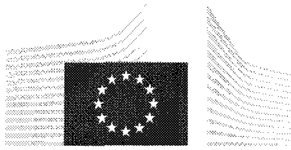

EUROPEAN COMMISSION
Directorate General Internal Market and Services

FINANCIAL MARKETS
**Financial markets infrastructure**

Brussels, 13th September 2013
DG Markt G2 NG/acg (2013) **3259695**

Ms Melissa Jurgens
Secretary of the Commodity Futures
Trading Commission
Three Lafayette Centre
1155 21st street, NW
Washington D.C.

**Subject : Comments of the European Commission on CFTC's draft rules on Systemically Important Derivatives Clearing Organisations**

The European Commission welcomes the opportunity to comment on the draft rules on Systemically Important Derivatives clearing Organisations (SIDCOs) released for consultation by the CFTC on 16 August 2013. The definition of an enhanced regime for SIDCOs consistent with the Principles for financial market infrastructures (PFMIs) adopted last year by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions is an important step to improve the reliance of the global financial system. We would like to express comments on both the structure of the SIDCO regime (1.) and its content (2.).

1. **Structure of the SIDCO regime**

**Flexibility seems to be one of the main objectives sought by the CFTC in the definition of this regime.** The definition of an 'opt-in' procedure for the DCOs that would not have been designated as systemically important by the Financial Stability Oversight Committee is welcome in that respect. CCPs that wish to operate under safer standards and compete on the basis of the quality of their risk-management rather than the cost of financial resources collected from their users should not be prevented from doing so.

**However, the structure of the proposed regime is characterised by complexity.** The application of the draft SIDCO regime would not result in a simple dual regime for CCPs registered with the CFTC whereby CCPs registered by the CFTC would be either regulated as DCOs or as SIDCOs. The conditions defined for the application of the additional financial requirements set out in the SIDCO regime imply that CCPs registered as SIDCOs could be subjected to different requirements depending on whether

Commission européenne/Europese Commissie, 1049 Bruxelles/Brussel, BELGIQUE/BELGIË - Tel. +32 22991111
Office: 04/056 - Tel. direct line +32 229-5.57.58 - Fax +32 229-9.30.71

http://ec.europa.eu/internal_market/
patrick.pearson@ec.europa.eu

they are considered as 'internationally active' or clear 'products with complex risk-profiles'[1]. In practice, the SIDCO regime would consist in at least two different regimes: one for internationally-active/complex products CCPs the financial resources of which should cover the losses caused by the default of the two biggest participants (Cover 2) and one for other SIDCOs which should comply with a 'Cover 1' requirement. In total, CFTC's regime for CCPs would include three layers: 'normal DCOs', 'non-internationally active/non-complex products SIDCOs' and 'internationally active/complex products SIDCOs'.

**This complexity is unnecessary and could raise significant issues. First, there is no compelling argument to draw a distinction between internationally active SIDCOs and non-internationally active SIDCOs.** An internationally active DCO that serves foreign clearing members or foreign trading venues is by nature systemically important. This international exposure means that the effects of a failure in its risk management could not be limited to US soil. Conversely, it is hard to imagine that a systemically important CCP in the US would not be systemically relevant at international level. Given the size of US markets covered by such a CCP and the interconnectedness between financial institutions at international level, the effects of a failure in its risk management would not be contained within US borders.

**Second, the multiplication of layers in the regimes applied to CCPs in the US would be detrimental to the objective of building equal conditions of fair competition between CCPs registered in the US and at global level more broadly.** For instance, non-internationally active SIDCOs could benefit from a competitive advantage relative to internationally active SIDCOs. Because they would be subject to less stringent financial requirements, they could be more attractive to market participants, and thereby build-up their market share on the basis of lower risk management. Competition on risk grounds would be encouraged.

**Third, this three-layer regime would be problematic for the implementation by banking supervisors of the new Basel 3 requirements on exposures to CCPs.** How can this classification be reconciled with the concept of 'Qualifying CCP' (QCCP) which drives the new capital requirements? It is not ascertained that banking supervisors could accept applying the more favourable treatment granted to QCCPs to all SIDCOs – be they internationally active or not-, whilst these CCPs would comply with objectively different risk-management requirements.

**Fourth, this approach will make European Commission's equivalence assessment more difficult.** EU Regulation No 648/2012 on OTC derivatives, CCPs and trade repositories ('EMIR') sets out a recognition procedure for foreign CCPs providing services to clearing members established in the EU. A pre-requisite to the recognition of a foreign CCP by the European Securities Markets Authority (ESMA) is the adoption by the European Commission of an equivalence decision verifying that CCPs established in the foreign country are subject to equivalent legally binding requirements. Since European Union's legislation does not include distinctions as those contemplated in the

[1] See §39.33 (a) (2).

draft SIDCO regime, a positive assessment of the whole SIDCO regime might be challenging.

**The European Commission would therefore recommend dropping the distinction between internationally active and non-internationally active SIDCOs. A regime based on a simple distinction between DCOs and SIDCOs would address the issues described above whilst at the same time achieve consistent results.**

2. **Content of the SIDCO regime**

The Commission acknowledges that the proposed rules bring improvements in a number of areas. However, the rules could be improved or further detailed in order to achieve full international consistency with the PFMIs.

**The scope of the 'cover 2' requirement on credit risk is too limited.** As explained above, this principle should apply to all SIDCOs and not only to internationally active ones. Moreover, the scope of application in terms of products which is essentially restricted to credit derivatives – though the CFTC may extend this approach to other products with more complex risk profile[2]- is too narrow. Linking the 'cover 2' requirements to the nature of the products omits the fact that CCP clearing members are very often active on a wide range of products, including various types of OTC derivatives, listed derivatives and cash products. If two clearing members default simultaneously – or within a short time interval- on the market segment of credit derivatives, they will also default simultaneously on the market segments cleared by the CCP. **A more conservative approach would be to apply the 'cover 2' requirement to all the products cleared by a SIDCO.**

**The draft rules include useful developments on stress testing. They should however be more detailed and prescriptive on certain aspects in order to set a meaningful benchmark for all SIDCOs.**_A good illustration is the requirement to *'conduct an assessment of the theoretical and empirical properties of [the SIDCO's] margin models'*[3]. This requirement is not sufficient to define a common minimum benchmark for the calculation of CCPs' initial margins. This requirement should include detailed parameters in terms of minimum liquidation period for each type of products. This would be in line with the PFMIs which require that *'close-out periods should be set on a product-specific basis'*_because less-liquid products might require longer close-out periods'[4].

**The definition of the SIDCO rules should be the opportunity to improve the DCO regime that provides a minimum liquidation period of one day for listed derivatives.** Past experience and studies demonstrate that a one-day liquidation period is based on unrealistic assumptions as to the capacity of the market to absorb –without adverse price-

[2] See §39.33 (a) (3).

[3] See 639.36 (b) (7) (d).

[4] See PFMIs, Principle 6, §3.6.7.

effect- the liquidation of the position of a big clearing member. Moreover, this relies on the assumption that a CCP is able to adapt its level of initial margin on an on-going basis up to the default of the clearing member. Such assumptions do not reflect how CCPs and markets currently operate. These arguments support the choice made by the European Union to set a minimum liquidation period of two-days for listed derivatives.

**The divergence between EU and US rules in that area is a source of competitive distortion between EU and US listed derivative markets as well as a threat to global financial stability.** The competitive effect is the most material for products with highly substitutable markets on both side of the Atlantic. In the middle run, the maintenance of such a spread between EU and US requirements would lead to relocation of activities towards the area with the cheapest clearing costs. Attraction of business also means concentration of risk in CCPs with weaker risk management that could prove detrimental to financial stability.

In addition, other important parameters of CCPs' initial margin should be further detailed for each type of product, such as historical look-back periods for the identification of data used for the calibration of models.

Further details on the methodology used to mitigate the pro-cyclicality inherent to initial margin would be useful. This is in line with the PFMIs which recommend limiting pro-cyclicality[5]

**These elements will have to be carefully weighted when equivalence decisions on the US regime applicable to CCPs will be made by the European Commission. More detailed enhanced requirements on the minimum parameters applied to the calculation of CCPs' initial margin along the lines explained above would significantly reduce the gap between the SIDCO regime and the EU regime, and hence, facilitate the adoption of an equivalence decision. Such a decision would be a major step to ensure that US CCPs will remain able to provide services in the Union and be considered by EU banks supervisors as QCCPs.**

In conclusion, the Commission would like to repeat its support to the efforts made by the CFTC to enhance the regime applied to SIDCOs and insist that the development of these rules is a unique opportunity to narrow the gaps between our rules to the benefit of global financial stability.

Patrick Pearson
Head of Unit

Contact:
Patrick Pearson, Telephone: +32 229-5.57.58, patrick.pearson@ec.europa.eu

[5] See PFMIs, Principle 6, §3.6.10.