HM Treasury

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response to the call for evidence

November 2015

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1 Introduction

1.1 On 12 March 2015, the government issued a call for evidence on recognised clearing houses. The call for evidence closed on 8 May 2015. This document is the government's response to that call for evidence where the government sought the views from respondents on topics relating to recognised clearing houses.

1.2 Chapter 1 of this document outlines the background to the call for evidence, and the questions asked within it. Chapter 2 provides a summary of the responses received on the call for evidence, of which there were a total of three. Chapter 3 sets out the government's response and next steps.

Background to the call for evidence

1.3 Part 18 of FSMA establishes the concept of Recognised Bodies (RBs). There are two categories of recognised body – Recognised Investment Exchanges (RIEs) and Recognised Clearing Houses (RCHs). The legal framework for RBs is separate from the FSMA authorisation framework for authorised firms, reflecting the different role of, and risks posed by, market infrastructure providers. RBs are exempted from the requirement to seek authorisation for regulated activities carried on in connection with the function for which they were recognised.

1.4 RB status comes with certain protections and special treatment. In general, RBs are subject to a different regulatory framework to that which governs authorised financial services firms. This means that when RBs carry on regulated activities within the scope of their exemption, those activities are governed by specific requirements for RBs instead of those applicable to authorised firms. This different regulatory framework reflects the different status of, and risks posed by, market infrastructure providers as compared to authorised firms.

1.5 The call for evidence was only concerned with RCHs. Of the five current RCHs, four are central counterparties (CCPs) and one operates a securities settlement system (i.e. a Central Securities Depository (CSD)). The five current RCHs are:

- Euroclear UK and Ireland Limited
- CME Clearing Europe Limited
- ICE Clear Europe Limited
- LCH Clearnet Limited
- LME Clear Limited

1.6 Regulation 648/2012 of the European Parliament and of the Council of 4 July 2012 "on OTC derivatives, central counterparties and trade repositories" (also known as the European Market Infrastructure Regulation or "EMIR") brought in new harmonised legal requirements for CCPs. Regulation 909/2014 of the European Parliament and of the Council of 23 July on improving securities settlement in the European Union and on central securities depositories (CSDR) will do the same for CSDs.

1.7 As a result of EMIR, domestic legislation was amended. RCHs which are CCPs have applied for re-authorisation under EMIR. Once all UK CCPs have been authorised under EMIR, domestic legislation setting out the requirements that RCHs must comply with will only apply in full to the RCH which operates securities settlement systems, Euroclear UK & Ireland Limited. Authorised CCPs will still have to comply with Parts 5 and 6 of the Recognition Requirements however.

1.8 At present the UK's only CSD, Euroclear UK & Ireland, is recognised as a clearing house under Part 18 of FSMA and so must meet the relevant recognition requirements. Once CSDR is fully in force, some or all of those recognition requirements will need to be disapplied in relation to CSDs; they will be replaced by CSDR's authorisation and operating requirements.

1.9 As part of the domestic implementation process for CSDR, the government needs to consider how best to amend legislation applying to CSDs in the UK. Under consideration is whether CSDs subject to CSDR authorisation requirements should continue to be regarded as clearing houses. If recognising CSDs as clearing houses is no longer appropriate once CSDs are authorised under CSDR, the government needs to consider whether there should be a new CSD category of RB which will benefit from a FSMA exemption similar to that for other RBs.

1.10 Separately, given the ongoing broader reforms and developments in financial markets, the government is aware that there are, and may continue to be, market innovations in clearing. For example, clearing systems are being proposed which seek to operate some form of multilateral netting of transaction exposures, possibly without the involvement of a central counterparty, and financial markets are also seeing new services and providers emerging.

1.11 It is important for the government to consider how these developments should fit within the existing approach to regulating market infrastructure providers. Given the importance of market infrastructure providers to the broader financial system, it is essential to identify entities which should have RB status and regulate them appropriately. However, the privileges that come with RB status should not be extended to entities if that would be inappropriate. The government wishes to strike a balance between these two objectives. As a result of these developments, the government issued a call for evidence on 12 March 2015 featuring the questions set out in Box 1.A.

Box 1.A: Recognised clearing houses: call for evidence questions

Question A

Can you provide examples of entities, or types of entity, which carry out or propose to carry out the activity of clearing in the financial markets but which are not CCPs? If so, could you provide a detailed description of how they work or might work and the scale of their activities?

Question B

Do you consider that this type of entity should fall within the RCH category?

Question C

If the answer to Question B is yes, do you consider that the RRRs or Part 7 of the Companies Act 1989 should be amended? If so, then how?

Question D

Do you consider that CSDs should fall within the RCH category once the authorisation regime for CSDs under CSDR is in operation?

Question E

If the answer to Question D is no, should a separate category of RBs be established for CSDs?

Question F

What services and activities are likely to be provided or carried on by CSDs in addition to the core and ancillary services listed in the Annex to CSDR?

2 Summary of responses

A. Can you provide examples of entities, or types of entity, which carry out or propose to carry out the activity of clearing in the financial markets but which are not CCPs? If so, could you provide a detailed description of how they work or might work and the scale of their activities?

2.1 Two of the three respondents answered this question. One of these respondents stated that they were not familiar with any entities in the UK which are not CCPs that carry out the activity of clearing in financial markets by acting as a central counterparty and guaranteeing the performance of cleared transactions.

2.2 The other respondent to answer this question expressed a view that some market participants offer post-trade settlement services known as Model B clearing which they believe to fall within the description of clearing provided in the call for evidence. They described Model B clearing as involving a clearing agent that takes on the trading and related settlement liabilities of its client.

2.3 In addition to this the same respondent highlighted that there may be one or more risk management companies being established which aim to provide margining and netting solutions for un-cleared OTC derivatives.

B. Do you consider that this type of entity should fall within the RCH category?

2.4 The only respondent to identify relevant entities did not believe that they should fall within the RCH category, as it should be maintained for CCPs as defined and authorised under EMIR.

2.5 They highlighted the importance that the protections afforded under Part 7 of the Companies Act 1989, which are associated with the RCH classification, be only applied to entities that are genuinely integral to the maintenance of financial markets.

2.6 Further to this, they stated that should the government decide that there are other types of market participant which require RB status, any extension of the current protections should be consulted on and implemented in a transparent manner.

C. If the answer to Question B is yes, do you consider that the RRRs or Part 7 of the Companies Act 1989 should be amended? If so, then how?

2.7 Given the previous answers, no respondent answered this question.

D. Do you consider that CSDs should fall within the RCH category once the authorisation regime for CSDs under CSDR is in operation?

2.8 All three respondents provided views on this question. All three set out the view that CSDs should not fall within the RCH category once CSDR's authorisation regime is in operation – but that CSDs should retain RB status.

E. If the answer to Question D is no, should a separate category of RBs be established for CSDs?

2.9 Respondents explained the importance of CSDs as a financial market infrastructure, and the differences between them and CCPs. All three respondents were supportive of the creation of a new category of RBs, specifically a Recognised Central Securities Depository (RCSD). This would allow CSDs to retain RB status.

2.10 Further comments from one respondent suggested that a new RCSD status would enable the removal of some historic complexity, for example in the Recognised Requirement Regulations

which distinguish between the regulatory obligations of RCHs which are CCPs and of current RCHs which are not CCPs.

F. What services and activities are likely to be provided or carried on by CSDs in addition to the core and ancillary services listed in the Annex to CSDR?

2.11 One respondent explained that because of CSDR a CSD would only be able to provide services that are authorised, and that it would only be able to obtain authorisation in relation to the activities within the scope of the Annex to CSDR.

3 Government response and next steps

3.1 The responses received have been helpful in informing the government of non-CCP clearing activity, and the views of respondents related to these entities with regards to RB status. In addition to this they have also set out clear unified views as to the future treatment of CSDs as RBs.

Key messages from government

3.2 Following the review of responses received the government notes there are differing views on whether there are entities that undertake the activity of clearing which are not CCPs, for example Model B clearers and risk management companies aiming to provide margining and netting solutions for un-cleared OTC derivatives. The government will continue to keep market developments under review to determine whether or not the regulatory treatment of such entities is appropriate.

3.3 Should any decision be made to change the regulatory treatment of such entities as a result of the government's future considerations of these firms, any such amendments to domestic legislation would be consulted on – in line with the views expressed by one respondent to the call for evidence.

3.4 Regarding the treatment of CSDs as RBs, the consistent opinion of respondents to retain RB status for CSDs and to create a new RB status for them (RCSDs) will be reflected in a forthcoming consultation on implementing CSDR. In this consultation amendments to domestic legislation will be set out as to how a new RB status could be delivered. The government would encourage respondents to the call for evidence to consider the approach that will be set out in the forthcoming consultation.

Summary of actions

3.5 The government will respond to the call for evidence by:

- considering further the activities of Model B clearers, and risk management companies providing margining and netting solutions
- taking forward the suggestion of a new RB status for CSDs (an RCSD) in the forthcoming consultation on implementing CSDR domestically

A List of respondents

A.1 There were a total of three responses to the call for evidence, listed below;

- Association for Financial Markets in Europe (AFME)
- Euroclear United Kingdom and Ireland Limited (EUI)
- LME Clear

HM Treasury contacts

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