

# European Commission equivalence decisions a welcome development for Asia Pacific clearing houses

In a welcome development for clearing houses ("**CCPs**") in Hong Kong, Singapore, Australia and Japan, the European Commission adopted its first equivalence decisions for the CCP regulatory regimes in these Asia Pacific jurisdictions on 30 October 2014. This paves the way for eleven CCPs<sup>1</sup> from these jurisdictions to obtain recognition in the European Union ("**EU**"), although cooperation arrangements still need to be put in place between the European Securities and Markets Authority ("**ESMA**") and the relevant regulators.

For European firms, recognition by ESMA of CCPs established in Asia Pacific is important for compliance with Article 25 of the European Market Infrastructure Regulation ("**EMIR**") and to avoid the imposition of prohibitive capital requirements on exposures to CCPs under the Capital Requirements Regulation ("**CRR**") following expiry of the transitional period.

Market participants should also be aware that the European Commission is continuing its equivalence assessments of additional jurisdictions (which include the United States, India and South Korea).

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**Australia:** ASX Clear (Futures) Pty Ltd. and ASX Clear Pty Ltd.

**Hong Kong:** HKFE Clearing Corporation Limited, Hong Kong Securities Clearing Company Ltd., OTC Clearing Hong Kong Limited and The SEHK Options Clearing House Limited

**Japan:** Japan Commodity Clearing House Co., Japan Securities Clearing Corporation and Tokyo Financial Exchange, Inc.

**Singapore:** Singapore Exchange Derivatives Clearing Limited and The Central Depository (Pte) Limited

## Why are the equivalence decisions important?

For non-EU CCPs that are seeking recognition from ESMA, the European Commission's equivalence decision for the regulatory regimes of CCPs in Hong Kong, Singapore, Australia and Japan represents a major milestone.

While additional requirements need to be fulfilled in order for CCPs in these Asia Pacific jurisdictions to become recognised by ESMA, this recognition is important for four reasons:

### 1. Article 25 of EMIR

Under Article 25 of EMIR, a CCP that is established outside of the EU can provide clearing services to entities established in the EU only if the CCP is recognised by ESMA. In other words, a CCP that is not recognised by ESMA cannot have any European established institutions as clearing members; and

### 2. Article 301 of CRR

Under the CRR, a firm may only capitalise its exposures to a CCP based on the beneficial methodology provided under Article 301 if the CCP is a qualifying CCP ("**QCCP**"). Under the Capital Requirements Directive IV, a non-EU CCP can only be a QCCP if it has been recognised by ESMA under Article 25 of EMIR.

Where a firm has exposure to a non-QCCP, this exposure must be capitalised in a manner which is much more costly to the firm when compared to exposure to a QCCP.

### 3. Greater choice of venues for clearing

With the first mandatory clearing obligation under EMIR imminent, firms that will become subject to

this obligation will be required to clear 'in-scope' derivatives transactions only with EU CCPs authorised by ESMA or non-EU CCPs recognised by ESMA.

It should be noted that ESMA is currently consulting on proposals to subject certain classes of FX non-deliverable forwards to mandatory clearing. The proposed classes include a number of currency pairs involving Asian currencies, such as Chinese Renminbi, Indian Rupee and Korean Won. Currently there is only one EU CCP that offers clearing for these products (LCH.Clearnet Ltd), while both OTC Clearing Hong Kong Limited and Singapore Exchange Derivatives Clearing Limited offer clearing for all or some of these products. The recognition of these Asian CCPs would give firms subject to mandatory clearing under EMIR greater choice of venues for clearing.

### 4. Expansion of scope of mandatory clearing under EMIR

The recognition of a non-EU CCP by ESMA will trigger a clearing obligation procedure under Article 5(2) of EMIR. ESMA has six months from the date of recognition of a non-EU CCP to assess the classes of products which are cleared by the CCP to determine whether any of the product classes should be made subject to mandatory clearing under EMIR. This process could lead to the expansion of mandatory clearing under EMIR to classes of products which are not clearable through EU CCPs.

## Key points

- The European Commission adopts equivalence decisions for Hong Kong, Singapore, Australia and Japan
- Cooperation arrangements still need to be put in place between ESMA and the relevant regulators before CCPs in these jurisdictions can be recognised
- The European Commission is continuing its equivalence assessments for additional jurisdictions (including the United States, India and South Korea)
- The transitional period under the CRR may run until 15 March 2015

## Which market participants are affected by the equivalence decisions?

All market participants who trade directly or indirectly through a clearing house are affected by the equivalence determinations:

### 1. European firms

For European firms, it is important for Asia Pacific CCPs to achieve recognition so that firms established in the EU can join as clearing members and avoid the potentially prohibitive cost impact under the CRR;

### 2. End-users

For end-users, a delay in the recognition process could potentially lead to reduced competition among bank counterparties and higher pricing as the market could become bifurcated between European

firms (that could clear through only European CCPs authorised under EMIR) and non-EU firms (that may be able to clear through all CCPs); and

### 3. Non-EU CCPs

For non-EU CCPs, an inability to obtain recognition from ESMA may have a significant impact on its business as European firms would be prohibited from joining directly as clearing members and may find it impossible to trade (whether directly or indirectly) through such a CCP on a profitable basis as a result of the CRR.

## What comes next?

Under Article 25 of EMIR, there are a number of requirements which need to be fulfilled before a non-EU CCP can become recognised by ESMA. Apart from the European Commission adopting a positive equivalence decision with regards to the CCP regulatory framework in the relevant jurisdiction, it is also necessary to fulfil the following conditions:

1. the CCP must be authorised and supervised in such jurisdiction under the regulatory framework which has been determined to be equivalent by the European Commission;
2. the relevant jurisdiction must be considered to have equivalent systems for anti-money-laundering and combating the financing of terrorism; and
3. cooperation arrangements must be put in place between ESMA and the relevant regulatory authorities from such jurisdiction.

It should be noted that the last requirement in relation to cooperation arrangements can only commence when the relevant jurisdiction is

determined to be equivalent by the European Commission.

Market participants should take a keen interest in the process for putting in place such cooperation arrangements. In particular, the conditions that ESMA must have (a) access to all information requested by it regarding CCPs authorised in non-EU countries and (b) the ability to conduct on-site inspections of such CCPs may complicate negotiations between ESMA and the relevant regulatory authorities.

## What about the other jurisdictions?

*United States, India, South Korea and others*

Commissioner Barnier confirmed that the United States is part of the list of twelve additional jurisdictions which are being assessed on equivalence by the European Commission. It is presumed, on the basis of the list of jurisdictions from which non-EU CCPs have applied, that India and South Korea are also in this category.

The equivalence assessment is based on three criteria:

1. the non-EU CCP must be subject to equivalent legally binding requirements to those set out under EMIR;
2. the legal and supervisory arrangements in the relevant jurisdiction for CCPs must provide for effective supervision and enforcement; and
3. the legal and supervisory arrangements in the relevant jurisdiction must include an effective equivalent system for recognition of CCPs established in other jurisdictions.

There is some uncertainty as to whether and when any additional

equivalence decisions will be adopted by the European Commission.

It is particularly interesting to note that India was specifically mentioned by Commissioner Barnier as a jurisdiction that would soon become determined as equivalent (alongside Hong Kong, Singapore, Australia and Japan) in a statement from 27 June 2014, but was ultimately not included in the announcement made on 30 October 2014.

*The People's Republic of China ("PRC")*

As a jurisdiction where no CCP has applied for recognition from ESMA, it is unlikely that the European Commission will carry out an equivalence assessment in relation to the PRC at this stage. However, for European firms that are trading (directly or indirectly) through CCPs based in the PRC (such as the Shanghai Clearing House), there is a high likelihood that such firms will soon be faced with a difficult choice of whether to cease trading on PRC CCPs or to bear the higher capital costs involved in maintaining access to such CCPs. It is also important to bear in mind that the PRC has introduced mandatory clearing of Renminbi interest rate swaps since July 2014 and it is expected that the scope of products subject to mandatory clearing in the PRC will be expanded over time. Recognising that CCPs based in the PRC are all state owned entities, some market observers predict that an inter-governmental approach (whereby the PRC government will negotiate directly with ESMA) may be adopted to resolve this situation. However, it is not clear whether and when this will happen.

## Is there a deadline by which non-EU CCPs need to obtain recognition from ESMA?

### EMIR

Strictly speaking, EMIR does not include a deadline by which non-EU CCPs must obtain recognition from ESMA. However, ESMA is required to make a decision on recognition within 180 working days of the submission of a complete application by a non-EU CCP. As non-EU CCPs that applied for recognition from ESMA prior to the deadline set under Article 89 of EMIR benefit from transitional relief during the assessment period, there are no disadvantageous consequences under EMIR for such CCP even if ESMA has not recognised the CCP yet. It is important to note that non-EU CCPs that did not provide clearing services in the EU prior to the date set under Article 89 of EMIR or did not make a recognition application prior to this deadline will not benefit from any transitional relief.

### CRR

Under Article 497 of CRR, transitional relief from the higher capital costs for exposures to non-QCCPs is scheduled to expire on 15 December 2014. This was originally scheduled to expire on 15 June 2014, but had been extended by the European Commission in accordance with Article 497(3) that allowed for such extension "in exceptional circumstances where it is necessary and proportionate to avoid disruption to international financial markets".

However, it is important to note that the European Banking Authority has indicated that it considers that institutions are able to rely on the provisions of Article 311 of CRR to continue to treat non-EU CCPs as

QCCPs until 15 March 2015 in circumstances where ESMA still has not determined the application for recognition by 15 December 2014 (assuming that such CCP qualified for the transitional treatment under Article 497 of CRR before 15 December 2014)<sup>2</sup>.

Finally, there have been indications from the European Commission that it is exploring an extension of the 15 December 2014 deadline under the CRR in order to avoid potential fragmentation of the market through imposition of prohibitively high capital costs on European firms using non-QCCPs.

## What is (and is not) covered by the equivalence decisions?

Market participants should be aware that the equivalence assessments announced by the European Commission relate only to the CCP regulatory regimes of these jurisdictions for the purposes of Article 25 of EMIR. Separate equivalence decisions (relating to the legal, supervisory and enforcement arrangements of a non-EU jurisdiction for mandatory reporting, mandatory clearing and risk mitigation) for the purposes of Article 13 of EMIR have not yet been adopted.

This distinction is important as many firms are looking at the possibility of relying on the EMIR intragroup exemption in relation to mandatory

clearing of transactions entered into between a EU firm and a non-EU firm that belong to the same group of companies. This exemption is available only if the jurisdiction of the non-EU firm has been declared equivalent by the European Commission under Article 13 of EMIR.

## Conclusion

The recognition of CCPs established in Asia Pacific by ESMA is of great significance to European firms, market participants and CCPs in the region, and substantial resources have been dedicated to achieving a favourable result for such CCPs.

The equivalence decisions adopted by the European Commission on 30 October 2014 represents an important development for Hong Kong, Singapore, Australia and Japan, and fulfils the first requirement needed for CCPs from these jurisdictions to obtain recognition from ESMA.

It is important for market participants to pay attention to whether such recognition will be achieved before the expiry of transitional relief under the CRR (which potentially extends to 15 March 2014), and whether and when other jurisdictions (such as the United States, India and South Korea) will also be determined to be equivalent by the European Commission.

<sup>2</sup> See the Q&A section for the European Banking Authority at [http://www.eba.europa.eu/single-rule-book-ga/-/qna/view/publicId/2014\\_1126](http://www.eba.europa.eu/single-rule-book-ga/-/qna/view/publicId/2014_1126)

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