing one, but with the adjustments brought about by the colleges of national competent authorities.* The case of the Icelandic banks, which operated the EU via branches based upon the mutual recognition arrangements under the EEA framework, nicely illustrated how host states can be adversely affected by the insufficient quality of the home country supervisor and, at the same time, that home Member States may lack the financial resources to foot the bill when insufficient supervision leads to markets' disruptions. Neither the Lamfalussy report nor post-financial crisis official reports or studies advocated a "wholesale transfer of day-to-day supervision"[15] at the EU level.

**29.** This was partly due to subsidiarity concerns (although it is true, as it has been noted[16], that "the EU is able to justify the choices on the basis of a fairly undemanding subsidiarity reasoning which the Court of Justice is content with"), but most importantly to burden sharing and fiscal responsibility concerns: "As long as the financial burden of a failure is borne at national level, supervision – so the argument goes – should be a matter for Member States".[17] Ironically, this was vividly depicted by the EMIR legislative history. *While the European Commission originally envisaged to centralise CCPs supervision[18], it conceded then that, since Member States had to bear the fiscal burden of a CCP going insolvent, supervision should rest at Member State level (supported by supervisory colleges).* This indicates however that, today, once it has become quite apparent that resolution of systemically relevant CCPs can hardly be a Member State affair, the fiscal responsibility argument is more pushing towards a day-to-day EU supervisory involvement.

**30.** *In the literature, also concerns on the legal basis under the CJEU Meroni case were often voiced to support the intervention-based approach in lieu of the EU day-to-day supervision.*

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[13] For a thourough discussion compare P. Schammo, 'EU Day-to-Day Supervision or Intervention-based Supervision: Which Way Forward for the European Sysrem of Financial Supervision?, *Oxford Journal of Legal Studies*, Vol. 32, No 4 (2012), pp. 771-797

[14] Schammo, *cit.*, p. 774

[15] Schammo, *cit.*, p. 777

[16] Schammo, p. 779, where additional references, also to recital (35) of CRA Amending Regulation, using the pan-european structure and impact of CRA to justify EU supervision in compliance with Article 5 TEU

[17] Schammo, *cit.*, p. 780.

[18] COM (2009) 252 final

These constitutional concerns are, at least to some extent (but to what precise extent is still vividly debated) now dispelled by the CJEU '*Esma shortselling'* judgement of 22 January 2014, in case C-270/12. It is clear, nonetheless, that even if EU authorities are granted the day-to-day supervisory authority, they would need to make wide use of downwards delegation of tasks to national competent authorities.[19]

**31.** This led some authors to conclude, a few years ago, that "the EU is not especially well-equipped to play a day-to-day supervisory role, not least because its spending power is restricted – hence the fiscal responsibility argument. Indeed, in many instances, EU bodies such as the ESAs have fewer powers, resources and experiences than national authorities". It was argued, therefore, that "day-to-day supervision of market actors raises particular challenges, on top of the more traditional issues and questions, such as those raised by the need to respect the principles of conferral, subsidiarity and proportionality, or for that matter the Meroni doctrine". Thus "(...) a supervisory model based on intervention powers is *prima facie* more promising" [20], although this model has its challenges too (these are exceptional powers subject to conditions and requirements).

**2.- EU day-to-day supervision and third-country equivalent supervision. Lessons from CRAs**

**32.** So far the academic view in the wake of the establishment of the European System of Financial Supervisors. But what are the lessons that we can now draw from the first years of experience of EU (ESMA) day-to-day supervision?

**33.** As noted in the literature[21], 'the transfer of direct supervisory power over CRAs [was] a major development as it has required the EU institutions to design an operational model which may support extensive transfers of direct power to ESMA in the future' (*and, incidentally, it should also be noted that this poses for Brexit an additional issue, because in the fields where direct supervisory power are allocated to ESMA, UK regulators "have not been conveyed special supervisory tasks" – CRAs are the first example – and "they would have to organise themselves if the UK rating activities were to be continued"*[22] *under the TCE regime)* . As clearly witnessed by ESMA annual reports on CRAs supervision, such day-to-day supervision has been robust and intrusive and stakeholders' reactions generally positive, so far[23]. ESMA supervision is 'executed through a range of supervisory tools, including ongoing, risk-based and proactive day-to-day supervision, thematic assessment of risk and risk analysis'.[24] A suite of direct supervisory powers are conferred upon ESMA by Article 23: request of information 'by simple request' or 'by decision' (Article 23b); investigations (Article 23c) and on-site inspections (Article 23d).

**34.** Despite its exclusive supervisory and enforcement competence over EU CRAs (which also implies that ESMA chairs the global college of supervisors of Fitch and is a member of the global college of Moody's and Standard & Poor's colleges, chaired by the US SEC) , ESMA can rely, if needed (it has developed its own supervisory capacities), on national competent authorities as its operational arms, through delegation of tasks (Article 30).

**35.** *The academic claim that intervention-based EU supervision is preferable is seemingly contradicted, at least in this limited field, by the CRA experience, and eventually by the (so far equally successful) direct ESMA supervision of trade repositories*. Also day-to-day EU supervision fared well, although it is fair to acknowledge that the direct transfer of 'workaday' supervisory competence was easier in this segment of the financial market because CRAs' supervision did not imply any burden sharing or fiscal responsibility.

[19] Schammo, *cit.*, p. 783-786.
[20] Schammo, *cit.*, p. 787.
[21] N. Moloney, *EU Securities and Financial Markets Regulation*, 3 edition, Oxford University Press, 2014, p. 670
[22] E. Wymeersch, 'Brexit and the Equivalence of Regulation and Supervision', *EBI Working Paper Series* 2017, No. 15, p.11
[23] Moloney, *cit.*, p. 673
[24] Moloney, *cit.*, p. 674

**36.** ESMA direct day-to-day supervision applies, though, only to EU-based CRAs. But useful lessons which can be drawn from CRAs' regulation go beyond EU-based CRAs. Indeed, also ratings originated by CRAs established in third countries – and not directly supervised by ESMA - can 'access' the European market and can be used for regulatory purposes, provided however that (1) the third-country's ratings are endorsed by an EU CRA being part of the same group or (2) the third-country CRA has no affiliation nor presence in the EU and has been certified by ESMA (and substituted compliance applies). As rightly noted[25] "the directive is based on the idea that EU financial institutions may only use ratings that have been issued by agencies established outside the EU if the rating has been either endorsed by an EU agency or has been issued by a third country agency certified as subject to an equivalent regime".

**37.** *What is seemingly relevant for our purposes is the level of precautions which are taken by the EU legislators in regulating the conditions for endorsement and for equivalence/certification. Useful parallels could be be drawn, with all due differences, with the envisaged 'tiered' regime currently proposed for CCPs*.

**38.** *CRA's certification* is granted only if (i) the legal and supervisory framework of the third country is 'equivalent' to the EU CRAs' regime according to the European Commission's assessment (so far with Argentina, Australia, Brazil, Canada, Hong Kong, Japan, Mexico, Singapore, US); (ii) appropriate cooperation arrangements are in place with the third country and its supervisor(s) and, most importantly, (iii) the CRA does not have systemic importance for the stability or integrity of the financial markets in one or more Member States, and (iv) the rating refers to a non-EU issuer or instrument. In other words, reliance on equivalence and thus on third country substituted compliance via day-to-day supervision of the home (non EU) competent authority is warranted, for non-EU CRAs, only where non EU instruments are concerned and no risks of financial stability are at sight. Something that, *mutatis mutandis*, may closely resemble the situation of Tier1 CCPs in the envisaged EMIR reform.

**39.** *CRA's endorsement* is made available for CRAs that are affiliated or work closely with EU registered CRAs, which endorse their credit ratings. The endorsing CRA is subject to direct day-to-day ESMA supervision (there is thus a double supervision) and assumes full and unconditional responsibility for ensuring that all the conditions for endorsement are met. Endorsement can apply – unlike certification – also to ratings concerning EU issuers or instruments; nonetheless, there must be 'an objective reason' for such rating to be performed outside the EU and, on top of that, ESMA must have assessed that the third country legal and supervisory framework meets the conditions for endorsement and a MoU with the third country home competent authority has been signed. MoU, as nicely exemplified by the ESMA/SEC agreement "concerning consultation, cooperation and the exchange of information related to the supervision of cross-border regulated entities", cover also on-site visits (Article 4). Specific provisions for CRAs are set out in Annex 1 and detail both unsolicited assistance and advance notification of significant events affecting the operations or activities of a cross-border CRA and exchange of specific information e.g. on internal control procedures, financial statements, examination reports and findings. *ESMA noted however that CRAR includes a number of exceptions for endorsed ratings in the areas of conflicts of interest, sovereign ratings and structured finance, and these exceptions may become an impediment to effective supervision, which could be difficult to mitigate in the cooperation arrangements with the competent authorities for third-country CRAS. To solve this, with the update of the guidelines on the application of the endorsement regime adopted on 17 November 2017 (and applicable from 1 January 2019), ESMA changed its previous*

[25] E. Wymeersch, 'Brexit and the Equivalence of Regulation and Supervision', p.9

*approach by adding a new requirement* (based on a innovative reading of Article 4(3)(b) CRAR), according to which the endorsing EU CRA shall also verify and be able to demonstrate on an ongoing basis to ESMA that the conduct of the credit rating activities by the third-country CRA resulting in the issuing of the credit rating to be endorsed fulfils requirements which are at least as stringent as those of CRAR. This means that ESMA performs a double supervision but 'delegates' extraterritorial control over the application of internal rules 'at least equivalent' to those mandated to EU CRAs to the EU component of the CRA's group and makes use of the powers provided in CRAR to ask the endorsing CRA for information about the conduct of such third-country CRA, with the possibility to take enforcement action against the endorsing CRA if it has not ensured the ongoing respect by the endorsed CRA of standards which are as stringent as those established by CRAR.[26]

**40.** The academic assessment of this third-country regime is that ESMA has taken a robust and uncompromising approach and that this indicates the 'capacity of the EU regime to shape regulation internationally'.[27] *In other words, this is a first, interesting example of extraterritorial (albeit delegated) supervision by ESMA over financial entities established in third countries (and affiliated to an EU entity); and it is equally interesting that substituted compliance (for certified CRAs) is relegated only to situations where the supervised entity is not posing any systemic risk to the financial stability of one or more Member States*. It could be added that this model, in due course, could perhaps nicely act also as a blueprint for audit firms third-country recognition and audits endorsement, if and when the current decentralised supervisory system over EU and third-country auditing firms as set out by Directive 2006/43/EC (which is based on a Commission's equivalence finding and a principle of substituted compliance) were replaced by a centralised ESMA competence.

**3.- EU/third-country coordination in supervision where no equivalence regime applies. Lessons from AIFMs and banking.**

**41.** Another interesting example of *de facto* extraterritorial application of the EU supervisory regime via cooperation with third country supervisors is offered by AIFMD and this, quite complex, regime is to some extent significant for our purposes, because (i) severe disturbances in the AIF market may pose financial stability concerns for Europe (exemplary of these potential systemic consequences of AIFMs' activity and of the ensuing inter-institutional cooperation duties is Article 53 AIFMD) and (ii) all investment funds originated from third countries, being by definition non-UCITs since they are not located and managed in the EU as required by Directive 2009/65/EC, qualify as AIFs. Non-EEA AIFMs can market AIF interests to EEA investors only where permitted by national private placement regimes (running in parallel with the passport option until 2018) or if they establish an EEA-based registered AIFM to market AIF interest to EEA investors. EU-wide passport is offered to non-EEA AIFMs and AIFs, provided however that they accept becoming subject to substantially all the obligations of the AIFMD, including those relating to capital requirements, depositaries and remuneration, on a global basis (unless an exemption is granted, provided however that equivalent requirements apply in the third country and the AIFM can demonstrate that "it is impossible to combine such compliance with compliance with mandatory provision in the law to which the non EU AIFMD or AIF is subject": Article 37(2)a) and an appropriate MoU is in place with the third country supervisor and the effective exercise by the relevant EU supervisory competences is not being prevented by the legal and supervisory regime of the third country (Articles 40 AIFMD).

[26] ESMA, Final report, 17 November 2017, ESMA33-9-205, p. 6-7
[27] Moloney, *cit.*, p. 680.

**42.** This is so, despite the very fact that the EU legislator deliberately omitted a country-by-country determination of equivalence as a condition to EEA market access. *In turn, ESMA – to which earlier versions of the AIFMD envisaged the conferral of the third country authorization decision (something that did not win the necessary consensus) – is empowered to carry out peer review of the authorization and supervision in the EU of non-EU AIFMs (Article 38 AIFMD).* ESMA can also make a request, under Article 9 of Regulation No. 1095 and Article 47(4) AIFMD, to national competent authorities "to impose restrictions on non-EU AIFMs relating to the management of a AIF where its activities potentially constitute an important source of counterparty risk to a credit institution or other systemically relevant institution" (Article 47(4)c).

**43.** No equivalence regime exists also for third-country credit institutions. Unlike third-country AIFMs, they can operate in the European Union only via a subsidiary or a branch, in this authorised by the host country supervisor and, in the case of the branch, not enjoying the EU passport (but limiting activity to the Member State of establishment).[28] This is not the entire story for banking, though, because under MiFID II and MiFIR most wholesale investment banking activities are eligible to a third-country passport, meaning that the registration of a branch in one Member State will allow the provision of investment services to sophisticated clients throughout the EU without further authorisation; however, also in this case the establishment of such a branch will require a bilateral cooperation agreement between the third country and the home branch competent authority. It should be also noted that the CRD and CRR reform envisages now that third country banking groups with significant activities in the EU will have to set up an intermediate holding company or a fully authorised EU credit institution. No equivalence applies, in turn, to the operation of payment systems or the operation of bank resolution and insolvency.[29] The absence or substantial limitation to third country equivalence makes it very relevant the way consolidated supervision is organized. To this aim, the Council may conclude cooperation agreement with third countries (Article 48 and 127 CRD IV).

## III.- Open questions raised by the proposed reforms in light of experience

### 1.- Three preliminary overarching considerations leading to questions.

**44.** Against this backdrop of reforms and of these experiences in neighbouring fields of the financial sector, it is now time to address at least some of the questions which arise on the merit of these proposed reforms and on the likely challenges which may lie ahead. Three major trends seem to emerge in the evolutionary reshaping of supervisory remits.

**45.** First, as rightly noted[30], there has been a clear "shift in emphasis in financial regulation toward financial stability" and *"preservation of financial stability necessitates international coordination". This has given the EU "reason to rethink its traditional decentralised authorisation model for third country firms" because "decentralised decision-making makes it harder to control systemic risk". ESMA is granted a pivotal role in this, and this is so because it is the only EU-28 financial supervisory agency with experience of direct supervision. The proposed reform of CCPs supervision indicates, however, that a complementary role is also given to the central banks of issue. This is in turn consistent with the emphasis recently given to financial stability in the fulfilment of the central bank mandate, in particular for the ECB, for which the preservation of financial stability can be considered a secondary and complementary mandate alongside the price stability mandate,*

[28] E. Wymeersch, 'Brexit and the Equivalence of Regulation and Supervision', p.15
[29] J. Armour, 'Brexit and Financial Services', *Oxford Review of Economic Policy (Brexit special issue)*, 2017, p. 15
[30] J. Armour, *cit.*, p. 9

*based in Article 127(1) and (5) of the TFEU[31]. Moreover the smooth functioning of the payment system is also at stake, when financial stability concerns arise.*

**46.** Second, special attention must be given to the systemic risks in the interconnected financial system of the euro area. Such risks are by nature cross-border and need a euro area authority to monitor them. This was precisely the rationale underpinning the establishment of the Banking Union and of the SSM and SRM. At the time, however, Regulation N. 1024/2013 was adamant in excluding, in Article 1, any conferral on the ECB of supervisory tasks "relating to the prudential supervision of central counterparties". This is not the case, though, of CCPs with banking license. For them Article 2(20) of Regulation No. 468/2014 of the ECB (Framework Regulation) acknowledges that a CCP as defined in Article 2(1) EMIR may "qualify as a credit institution within the meaning of Directive 2013/36/EU" and posits that, in this case, also the CCP shall be considered a supervised entity in accordance with the SSMR, but without prejudice to the (parallel) supervision by relevant national competent authorities as laid down under EMIR. Also the financial burden for measures supporting the financial stability of the euro area "is gradually transferred to European shoulders, as the establishment of the Single Resolution Fund and of the European Stability Mechanism make clear".[32] To some extent, the same logic underpins the role envisaged for the ECB in respect to Tier 2 CCPs. *Still, the way this problem is currently addressed, seems to suggest that this is a work in progress and an unfinished work*. Indeed:

a) even if the financial system's interconnectedness is well-established, as well as the need for coordinated action that tackles the problem at the level of the "network", the resilience of certain ideas, such as the micro-prudential rather than macro-prudential logic of supervision[33], based on allegedly only national fiscal burdens, is surprising. We discuss this logic in our final reflections.

b) Moreover, in the new European supervisory system it is also somehow striking that CCPs supervision is deviating from the functional allocation of supervisory competences, and assigns also prudential remits to ESMA, albeit to be exercised in agreement with the ECB and the other central banks of issue, whilst no role whatsoever is foreseen for the SRB for Tier 2 CCPs with the proposal on CCPs recovery and resolution.[34] *On one hand, this may be an indication that, in due course, due to the gradually increasing remits of direct supervision conferred upon ESMA, path dependency may take Europe to choose a consolidated supervisor model rather than a twin-peak model*. On the other hand, this conflicts, however, with the increasing centrality of the ECB, both as monetary institution presiding over price stability, payment systems and financial stability and via the SSM, as dominant banking prudential supervisor in Europe, as recently witnessed by the relocation of Nordea into the eurozone: a predominance that Brexit is certainly going to further emphasize in the years to come. It is such recognized predominance of the eurozone within Europe especially after Brexit and of the ECB as predominant micro and macro prudential supervisor that provided rationale for claiming a better role for the ECB over Tier 2 CCPs clearing euro-denominated trades which could pose systemic risks to the financial stability of the eurozone, and should therefore be supervised by the institution in charge of monetary policy, financial stability and smooth functioning of payment system. Yet,

[31] O. Issing, 'The scope for financial stability considerations in the fulfillment of the mandate of the ECB/Eurosystem', forthcoming in *Journal of Financial Regulation*, 2018 (on file with JFR).

[32] O. Issing, 'The scope for financial stability considerations in the fulfillment of the mandate of the ECB/Eurosystem, p. 38 (of the manuscript).

[33] Compare on this K. Alexander, 'The European Centrral Bank's supervisory poker: the need for enhanced macro-prudential supervision', in *Shaping a new legal order for Europe: a tale of crises and opportunities*, ECB Legal Conference 2017, Frankfurt, 2017, p. 349

[34] K. Lannoo, *cit.*, p. 6.

in our view, this rationale would have justified a CCPs supervisory reforms more closely mirroring the SSM/SRM.

**47.** Third, the current piecemeal approach to third-country equivalence opens the question on the grounds on which the “equivalence” regime should be based. The Commission’s official position is that the base is “discretion”, and, despite the increasing presence of rules-based systems with a technical assessment, for both Tier-1 and even Tier-2 CCPS, it will insist on that “final discretion”, which may be an open door to political considerations. A discretion-based system seems harder to justify in the presence of two decisions, one about the impact of the CCP, and another about the equivalence of the regulatory and supervisory system, both grounded on specific rules. Yet the limits to discretion depend on the existence of a sufficiently strong *legal principle.* As we argue in our final reflections, free movement of capital offers the promise of being a principle that is sufficiently strong, sufficiently flexible, and functionally adjusted to the task ahead. The problem is the existing case law by the Court of Justice, under which free movement of capital with third countries in a context where it overlaps with other freedoms has been left in a deliberately weak position.

## 2.- Is the ESMA Executive Session a workable governance tool?

**48.** In addition to the general considerations offered above, further more specific questions arise. *The first question relates to the overall consistency of the hybrid solution offered by the ESMA Executive Session within the frame of the future supervisory architecture envisaged by the ESAs reform.* According to the CCP ESMA proposal of June 2017, ESMA permanent members of the Executive Session (head and two independent directors) appointed by the Council following the open selection procedure launched by the European Commission are granted a predominant role within the CCP Executive Session, have specific knowledge and experience relevant to the supervision and regulation of CCPs and represent “EU-wide” interests as opposed to the other voting member of the Executive Session, i.e. the representative of the competent authority of the Member State where the CCP is established. Permanent members appointed by the European Commission and the ECB are not granted voting rights. In turn, the Executive Session staff must be significant in number (almost 50 persons) and fully dedicated (with due segregation of duties). Adequate resources shall be ensured via additional funding, supported by supervised CCPs. *Everything made sense, as long as the Commission proposed in September 2017 a new governance for ESMA.* In other terms, the CCP Executive Session was designed having in mind the weak role warranted to the interest of the Union within the current governance system of the ESAs, where the Chair and the Executive Director are non voting members of the governing bodies. *If, however, ESMA governance is going to be thoroughly reshaped within the context of the ESAs reform as envisaged in the proposal for an amending regulation put forward by the European Commission in September 2017*, precisely to ensure a predominance of the “EU-wide” interest, a “two-headed” organizational structure for ESMA may become unnecessary and a breeding ground for complexities and conflicts.

**49.** Merging or at least bridging, on this point, the two reforms seems possible, by ensuring that at least three of the 6 members of the Executive Board of ESMA have the skills and experiences (although this may restrict the number of candidates, since not many people have such specific experience in non CCP countries) currently required for the Head and Directors of the CCP Executive Session and shall be assigned with the corresponding responsibility. Providing that they should sit in the CCP Executive Session being at the same time fully fledged members of the Executive Board would be a simple (and, in principle, easy to get) adjustment to the current proposals, if further major amendments to the structure and role of the Executive Session were considered premature or difficult to achieve in the current legislative process.

**3.- Is the middle-ground of an ESMA Executive Session chairing the college sufficient or would straight-forward oversight centralisation be preferable? What role for proportionality in this context?**

**50.** This poses, however, a more fundamental question. Is reliance on colleges of supervisors for EU CCPs, mediated by the complex role and structure of the ESMA Executive Session (with the Head of the CCP Executive Session chairing the college and the permanent members having voting right, with the exception of the member appointed by the European Commission), as envisaged in the current proposal preferable to a straightforward oversight centralisation under the responsibility of ESMA, with the national competent authority participating to relevant decisions affecting CCP established in that Member State (like in the SRB setting for resolution decision)?

**51.** As already mentioned above, the argument used to support the *status quo*, and thus a leading role for the home country supervisor is national fiscal responsibility. This was recently voiced, for instance, by the UK government and the House of Lords noting that neither the European Commission nor any other European body can bear the fiscal responsibility in the event of failure of the CCP and that, therefore, in the absence of any cross-border fiscal burden sharing arrangement for failing CCPs there could not be European supervision for them. But this argument appears to neglect, at least to some extent, (i) the "network" logic of financial markets, and especially of financial market infrastructures, which creates a network externality; (ii) the possible risks posed by systemically relevant EU-based CCPs for the European economy as a whole[35] and (iii) the expectation that CCPs could request access to central bank last resort liquidity in the event of a crisis of liquidity.[36] The latter is a scenario admitted as credible by ISDA and recently acknowledged by a member of the executive Board of the ECB, although with the precision that this would be done at the ECB discretion to avoid moral hazard.[37] We come back to these points in our final reflections.

**52.** In turn, ESMA's peer reviews have revealed substantial differences in national supervision and within the CCPs' colleges, also "in the methods applied by the CCPs to determine the initial margins and the default fund contributions".[38] This indicates that, if, as it has been authoritatively stated, on CCPs supervision there should not be "any room for complacency"[39], any path dependent shyness in shaping a European direct supervisory role may prove misguided. To be true, supervisory convergence is, to some extent, facilitated by

[35] As it has been correctly noted "CCPs have grown in scale and scope to the extent that a disruption affecting a major CCP would have a significant impact on banks markets and the instruments central banks rely on to perform the core central banking activities: (...) many of central banks key monetary policy counterparties are participants in CCPs around the world and are thus directly exposed to potential strains in centrally cleared markets. Asset classes such as repos, which play a direct role in monetary policy operations, are increasingly being cleared through CCPs. Any closure of certain repo market segments due to a CCP failure would therefore inevitably limit central banks ability to align money market conditions with monetary policy intentions". B. Coeurè, *cit.* In other words, although CCPs have become a central financial market infrastructure precisely to reduce systemic risk previously hidden in opaque, over-the-counter trading of derivatives, their success has made them a possible source of systemic risk, which by its very nature transcends national boundaries. The concern is made simply more acute by the finding (shared by ISDA and the European Commission) that, in the future, most of the activity is likely to focus around two or three major, systemically relevant CCPs in Europe.

[36] On this implied assumption, compare ECB and BoE (2015), *European Central Bank and Bank of England announce measures to enhance financial stability in relation to centrally cleared markets in the EU*, Press release, 29 March 2015 (available on the ecb website).

[37] B. Coeuré, 'European CCPs after Brexit', speech aat the Global Financial Markets Association, Frankfurt am Main, 20 June 2017, p. 1 (available on the ECB website).

[38] V. Brühl, 'Clearing of euro OTC derivatives post Brexit – an anlysis of the present cost estimates', p. 5; ESMA (2016), *Peer Review under Emir Article 21, SUpervisory activities on CCPs' Margin and Collateral Requirements* (available on the ESMA website)

[39] B. Coeuré, 'European CCPs after Brexit', *cit*.

the global standards and requirements for CCP risk management developed over time by the Committee on Payments and Market Infrastructures, IOSCO and FSB, but needs an appropriate supervisory framework to deliver the desired results.

**53.** Also the most recent (2017) ESMA Annual peer review of EU CCP supervision[40] covering the national competent authorities of the 12 Member States where the authorised 17 EU-based CCPs are established found that, albeit the functioning of the colleges is overall satisfactory, there are significant differences across colleges and in the way the chairing home supervisor displays its function and involves other college members in topical reviews of CCPs deliverables. Moreover, the level of engagement and challenge by college members has been diversified, with several members relying fully on the review by the chairing national competent authority and the scrutiny by some other more active college members. This is true also when the college is asked to adopt an opinion, because time frames appeared to tight. Interestingly enough, one college experienced the delegation of supervisory tasks related to the assessment of compliance with EMIR prudential requirements to ESMA.[41]

**54.** This seems to indicate that an even more centralised approach could be justified for EU CCPs of systemic relevance for European financial stability. At the same time, however, this also questions the overall consistency of the current approach in the reform proposal not to differentiate among Tier 1 and Tier 2 EU CCPs, unlike for third-country CCPs. If EU-wide systemic risk is the proper rationale supporting the new oversight tasks of ESMA Executive Session (and its role within the colleges) over EU based CCPs, the principles of conferral, subsidiarity and proportionality may advocate for a two-tier system and thus for the survival of the existing supervisory architecture for non systemically relevant CCPs for the financial stability of the Union.

**4.- Is the tiered approach to third-country CCPs worth some additional fine-tuning?**

**55.** But the most important, and thorny, issue revolves around third-country systemically relevant CCPs. Currently 28 CCPs outside the EU have been recognised by ESMA with additional 10 having applied and awaiting a decision of the Commission as regards the equivalence of their regulatory and supervisory regimes. Under the current proposal, non-systemically relevant third country CCPs (Tier 1) will continue to be able to operate under the existing EMIR equivalence. *Systemically relevant CCPs (Tier 2) will be subject to stricter requirements and namely: (a) they shall comply with prudential requirements (capital requirements, margins, conduct of business rules) for EU CCPs, unless ESMA determines there is "comparable compliance" because the third-country rules are comparable to those of EMIR; (b) they shall comply with any additional requirements set by EU central banks (types of collateral held in CCP, segregation arrangements, liquidity arrangements); (c) the CCP shall agree with ESMA to provide the same with all relevant information and enable on-site inspections. This means that Tier 2 CCPs should in principle be subject to joint supervision by ESMA* (and with a significant role for the central bank of issue) and their home country supervisor, under the necessary cooperation arrangements. This is a new, interesting, example of extraterritoriality in global financial regulation[42]: and one which nicely exemplifies the existing "trade-off between financial stability and open markets"[43], the perils which lie beneath unilateral decisions of equivalence, when "each state decides unilaterally whether another country's regulation and supervision is 'equivalent' or

[40] 21 December 2017, ESMA70-151-812

[41] Ibidem, point 24.

[42] Compare on this, the excellent analysis of M. Lehmann, 'Legal Fragmentation, Extraterritoriality and Uncertainty in Global Financial Regulation', *Oxford Journal of Legal Studies*, Vol. 37, No. 2 (2017), pp. 406-434

[43] M. Lehmann, *cit.*, p. 434

'substituted compliant' with its own"[44] and the sensible opportunity of the academic view claiming that "from a macroeconomic viewpoint, it would be better if the comparison of different regimes were put in the hands of a neutral body, for instance a panel of regulators chosen from different countries" (transcending the same integrated area).[45]

**56.** Only future will tell if this new system will fare better than the existing one (EMIR rules on equivalence), which, in the words of the European Commission, "demonstrated certain shortcomings as regards ongoing supervision in third countries, meaning that EU authorities may not become aware of new or growing risks to the EU financial system". Much will depend on how ESMA will exercise the extra-territorial supervisory prerogatives agreed upon with the third-country CCP as a condition for recognition.

**5.- Should the majority of euro-denominated trades be cleared in the EU?**

**57.** This also introduces to the most controversial part of the proposal. Tier2 third-country CCPs that are of "specifically substantial systemic significance" for the EU could become a third class, for which ESMA, in agreement with the relevant EU central banks, has the power to recommend to the Commission that they should not be recognised (in this way imposing relocation within the EU, to be able to provide clearing services to EU clearing members and EU clients).

**58.** The rationale for such a regulatory move lies, quite clearly, in Brexit. As noted by a member of the ECB Executive Board,[46] "the UK decision to leave the EU is prompting a significant rethink of the European approach to the supervision of systemically important global CCPs. The major clearing houses in the UK provide key services for continental banks active in securities and derivatives markets. According to ECB estimates, UK CCPs clear approximately 90% of the euro-denominated interest rate swaps of euro area banks and 40% of their euro denominated credit default swaps. These figures should give you a sense of how relevant these CCPs are for the stability of the euro". However, "the current EU regime regarding third-country CCPs was never designed to cope with major systemic CCPs operating from outside the EU". Relocation would come, however, with its (great) costs: the biggest threat comes from the loss of systemic efficiency and liquidity which would derive from a fragmentation of central counterparty's activities among multiple CCPs within the European Union (as it has been noted,[47] "optimal efficiency for clearing is achieved if the clearinghouse can offset related securities, commodities and derivatives exposures through netting to reduce the total cumulative exposure per member. By concentrating global clearing in London, banks have been able to clear and margin more efficiently than if they ha to independently clear and margin non-euro exposures in London and euro-denominated exposures with an EU-located clearinghouse"). As one author rightly put it[48] "Large OTC derivatives business depends on an ecosystem of players that cluster in large financial centres. It requires the presence of large banks with big balance sheets, broker-dealers, institutional investors, law firms and a robust regulatory environment, experienced advisors and consultants, infrastructures and IT connections: all elements that cannot be easily moved".[49]

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[44] M. Lehmann, *ibidem*

[45] M. Lehmann, *ibidem*

[46] Coeurè, cit; see also Y. Mersch, 'Evolving regulatory environment for CCPs – the perspective of a Central Bank', speech at the Financial Services Summit, Windsor, 10 November 2017 (accessibile on the ECB website)

[47] K. Tyson, *cit.*, p. 102

[48] K.Lannoo, *cit.*, p. 10

[49] The idea that relocation costs should not be a decision criterion, arguing that relocation costs would amount to approximatively of aound 3.2. Billion (instead of the almost 100 Billion argued by some members of the industry), V. Brühl, 'Clearing of euro OTC derivatives post Brexit – an anlysis of the present cost estimates', pp. 2-13

**59.** Also legal concerns are, to some extent, relevant to better understand this move. On one hand, current cooperative arrangements with UK Authorities are based under EU law and are under the scrutiny of the CJEU: something that could pose a problem after Brexit. On the other hand, the EU Settlement Finality Directive applies only to Member States infrastructures and not to third-country systems. As it has been noted,[50] “as a result, if EU participants in a third-country system were to become insolvent, the courts could, based on their national insolvency laws and depending on whether or not their national legislator has activated the option provided for in recital 7, require the unwinding of orders, thereby undermining the system integrity”. Finally, although the supervisory decision to deny recognition would be in the hands of the European Commission, upon proposal of ESMA, it is unclear what margin of discretion the EU Commission enjoys in this determination and, above all, how specific should be the financial stability arguments and reasoning to support “selective” non –equivalence (e.g. for UK post-Brexit) and to what extent this may be subject to judicial review.

**60.** Whilst the introduction of a last resort instrument to force relocation within Europe cannot be considered surprising in the light of the ill-fated Eurosystem Oversight Policy Framework of 2011, it is nonetheless striking that forced relocation is preferred to extraterritorial direct day-to-day supervision, although this is the approach adopted for instance by US supervisors in respect of most systemic CCP Services (e.g. on LCH Clearnet Limited’s SwapClear service).[51] Eillis Ferran recently questioned if recognition of third-country equivalence in EU financial law is going to translate into “an obstacle or a way forward for future EU-UK bilateral arrangements”.[52] The proposed European policy choice on relocation may easily convert into an obstacle, and a very costly one for both UK and Europe. Day-to-day EU co-supervision is certainly less costly, and may be equally effective, with relation simply acting as a signal, that extreme measures would be available to Europe if joint, US-style third-country supervision over LCH Clearnet proved seriously insufficient.

### 6.- Does the EU general principle of non-discrimination and free movement of capital apply for third-countries CCPs, and if yes, how?

**61.** This takes us to the last question, which introduces to the last section of this paper. To what extent free movement of capital, with its *erga omnes* effects, and the general principle of non-discrimination under Article 18 TFEU, already invoked by the United Kingdom in case T-496/11, could stand in the way of such a forced re-location, considering that extraterritorial day-to-day ESMA joint supervision (fed by ECB requirements) may be feasible, more aligned with comparable international practice and less disruptive? We come back to this point at the end of our final reflections.

## IV- First tentative conclusions and an attempt of conceptualisation inspired by a more systemic view.

### 1.- The resilient logic of ‘home country’ criterion in relation to CCPs.

**62.** As noted above, the attribution of supervisory competence over CCPs to their home country authority is justified on the logic that ‘whoever foots the bill should also choose the menu’. It is a catchy idea, with intuitive political appeal. Unfortunately, it is at least partly wrong. The 2007-2008 crisis showed, according to some authors, the flawed logic of assuming that a universe of financial institutions, each of them individually solvent, necessarily results in a solvent, and riskless, financial system. Macroeconomists emphasize that this pays no

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[50] Mersch, p. 2

[51] Compare FIA; feedback form FIA on EC EMIR Review Proposal . Part 2, 7 September 2017, p. 3

[52] E.Ferran, ‘Recognition of third country equivalence in EU financial law – n obstacle or a way forward for future EU-UK bilateral arrangements?’, in *ECB Legal Conference 2017*, p. 206

attention to the logic of the system.[53] More specifically, others have pointed to the logic of contagion, while others focus on the market's *network structure*, or topology, as a decisive component of its dynamics, and its stability.[54] Under these new assumptions, even assuming that the "cost" of a failed CCP is assumed by its home country authorities (something that is not really credible with mammoth financial institutions like systemically relevant, "Tier2" CCPs, clearly "to big to be saved" by a single Member State), there is a "network externality", in terms of inefficiencies or risk, which is generated by the network's structure, and is not pre-assigned, but absorbed by the system as a whole.

**63.** Under this assumption, the analysis is much more complex, and would require measuring how much of the benefit of its positioning within the network accrues to an individual "node" (e.g. a specific CCP) or "component" (e.g. a specific CCP, and the other nodes, such as financial institutions, that have the stronger links to it) and its "home" jurisdiction/s, in comparison with how much of the "cost" or "risk" of the network structure is taken by that node, component, and its jurisdiction/s. This calculation is extremely challenging, and subject to debatable assumptions, but it is a more accurate description of the network's distributional properties than the micro-prudential approach followed up to this point. Even if we assume the worst, i.e. that the calculation is either impossible to make, or that a consensus over the exact figures is impossible, that does not render the argument in favour of home country supervision a valid one.

**64.** Another point to show how skewed the justification for the traditional distribution of competences is lies in the nature of the risk borne by CCPs, and the system. We submitted that the attribution of competence to the home supervisor is based on the assumption that its national authorities will bear the cost in times of crisis. Yet, that assumes that, in a crisis scenario, the natural course of action is for the loss to be borne by the State, when, quite on the contrary, *the likelier scenario is for the losses to be mutualized, via a default fund, contributed by different market participants, and a plausible scenario may be to obtain liquidity from the central bank of issuance, via market participants*.

**65.** This is evidence of how pervasive certain ideas deeply embedded in the law, in this case the micro-prudential argument, are. Of all the subjects of the law of finance, one would expect the rules on centralized clearing and CCPs to be the most permeable to a logic of macro-prudential supervision, based on network structure, given that it was this logic that inspired the rules in the first place. In a scenario where we assume rational actors, we only need centralized clearing if part of the risk lies in each market participant's inability to gauge not its counterparty's solvency, but the exposure it has to third parties who may be less solvent, or its exposure to third parties, who are, themselves, exposed to third parties who are less solvent, and so on. And yet, after passing an extraordinarily intrusive piece of legislation, which forces financial institutions to change their contracting practices, when it comes to the system's supervision, legislators fall back, to some extent, to a micro-prudential logic. To be sure, supervisory colleges and the role of the central bank of issuance, are a testimony that the new rules acknowledge also to some extent a network logic. But it is a matter of degree. And we submit that the degree of persisting reliance on home country control is unwarranted from a macroprudential perspective: the same which inspired CCP regulation itself.

**2.- The strengthened role of ESMA and central banks. Too many voices, but no clear "process".**

[53] *Principles of Financial Regulation* Geneva Reports on the World Economy (2009).

[54] D. Acemoglu, A. Ozdaglar; A. Tahbaz-Salehi, 'Systemic Risk and Stability in Financial Networks', *Massachusetts Institute of Technology Department of Economics Working Paper Series* (January 15, 2013); A. Cabrales, P. Gottardi, F. Vega-Redondo "Risk-sharing and contagion in networks" (February 2016).

**66.** The current supervisory system increases the number of necessary voices in the supervisory college, which is welcome, but this also introduces two separate sources of friction, which need to be monitored closely. First, it combines the idea of multi-national supervisory colleges, with a EU-centralized logic, through the presence of ESMA and the Commission, coexisting with a predominately eurozone logic, through the presence of the ECB, in the Executive Session. The former is less coordinated, and less likely to be reflective of a general (EU) interest, but it is easier to transplant to an increasingly international environment, which transcends the boundaries of the EU, and may benefit from new ideas. The second offers a more coordinated vision, in exchange for less diversity of views. The new approach will very likely result in a (quite likely) core-periphery structure, with a clearer decision-making process, where EU interests dictate the agenda. This is likely necessary, provided however that also diversity of views is sufficiently preserved. In turn, the more plural supervisory structure for third-countries with CCPs that may significantly affect the EU, by being more balanced (composed of the third-country authority, as well as the Executive session), may result in more opinions being heard, and a more robust decision-making process.

**67.** In second place, the reforms introduce a complicated governance structure, including (i) ESMA; (ii) ESMA's Board of Supervisors; (iii) ESMA's Executive Board; (iv) ESMA's CCP Executive Session. Even inside the CCP Executive Session the role of the ECB and the central bank of issue (CBI) is not fully clear, since the ECB is a permanent, member (new article 44 (1) (a) (ii) ESMA Regulation), and the CBI a non-permanent member (new article 44 (1) (b) (ii) ESMA Regulation), neither of them vote, but they have a veto right over many important aspects (new article 21b ESMA Regulation). This is extremely complicated from the "internal legitimacy" perspective of decision-making and deliberations (e.g. could the ECB or CBI announce their intention to veto before the others cast their votes?). From the perspective of "external legitimacy", if a bad decision is made, who will be responsible for it?

**68.** In third place, more careful consideration needs to be given to the role of the ECB and the central bank of issuance. In what capacity must these be present in the CCP's Executive Session? As supervisory authorities or monetary ones? The kind of people that should be sent by these institutions, and the kind of interests that they should seek to preserve, are different. In case of breach of margin or liquidity requirements, the decision adopted by a supervisor, concerned about high supervisory standards, may be different from the decision adopted by a monetary authority, concerned about monetary stability. In this sense, new article 18 (2) EMIR adds the ECB as a *"supervisory authority"* among the permanent members, and the central bank of issue among the non-permanent members, which means that, in many cases, the ECB will be represented twice, as monetary and supervisory authority.

### 3.- Tier-2 CCPs, and joint supervision on an ongoing basis

**69.** The first relevant aspect for analysis is the *operational functioning* of the system, in particular the relationship between its legal foundations and its operation on a day-to-day basis. The post-crisis institutional framework has seen the emergence of composite supervisory efforts, most notably the joint supervisory teams of the SSM,[55] which may offer a useful experience to understand how such arrangements can work in practice.

**70.** Any conclusions from SSM, however, should be taken with a pinch of salt, in the understanding that, in the SSM Framework, form follows function, and the "tasks" undertaken by each party are grounded in legal "mandates" that are expressly contemplated

[55] ECB *Guide to Banking Supervision* (Nov. 2014) p. 17.

in the law. The mandates may not be fully clear, and the General Court has surprised some in recent decisions, when it indicated that the supervisory competence under the SSM corresponds to the ECB, and the NCAs exercise their powers by delegation.[56]There is, in other words, a set of rules, applicable both to the ECB and the NCA, and their corresponding principles, on which the courts can fall back in order to draw limits, and interpret when a certain task can be carried out by, or be attributed to a certain authority. The legal basis is not as clear and in any event different in case of the joint supervisory efforts carried out by ESMA and the competent authority of the third country.

**71.** The supervisory competences include requests for information (new article 25c), general investigations (new article 25d) and on-site inspections (new article 25e). To give an idea of the type of difficulties that may arise, article 25e states that ESMA may conduct all necessary on-site inspections at *any* business premises of Tier 2 CCPs, and "the relevant central bank of issue shall be invited to participate in such on-site inspections". The officials may enter *any* business premises or land, and examine any information, as well as to seal any business premises and books or records. ESMA shall give notice to the third-country competent authority (but may decide to not notify the CCP) which has to confirm that it does not object to the inspections, and may be invited to participate in them, and may be requested to carry out specific investigatory tasks, and will afford the ESMA staff *"the necessary assistance, requesting, where appropriate, the assistance of the police or of an equivalent enforcement authority, to enable them to conduct their on-site inspection"* (article 25e (7)).

**72.** The problem is that, in case of third countries, including the UK after Brexit, this law will not apply, so it cannot be *per se* the source of (extraterritorial, EU) powers, meaning that these powers will require an express recognition under domestic laws. In its absence, a MoU subscribed between the competent authorities (which, by the way, stipulates that it is not legally binding upon the parties) can mean that any tasks performed by ESMA will be undertaken by delegation from the national competent authority, which may create problems of actions *ultra vires*.[57] More generally, it is unclear which is the body of law, including principles, to fall back in case there are doubts as to whether ESMA can do certain acts or not, or certain safeguards apply, or not. The home-host authority guidelines for banks are not applicable in this context, where the host authority enjoys similar prerogatives to the home one.

**73.** The second consideration is how the new ESMA mandate sits with the *Meroni* doctrine, even after its re-statement in the *UK v Parliament and Council ('ESMA short selling'*) case law. Something that, to be true, is an aspect in common with the SRB mandate. The ESMA case did validate ESMA's original mandate, and was rightly generous in its interpretation, but it did not expressly overrule the doctrine, which, in principle, prohibits discretionary action by EU agencies. Time will tell if the Court, as we expect, is now ready to clarify that in the case of SRB and ESMA, it suffices that their acts are 'discretionary economic assessments' subject to a detailed set of rules and can be reviewed by the courts.

**74.** Regarding ESMA discretion, the degree of deference granted to ESMA with regard to the decision on "equivalence" seems relatively broad, and it remains to be seen how much leeway is given to it by the Commission Regulation that stipulates the criteria to classify a CCP as Tier-2. Regarding judicial review, whilst the new rules correctly provide for the full review by the Court of Justice of decisions to impose fines or periodic penalties (new article

[56] See, e.g. Judgment of 16 May 2017 T-122/15 ECLI:EU:T:2017:337 *Landeskreditbank Baden-Württemberg — Förderbank v ECB*.

[57] New article 25 (7) provides that *"ESMA shall establish effective cooperation arrangements with the relevant competent authorities of third countries whose legal and supervisory frameworks have been recognised as equivalent to this Regulation in accordance with paragraph 6", but that is short on detail about the nature that the role of ESMA will enjoy under the laws of the third country.*

25k), there is no such full review in the case of supervisory measures, like the decision on withdrawal of recognition (new articles 25m and 25n) even if, arguably, this is potentially the most drastic decision that may be adopted by ESMA. The above caveats notwithstanding, we do not expect *Meroni* to write a postscript from beyond the grave.

**75.** A second, minor, aspect that must be considered, however, is the possibility that, by assuming such broad competences in the field of recognition of third-country CCPs ESMA may be assuming competences that are shared between the Union and Member States, for being shared competences related to external action. The Recent Opinion 2/15 of the CJEU on the Free Trade and Investment Agreement between the EU and Singapore was sympathetic to the Commission's claims, but also showed that some of the Commission claims were outlandish. The result is that the assessment of which competences belong to the Union, and which to Member States, is a matter that needs careful consideration. In principle, investment leading to "control" was a Union competence, and the free movement of capital could also be a source of implicit competences, but not exclusive ones. Some State could legitimately raise an objection if it sees not only that the Union is assuming the exclusivity of competences that are shared, but also that it delegates those competences to a Union agency, rather than an EU institution.

**76.** A third, final, and major, aspect that needs to be considered (as we anticipated above) is that the new EMIR rules provide a framework for the enhanced cooperation and coordination between the third-country competent authority and ESMA (and the central bank) during supervision, but any such cooperation disappears in the "twilight" area, where a breach of rules can precipitate early intervention and/or resolution. There seems to be a lack of coordination between the system that can result in a withdrawal of recognition (new article 25m), and the system that results on resolution,[58] despite the former may very likely give rise to the latter.[59]

**4.- Broader, principle-based considerations (I). The consistency of regulatory and supervisory policy**

**77.** *The current institutional design for CCPs' supervision is motivated by two parallel forces: the wish to strengthen the role of EU-wide supervision by ESAs, and the need to deal with Brexit and preserve financial stability within the eurozone.* The former is a redistribution of competences from national authorities, and thus is easier, politically speaking, if the competences are assumed over 'new' types of entities, where national authorities had no time to develop established supervisory practices and teams, and thus no sense of "entitlement", or "endowment effect", which could influence an objective assessment of where do competences belong to make the most of supervisory efforts. Its main difficulty may lie in the regulatory and supervisory landscape that may evolve from there. The 2007-2008 financial crisis made the risks of "shadow banking" more salient: new, unregulated, or lightly regulated, entities, would not only compete in advantageous conditions with established players (which might be justified in terms of lowering entry costs, and increasing competition) but also increase the system's instability. Thus, "shadow banking" policy papers and actions mushroomed.[60] Yet at its heart shadow banking is a problem of consistency in the laws and regulations applicable to each financial activity: equivalent

[58] Article 22 of the Proposal for a Regulation on a framework for the recovery and resolution of central counterparties and amending Regulations (EU) No 1095/2010, (EU) No 648/2012, and (EU) 2015/2365 (hereafter: Regulation on the Resolution of CPPs).

[59] Article 22 (2) of the proposal for a Regulation on Resolution of CCPs provides that one of the indications that a CCP is "failing or likely to fail" is the withdrawal of its authorization. Even if the withdrawal of recognition is not the same as the withdrawal of authorization, in case of Tier 2 CCPs, which will have a large volume of clearing in the EU, this can be the case.

[60] FSB Shadow Banking: Strengthening Oversight and Regulation. Recommendations of the Financial Stability Board 27 October 2011; European Commission *Green Paper on Shadow Banking* COM/2012/0102 final; and Shadow Banking – Addressing New Sources of Risk in the Financial Sector COM/2013/0614 final

activities should be subject to equivalent rules, is the logical deduction. By those standards, shadow banking's is not only a story of entities seeking hidden, unregulated corners of the system, but also of regulatory subsidies, supervisory forbearance, or joint failures, as well as bad legislative technique, or combinations of all of them.[61]

**78.** The interaction between regulatory arbitrage and regulatory subsidies and supervisory forbearance are well illustrated by the role of US Government-Sponsored Enterprises (GSEs) Fannie Mae, and Freddie Mac, the rules on Money-Market Funds (MMFs), or broker-dealers, or the rules on repos, as well as the lack of mechanisms of market discipline in saving banks. Each example of shadow banking shows a complex story of interaction between special rules and special interests, growing in the shadow of those special rules, and entrenching themselves as the greatest defenders of their "specialness". None of these entities, the key players in the shadow banking system, were entirely unregulated.

**79.** Bad legislative technique is shown in turn both in the unwarranted idea of an identical regime for all and the inability of a piece of legislation to adapt to different factual situations justifying a differentiated application of the principles underpinning the rules. This is the case of the current Basel Framework, whose complexity and exacting nature is only bearable by large banks. The rules' complexity completely annuls the possibility of what would be the best solution in case of regulatory avoidance: to include a functional scope of application in the rules, and to apply the rules to every new case where the risk covered by the rule materializes. CRD/CRR rules have such functional scope of application (look at the definition of a "credit institution" in article 4 (1) CRR), but cannot be applied, because they would strangle any entity they applied to, e.g. a hedge fund, or an MMF. The side effect of such bad technique is that, for every new type of entity that poses a new type of problem a new set of rules gets passed, which address that problem, but, of course, are not more broadly conceived for future problems.

**80.** In light of this, consider the case of CCPs. Not only they are covered by special rules, which some would consider cumbersome; their supervision is entrusted to an EU-wide institution, which also has the presence of the central bank, and thus its application in practical terms is likely to evolve differently than the domestic practice. The incentive will be to move clearing away from this supervisory regime, towards internalized clearing inside banks, outside the EU, or both. If entities break-up clearing, or calling it something else, they may stay below the radar that renders a CCP Tier-2.

**81.** In this context, it is critical for ESMA and the ECB to obtain the cooperation of UK authorities, and their goodwill, in policing this type of evasive behaviour. The currently proposed regime, however, is more based on extraterritorial regulation, and the projection of supervisory powers abroad. Thus, it is critical that the cooperation agreements and MoU, as well as the legislation validating the joint supervisory efforts in the UK specify in full detail dialogue, exchange and communication.

**6.- Broader, principle-based considerations (II). Free movement of capital**.

**82.** A large part of the remaining questions depend not on the specific rules that will be adopted, but on the background principles that will be used to confront the "hard cases" after Brexit. In this regard, we are sorry to say that EU Law is quite unprepared, lacking, in its current form, any principles broad enough to help flesh out sound criteria to evaluate the action by EU and national authorities. Oddly enough, some such principles are present in the Treaties, only the current case law of the Court of Justice has crippling effect in their use.

**83.** One such principle is the free movement of capital, the only one of EU freedoms that is applicable to third countries outside the EU. The CJEU's practice has spawned an

[61] D. Ramos Muñoz, 'Shadow Banking: The Blind Spot in EU Banking and Capital Markets Reform', *European Company and Financial Law Review* vol. 13, issue 1 (2016) pp. 157-196.

extraordinary line of case law on free movement of capital, in particular in the context of control-enhancing corporate mechanisms for privatized companies, which looks like the oak tree that grew from the proverbial acorn.[62] Yet, the evolution of EU freedoms leaves a striking gap of protection in cases where third-countries are involved. Such gap is, in our view, difficult to justify in light of the values underpinning the CJEU's *own* case law.

**84.** The first aspect in the evolution of the CJEU's case law is the gradual homogeneization of the protection of the different freedoms. Even if the formulation of the exceptions is framed differently, say, for the freedom of establishment and the free movement of capital, the Court framed the protection in similar terms, and subjected the exceptions to a similar proportionality test for purposes of justification.[63]The gradual homogeneization of EU freedoms led the Court to state that, in cases where two of those freedoms were involved, once the specific national legislation had been examined under one, it was unnecessary to examine it under the other.[64]

**85.** It is at this point, however, when the Court made its argumentative sleight-of-hand, by holding that, in cases where one of the freedoms was preponderant, it was only necessary to examine the case under that freedom, with the implication that, instead of one *and* another freedom, or *either one* of the freedoms, a consistently-seeking approach, the Court moved to *either* one *or* the other, i.e. a discriminating approach between freedoms, where only one of them would protect the party.[65] The effect of this, in cases involving third countries, was that, if another freedom was involved with more intensity than the free movement of capital, there would be no protection under the latter. In cases involving freedom of establishment, the Court has thus distinguished between foreign direct investment, where the investment is made with the intention of controlling the target company, and portfolio investment, where there is no such indication.[66] In the case involving freedom to provide services that set the line for posterior case law, the Court held that a similar "centre of gravity" test applied, and that, having held that the freedom to provide services was preponderant, the Swiss entity had no right to rely on the free movement of capital.[67]

**86.** The problem of such a "conceptualist" approach is not only the impossibility to differentiate, in many cases, which of the freedoms has a greater weight, in a truly objective manner,[68]or the fact that conceptual distinctions tend to multiply (i.e. in more recent case law, the Court

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[62] See, e.g. decision of 14 February 2008 C-274/06, ECLI:EU:C:2008:86 *Commission v Spain*; decision of 23 October 2007 C-112/05 ECLI:EU:C:2007:623, *Commission v Germany*; 28 September 2006, C-282/04 and C-283/04 ECLI:EU:C:2006:608 *Commission v The Netherlands*; decision of 6 December 2007 Joined cases C-463/04 and C-464/04), ECLI:EU:C:2007:752 *Federconsumatori and Others (C-463/04) and Associazione Azionariato Diffuso dell'AEM SpA and Others (C-464/04) v Comune di Milano*.

[63] W. Schön, 'Free Movement of Capital and Freedom of Establishment', *European Business Organization Law Review (EBOR)* Vol. 17 (2016) p. 235, fn. 36, and case law cited therein.

[64] Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas Ltd* [2006] ECR I-8031, at 33; case C-524/04 Test Claimants in the Thin Cap Group Litigation [2007] ECR I-2157 at 34.

[65] Note the subtlety of the Court's language. The standard argument was that, when the restrictions on free movement of capital (or services) were an unavoidable consequence of the restriction on the freedom of establishment, they "did not justify an *independent* examination" in light of the articles corresponding to free movement (or freedom to provide services). Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas Ltd* [2006] ECR I-8031, at 33; case C-524/04 Test Claimants in the Thin Cap Group Litigation [2007] ECR I-2157 at 34. Then, the Court began stating that this same fact "did not justify an examination of the measure" (i.e. the word "independent" had vanished). See, e.g. case C-492/04 *Lasertec* [2007] ECR I-3777 at 25; case C-102/05 *Skatterverket* [2007] I-3881 at 27.

[66] Decision of 24 November 2016, case C-464/14 *SECIL*.

[67] Judgment of 3 October 2006, case C-452/04 ECLI:EU:C:2006:631, *Fidium Finanz*.

[68] The Court's case law has oscillated between the position of the person affected by the measure, the scope and objective of the measure, or the effect of the measure regardless of the position of the person (typically, a taxpayer). See W. Schön, 'Free Movement of Capital and Freedom of Establishment', *European Business Organization Law Review (EBOR)* Vol. 17 (2016).

had to distinguish the concept of restrictions to services (under article 59 TFEU), and restrictions of the movement of capital to or from third countries involving […] the provision of financial services (under article 63 TFEU[69]). It is the seeming lack of connection, and complete lack of explanation, between the Court's distinctions and the values the EU freedoms are meant to protect. Thus, speculative investment (i.e. with no durable and lasting link, nor seeking to gain control over a company, but sufficiently sizeable to be disruptive) would be more protected than FDI, trading by a UK high-frequency trader trading in the EU, but rendering its service to UK investors, would be more protected than a UK's CCP clearing activities to EU members. If the Court's concern is that the EU and EU countries should be able to restrict capital movements with third countries more than they are able to restrict capital movements within the EU, this is an extremely contrived way to accomplish that, one where the interests and values being protected are disconnected from the means for their protection.

**87.** Indeed, the grounds for allowing just the type of two-tier application of the freedom, with an appeal to the values protected by the articles that recognize EU freedoms, are already in the Court's case law. From early on, the Court accepted that capital movements from third countries could be subject to restrictions that would be inadmissible if they were imposed on EU Member States.[70] More recently, the Court has accepted that, in a tax case, an EU country may refuse a tax advantage to income from third countries if there is no information exchange regime with the third country allowing it to ascertain the situation giving rise to the advantageous treatment.[71]What would be easier than to extrapolate the reasoning to a situation where "equivalence", or "equivalence plus" for CCPs (or any other intermediary) is conditional upon the ascertainment of objective circumstances justifying it? This should perfectly fit the kind of process undertaken by ESMA for Tier-1, or Tier-2, even more in light of the fact that the free movement of capital already contemplates prudential regulation as a source of legitimate restrictions.[72]In our view, this would allow an analysis of the restriction under the principle of proportionality, bearing in mind the *prima facie* legitimacy of such restriction. In our view, this would merely rule out fully discretionary decision-making over the restrictions.

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[69] In a case where tax law prevented taxpayers who held their investment through intermediaries in other countries from being exempted from a municipal tax, the Court has held that "In the present case, the dispute in the main proceedings relates to the levying of supplementary municipal tax on income from investments made in another Member State and concerns therefore the consequences of the exercise of the free movement of capital for resident taxpayers. [35] Thus, it is precisely the exercise of that freedom which results, for the taxpayer, in the need to elect an intermediary for the payment of income from the investments concerned. The choice of that intermediary and, consequently, the issues concerning the freedom to provide services are, in such a situation, secondary in relation to the issues concerning the free movement of capital". See decision of 1 July 2010 case C-233/09 *Gerhard Dijkman, Maria Dijkman-Lavaleije v Belgische Staat*, ECLI:EU:C:2010:397 at 34-35. Yet, considering that such investments consisted sometimes in company stock, and other times in bank deposits, the bank deposits were not technically possible unless the taxpayer received a financial "service". See also the decision of 21 May 2015, case C-560/13, *Finanzamt Ulm v Ingeborg Wagner-Raith,* ECLI:EU:C:2015:347.

[70] The Court has held that "it may also be that a Member State will be able to demonstrate that a restriction on the movement of capital to or from third countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States, judgment of 18 December 2007, case C-101/05 ECLI:EU:C:2007:804 *Skatterverket* at 37. See also Case C-446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I-11753 at 171*)*.

[71] *"It is the Court's settled case-law that, therefore, where the legislation of a Member State makes a more advantageous tax system dependent on the satisfaction of requirements, compliance with which can be verified only by obtaining information from the competent authorities of a non-member State, it is, in principle, legitimate for that Member State to refuse to grant that advantage if, in particular, because that non-member State is not under any obligation pursuant to a convention or agreement to provide information, it proves impossible to obtain such information from that non-member State".* Judgment of 24 November 2016, case *SECIL* C-464/141, ECLI:EU:C:2016:896 at 64 with reference to judgment of 17 October 2013, *Welte*, C-181/12, EU:C:2013:662, at 63.

[72] Article 65 TFEU states that: "The provisions of Article 63 shall be without prejudice to the right of Member States: […] to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and <u>the prudential supervision of financial institutions</u>,"

**88.** This could create some difficulties, some interpretative, some political. From an interpretative perspective it is unclear how the analysis of EU freedoms, and the proportionality test for restrictions would play if the source of those restrictions were EU institutions and agencies, instead of Member States (as would be the case we discuss here). Even if the Court can be expected to be more lenient towards the former than the latter, the principle should operate in both contexts.[73] From a political perspective, this could hinder the Commission's clout when deciding on equivalence. However, if the proposed reforms on CCPs are any indication, it is that a discretion-based process, with political considerations, is being replaced with a rules-based process, with technical considerations. This is all for the better. If there are any concerns about the role of UK-based CCPs, these should be justifiable under a technical assessment of the risks for the system's operability and stability.

[73] In the case of the Commission, this would create an interesting conundrum, since article 64 (2) TFEU provides that: *"Whilst endeavoring to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to the other Chapters of the Treaties, <u>the European Parliament and the Council</u>, acting in accordance with the ordinary legislative procedure, shall adopt the measures on the movement of capital to or from third countries involving direct investment – including investment in real estate – establishment, the provision of financial services or the admission of securities to capital markets"* (the underlining is ours).