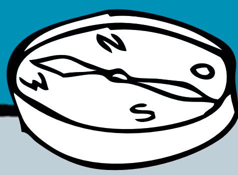
EXIT NEGOTIATIONS BETWEEN THE EUROPEAN UNION AND THE UNITED KINGDOM:

MINIMISE BREXIT RISKS AND STRENGTHEN THE EUROPEAN CAPITAL MARKET

Recommendations of Deutsches Aktieninstitut
2nd Position paper



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2nd Position paper of Deutsches Aktieninstitut e.V. on the Brexit negotiations
Version: 27 October 2017

Foreword

The United Kingdom's departure from the European Union will have considerable consequences for the European economy and society. It is not yet possible to predict how those will look like in detail since the outcome of the ongoing negotiations between the United Kingdom and the European Union is still completely open. This means that companies are losing valuable time they need to adjust to the new situation.

Deutsches Aktieninstitut therefore once more urges the negotiating partners to strive for constructive and practical solutions in order to minimise the negative impact of Brexit on the affected economies. The economy and the society ask for objectively substantiated and rational decisions reached by weighing up all positive and negative consequences.

To support the lead negotiators at regional, federal and EU level, Deutsches Aktieninstitut has put in place an interdisciplinary project. Members of Deutsches Aktieninstitut have provided input as regards to their specific experience and expertise in order to define which thematic areas should be assigned special importance in the negotiations. Concrete possible solutions that can minimise the negative impact on the affected economies are highlighted. I take this opportunity to warmly thank all members of the Brexit project for their excellent and time-consuming work.

This second contribution complements the first position paper issued in February 2017 and identifies further thematic fields with particular relevance for European companies. Both papers will be constantly reviewed, further discussed, revised and expanded as necessary. The documents are focused on issues topical at the time of publication. Future developments can and will make it necessary to adapt observations to the respective state of the negotiations.

The content of this position paper is divided into two parts: part I describes general, overarching considerations which should be taken into account in the framework of the Brexit negotiations. Part II goes into the details of the technical aspects and issues of regulation linked to capital and financial markets law which were not addressed in the first position paper.

Deutsches Aktieninstitut and its members would be pleased to act as competent discussion partners of the negotiators and other interested parties on the basis of the subsequent analyses and comments on Brexit.

Frankfurt am Main, October 2017

Dr Christine Bortenlänger

Chief Executive
Deutsches Aktieninstitut e.V.

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List of Abbreviations

BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
Brexit	Exit of the United Kingdom from the European Union
CCP	Central Counterparty
CDS	Credit Default Swap
CFTC	Commodty Futures Trading Commission
CRA	Credit Rating Agency
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CSDR	Central Securities Depositories Regulation
DFA	Dodd Frank Act
EBA	European Banking Authority
ECB	European Central Bank
ECJ	European Court of Justice
EEA	European Economic Area
EEAA	European Economic Area Agreement
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ESAs	European Supervisory Authorities
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETF	Exchange Traded Funds
EU	European Union
EU27	Remaining 27 EU member states after the exit of the UK
EUR	Euro
FCA	Financial Conduct Authority
FDF	Funded Default Fund Contribution
IOSCO	International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association
LCH	London Clearing House
LIBOR	London Interbank Offered Rate
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
OJEC	Official Journal of the European Union
OTC	Over-The-Counter
QCCP	Qualified Central Counterparty

PRA	Prudential Regulation Authority
PRIIPS	Packaged Retail and Insurance-based Investment Products
PSD	Payment Services Directive
RWA	Risk-Weighted Assets
SONIA	Sterling Over Night Index Average
TE	Total Exposure
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union
TR	Rrade Repositories
UCITS	Undertakings in Collective Investments in Transferabel Securities
UK	United Kingdom
UDF	Unfunded Default Fund Contribution
USA	United States of America
USD	US Dollar
WTO	World Trade Organization

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Executive Summary

The United Kingdom's withdrawal from the European Union (Brexit) in March 2019 poses considerable challenges for both sides. Never before has an EU Member State left the community of European nations. The situation is characterised by great uncertainty for all those involved. It is certain that the facilitations of the four fundamental freedoms and hence of the single market between the European Union and the United Kingdom will lapse with Brexit – unless it is agreed otherwise.

Within the framework of its Brexit project, Deutsches Aktieninstitut has identified the essential issues with relevance for financial and capital markets and which deserve particular attention due to their significance for business and society in connection with the Brexit negotiations. The results have been fed into two position papers.

The purpose of Deutsches Aktieninstitut's position papers on Brexit is to highlight how the negative impact of Brexit on the affected economies can be minimised.

The first position paper (February 2017) focused on the thematic blocks of capital and financial markets law as well as company law. In addition, it addresses overarching themes, which constitute the pivotal basis for the functionality of business and society irrespective of particular areas of law and sectors, and thus need to be taken into consideration in the negotiations. This second position paper (October 2017) adds to the ideas already outlined and encompasses further important thematic areas of capital and financial markets law with reflexions on clearing, benchmarks and rating.

Deutsches Aktieninstitut emphasizes the following crucial points for the exit negotiations:

1. No deal is the worst deal for all parties affected

The claim that "no deal is better than a bad deal" has often been heard in the past, in particular on the British side. However, if the negotiators on both sides actually fail to reach an understanding on the exit agreement and/or a future agreement, a chaotic situation from the end of March 2019 is pre-programmed. The belief that no agreement, a so-called hard Brexit, could be a better deal under some circumstances lacks any objective logic.

Given the close interdependences between the European Union and the United Kingdom, not only of an economic nature, such a failure to find a solution would lead to Brexit having the greatest possible negative consequences.

Even if many of the affected parties are already preparing for a hard Brexit as the worst-case scenario, political decision-makers must ensure that there will not emerge a disorderly situation in spring 2019. At present, it is not possible to foresee how the future cooperation will look like. Thus affected parties will be able to deploy appropriate measures only to a limited degree or will not have enough time to finalise such measures due to the extent of adjustments. For this reason, transitional arrangements are important and indispensable.

2. Risk and consequences of a hard Brexit can be reduced with transitional arrangements

Transitional arrangements are of decisive importance to buy more negotiating time, enable businesses to prepare for the new situation, and avert a no-deal scenario. The tight two-year timeframe for negotiations makes the mammoth Brexit project even more difficult. During this period, agreements must be reached on the United Kingdom's withdrawal from the European Union and the foundations laid for future relations. Without a transition period, less than eighteen months is left to do this. In this regard, it should not be forgotten that regulators, society and companies will have to react to the new rules and will have to adapt business processes, contracts and structures once the agreement will be concluded.

For that reason, two successive forms of transitional arrangements will be necessary: first, time-limited transitional arrangements will be needed from March 2019 onwards in order to prevent a hard Brexit – at least temporarily – and hence to give the negotiators additional time to draw up a definitive solution for the relationship between the EU27 countries and the United Kingdom. Ideally, these arrangements would entail the continuing applicability of as many of the existing requirements as possible and therefore preserve the status quo until date X. Further transitional arrangements will then be needed to follow on from the extended negotiating period after date X. Affected parties will face considerable changes as compared to the status quo and hence adjustments for which adequate time should be granted. In this context, thought should also be given to the grandfathering of existing transactions and contracts.

3. Third-country regimes in financial and capital markets law do not offer a resilient solution for the future relations between the European Union and the United Kingdom

The analyses on further Brexit-relevant thematic areas in financial and capital markets law in this paper once more show that the third-country regimes currently included in European regulations and directives are unsuited to the intensity of economic activity between the United Kingdom and the European Union. They do not offer a resilient solution for future fiscal relations in the event of a hard Brexit and the cessation of EU passporting. I.e. the possibility to provide regulated financial services across borders in exercise of the EU single market freedoms under simplified conditions.

The third-country regimes currently provided in European regulations and directives do not reach far enough. They do not encompass all thematic areas to be regulated in the framework of Brexit and, where they exist, are too narrowly framed for intensive trade relations. In addition, the rules have the disadvantage of being revocable in a relatively short term, which limits their general suitability and does not offer sufficient certainty and legal continuity for the various players.

Nevertheless, the existing third-country regimes can serve as a basis for a more comprehensive, "customised" equivalence regime in the framework of a bilateral trade agreement between the United Kingdom and the European Union. A wide scope, high level of certainty, and easy implementation of the third-country regime are key elements of a functioning agreement. Furthermore, third-country regimes that benefit providers from the United Kingdom should be made dependent on equivalent rules in the United Kingdom benefiting EU providers (reciprocity).

This position paper sets out the ideas of the Brexit project of Deutsches Aktieninstitut at this point in time and complements the first position paper issued in February 2017. It does not claim that the list of topics to be addressed is complete nor that the proposed approaches are definitive. As the negotiations unfold, probably dominated primarily by political considerations, the document may be expanded, elaborated and updated as and when necessary.

Frankfurt, October 2017

Part I: Brexit – overarching considerations

1 THE BREXIT NEGOTIATIONS HAVE STARTED

The withdrawal of the United Kingdom (UK) from the European Union (EU) in March 2019 will have far-reaching consequences on the European economy and society. The concrete impact on businesses, consumers and investors cannot be predicted at present, since these consequences depend on the final exit scenario, which has to be negotiated at political level.

For the best possible decisions to be reached in the upcoming negotiations, it is indispensable to be aware of the conceivable impacts of different scenarios. To this end, the most complete possible overview of the technical areas to be regulated in the exit negotiations is needed at an early stage. The more incomplete this overview, the greater the danger of concluding agreements that have not been fully thought through or completely disregarded areas, with the associated economic damage for both sides. This is already now emerging as an issue.

Deutsches Aktieninstitut welcomes the fact that citizens' rights along with the United Kingdom's financial obligations and the question of the Irish border have been given priority in the Brexit negotiations. It also supports statements from the European institutions that cherry-picking or a separation of the four fundamental freedoms cannot be accepted.

However, Deutsches Aktieninstitut is critical, if economic and societal aspects were to be subordinated to political considerations with no account being taken of the consequences likely to result. The "no deal is better than a bad deal" stance adopted by the British or the reticence of the EU's negotiators with regard to the necessary transitional arrangements give rise to fears of either a failure to understand the consequences of such a negotiating strategy or a deliberate disregard of the economic consequences of Brexit.

The planned negotiating strategy in stages – sufficient progress towards the exit agreement before any discussion of future relations can start – creates a clear structure. On the other hand, it means that agreements on future relations will be reached only at a late stage or, in the worst case, not at all. For the affected parties, this results in them having to plan for a "hard Brexit" by way of precaution.

HARD BREXIT:

The term "hard Brexit" is used in very different ways. In this paper, it stands for the situation where negotiators fail to reach a timely agreement for the future relationship between the European Union and the United Kingdom and at the same time no agreement on transitional arrangements will be concluded. In that case, the British would not only leave the single market and the customs union but there would also be no bilateral agreements on future relations or transition periods. Among others, WTO rules would become applicable. The term "cliff-edge Brexit" is also often used for such a situation in the literature and in public discourse.

This means that companies are preparing for market disruption and are already starting to adapt their structures and processes accordingly (e.g. supply chains or capacities at different locations). They are forced to accept the associated effort for restructuring as well as permanently higher cost structures.

If a free-trade agreement were to be concluded at some time after Brexit, a further adjustment of processes within companies would be less likely. Companies would only have limited willingness to once more leave the path they have chosen and to incur further costs to reverse the changes already made. A return to the status quo ante is not very probable due to the path already taken. Yet at the same time, this reduces the possible advantages of a comprehensive agreement. The readiness to work towards such a free-trade agreement could even be weakened, creating a self-fulfilling prophecy. This vicious circle must be avoided!

Deutsches Aktieninstitut does not believe that the European Union will be the major winner of Brexit as a result of future relocation of operations out of the United Kingdom. In the best case, the EU27 would gain a larger share of a cake that is smaller overall. On an international perspective, the British harm not only themselves with their Brexit decision but also the other countries of Europe.

On the one hand, such overarching consequences of Brexit should not be forgotten in the detailed technical questions and intra-European discussions on Brexit. On the other hand, the treatment of details in individual areas and sectors should not be subordinated to blind pursuit of general political objectives. Striking the right balance between the pursuit of overarching political objectives and the quest for solutions for individual areas is not simple but is nevertheless important.

Deutsches Aktieninstitut's Brexit project therefore wants to support negotiators at regional and federal level in Germany as well as at EU level with concrete indications of problem areas drawn from practice. The aim is to arrive at objectively underpinned and rational decisions reached by weighing positive and negative consequences. In the case of Brexit, the best possible outcome is probably the one that harms the least.

2 TRANSITIONAL ARRANGEMENTS ARE INDISPENSABLE!

2.1 WHY TRANSITIONAL ARRANGEMENTS ARE SO IMPORTANT[1]

The greatest threat to a good outcome – i.e. one which minimises damage – is the tight time-frame for the Brexit negotiations. Conditions for the United Kingdom's withdrawal from the European Union first need to be agreed and a basis for future relations needs to be identified – in the form of a comprehensive trade agreement in the best case. Following that, regulators and companies can start the mammoth task of reacting to the new requirements and adapting business processes, contracts and structures accordingly. Sufficient time is therefore the key factor for successful negotiations and the subsequent implementation of the negotiated outcome.

In this context, the need for a transition period or transitional arrangements is often underlined as a general solution. This leads to misunderstandings, since two successive forms of transitional arrangements are under discussion at the same time. It is important to differentiate between them:

- First, time-limited transitional arrangements will be needed from March 2019 onwards in order to prevent a hard Brexit, at least temporarily, thus buying the negotiators additional time to draw up a definitive solution for the relationship between the EU27 countries and the United Kingdom. Ideally, these arrangements would entail the continuing applicability of as many of the existing requirements as possible and therefore preserve the status quo until date X. The time gained also has to be used to negotiate a comprehensive free-trade agreement once the withdrawal conditions have been decided; this way avoiding a hard Brexit for the affected parties before the conclusion of the negotiations.

- After date X, further transitional arrangements will be needed following this negotiation period extended by time-limited transitional arrangements. Affected parties – be it businesses, society or supervisors – need sufficient time to adjust from the status quo to the new regulatory and supervisory requirements. This applies irrespectively of whether the basis would be a comprehensive trade agreement between the United Kingdom and the European Union or a standard third-country relationship in the continued absence of an agreement. In both cases, parties will face considerable changes and hence adjustments for which adequate implementation time should be granted.

[1] Cf. Deutsches Aktieninstitut, Exit negotiations between the European Union and the United Kingdom: Minimise Brexit Risks and Strengthen the European Capital Market, 28 February 2017, at https://www.dai.de/en/what-we-offer/studies-and-statistics/studies.html?d=475.

In the ideal case, the United Kingdom and the European Union will agree both forms of transitional arrangements and hence markedly reduce the damage caused by Brexit. It is important that an agreement will be reached rapidly on both (!) forms of transitional arrangements because, until they are agreed, companies will have to prepare for the worst case – a hard Brexit in March 2019. Yet this ties up considerable resources which could be better used elsewhere, and can lead to a worse end situation than would otherwise occur due to the path dependence of location and other decisions.

Transitional arrangements buy companies time and avert the frictions that would be preprogrammed in the event of a hard Brexit in March 2019.

Political decision-makers have repeatedly stressed that they are aware of the need for time-limited transitional arrangements. However, it is questionable whether such arrangements will finally be agreed and subsequently be implemented, since superior political aspects understandably play a large role. Should it ultimately not be possible to agree the first form of transitional arrangements, the second form, a longer implementation period, is all the more important. It will enable affected parties to make the necessary adjustments on the basis of a standard third-country relationship.

In her speech on 22 September 2017, Prime Minister Theresa May proposed a time-limited two-year transition period following Brexit starting in March 2019.[2] During that period, the United Kingdom should remain de facto in the EU single market and the customs union, and continue to pay its EU membership contribution of around 10 billion euro a year. The European Union has signalled willingness to talk about such a transition period. The conditions are that a basic agreement on the withdrawal conditions will be reached during the envisaged two-year timeframe and that the United Kingdom accepts all EU rules for this period. It is questionable whether the "time-limited extension" will be realised under these conditions.

Deutsches Aktieninstitut underlines that objective and constructive negotiations are a must, if considerable damage to the affected economies is to be averted. Only technically substantiated and rational decisions can mitigate the negative consequences of Brexit for both sides. However, so far it cannot be predicted how the future cooperation between the United Kingdom and the European Union will look like. Thus, players can prepare for the future situation only to a limited extent. Yet even if affected parties start to prepare now for a hard Brexit – with no knowledge of the solutions finally negotiated –, political decision-makers must ensure that there is not a disorderly situation in March 2019. The two forms of transitional arrangements could create the necessary buffer, reducing uncertainty among affected parties and giving them sufficient time for implementation.

The following paragraphs consider the possible shape of such transitional arrangements in greater detail whereby no distinction needs to be made between the two forms.

[2] Cf. Mirror.co.uk, Theresa May's Brexit speech in Florence in full, 22 September 2017, at http://www.mirror.co.uk/news/politics/theresa-mays-brexit-speech-florence-11220328.

2.2 HOW TRANSITIONAL ARRANGEMENTS SHOULD BE STRUCTURED

It would be preferable to decide binding transitional arrangements at EU level instead of the 27 EU Member States putting in place uncoordinated individual solutions. The latter would be particularly laborious for companies which operate in several EU countries. A survey of German Mittelstand companies shows that just under 83 percent of industrial businesses have important customers or suppliers in other European countries.[3] Many of these are concentrated especially in Western Europe (around 72 percent). The larger the firms, the more substantial their integration in the European market. In particular, the manufacturing industry sourced about 30 percent of its input materials from other European countries. To prevent market fragmentation and uncertainty among affected parties, Deutsches Aktieninstitut recommends that binding rules are created for as many thematic areas as possible.

Aiming for minimal transitional arrangements, for instance for customs duties only, would definitely fall short of what is needed. Transitional arrangements are urgently necessary also for financial services in order to avoid legal uncertainty and to enable the continuation of existing business relations by and with UK market participants. It is important that market participants have planning certainty and can prepare adequately for the new legal situation. For instance, banks need at least three years to adapt their infrastructure, processes and business relations to the post-Brexit status.[4] If the process of transforming the financial sector has not been completed in timely fashion at the time of Brexit, there could evolve fragmentation and liquidity losses in the market.

Deutsches Aktieninstitut expressly does not call for unlimited transition periods, since this would create an enduring irregular situation and special status for the United Kingdom. An appropriate period should be established in advance based on past practical experience.

By way of example (especially for the second form of transitional arrangements), those from MiFIR[5] could serve as a model. MiFIR comprises transitional provisions whereby third-country companies can still provide securities services or perform investment activities in the Member States in accordance with national rules for up to three years after a negative equivalence decision (article 54 MiFIR). For instance, the European Parliament has proposed the same timeframe in its April 2017 resolution.[6]

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[3] IW Consult GmbH, Mittelständische Unternehmen in Wertschöpfungsketten, Eine Studie im Auftrag der KfW Bankengruppe, Köln 2016.

[4] Cf. AFME, Planning for Brexit: Operational impacts on wholesale banking and capital markets in Europe, January 2017.

[5] MiFIR: Markets in Financial Instruments Regulation: EU Regulation No. 600/2014 of 15 May 2014 on markets in financial instruments and [...].

[6] Cf. European Parliament, Joint Motion for a Resolution on negotiations with the United Kingdom following its notification that it intends to withdraw from the European Union (2017/2593(RSP)), 10 April 2017, at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+MOTION+P8-RC-2017-0237+0+DOC+PDF+V0//EN.

However, transitional arrangements are only of real benefit to affected parties, if it becomes clear at a sufficiently early stage that there will be such provisions and what concrete shape they will take.

Should EU-wide provisions prove to be impossible, Germany must find a workable solution at national level.

Given recent developments, it appears that comprehensive European provisions are no simple matter. For this reason, the German legislator is also invited to find workable and effective transitional solutions jointly with the competent supervisory authorities.

Deutsches Aktieninstitut recommends that preparations are made immediately for this need and that transitional arrangements, grandfathering guarantees and other necessary instruments should be drawn up for the event that no EU provisions are agreed. The attractiveness of Germany as a financial location would also increase in this way thanks to predictable costs and planning certainty.

Part II: Regulatory aspects of Brexit in detail

3 CAPITAL AND FINANCIAL MARKETS LAW

Financial markets play a central role for the economic development in the Member States of the European Union and the European Economic Area (EEA). They are of decisive importance for the creation of jobs and economic growth.

Financial markets regulation is based on harmonisation provisions for completion of the single market (articles 114 and 26 TFEU[7]) as well as on the freedom to provide services across borders (either directly or through dependent branches) (article 56 et seq. TFEU), freedom of establishment for self-employed persons (article 49 et seq. TFEU) and free movement of capital and payments (article 63 et seq. TFEU). Of the four fundamental EU freedoms, free movement of capital is the only one that is broadly also applicable with respect to third countries. Nevertheless, under the case law of the European Court of Justice (ECJ) restrictions on free movement of capital can be justified in a third-country context, also if they would not be in a purely EU case.[8] In addition, article 64 TFEU opens up the possibility for the European Parliament and the Council to restrict movement of capital with third countries through new legislative acts also with respect to the provision of financial services.

Following the United Kingdom's withdrawal, current EU law immediately ceases to be applicable in the United Kingdom and must be superseded by national provisions. This is what the British government intends to achieve with the "European Union (Withdrawal) Bill" (previously the "Great Repeal Act"). This repeal law initially transforms all EU directives which exist at the time of withdrawal and have not already been transposed, as well as directly applicable EU regulations including case law into British law. Afterwards this "EU law" will be progressively superseded by new British law (or is intended to be superseded).

This means that the regulatory framework will be virtually identical in the two jurisdictions at the time of withdrawal. However, the assumption that business activities can therefore simply continue as before is wrong. In the first place, the lengthy process of recognising "equivalence" would first have to be completed. In the second place, such an equivalence regime is only envisaged, if at all, for specific products and services.[9] What is under discussion primarily is how applicable EU law should be adapted in relation to Brexit. However,

[7] TFEU: Treaty on the Functioning of the European Union, OJEC of 26 October 2012.
[8] ECJ of 28 October 2010, Établissements Rimbaud, C-72/09.
[9] See also comments in the first position paper of February 2017 and the following paragraphs.

it is of decisive importance that corresponding provisions are also demanded from the United Kingdom so that EU companies also have access to the London financial centre (reciprocity).

3.1 GENERAL ISSUES

The extent to which a licence remains possible for offerings from the United Kingdom into the European Union and vice versa, and for which companies, products and services – as well as how these offerings should be structured – depends on the outcome of the negotiations. Political decision makers should be strongly committed to working towards a compromise solution – softening a hard Brexit through third-country provisions and bilateral agreements between the United Kingdom and the European Union. In this regard, the long-term structure of these relations should minimise possible negative consequences for the European and international financial system.

Notwithstanding, a hard Brexit after March 2019 is currently taking shape. It appears almost impossible to find a shared solution for the often contrary interests and multifaceted thematic areas in the remaining negotiating period. As a result, it should be assumed that agreement will not be reached on all relevant issues in the withdrawal agreement in accordance with article 50 TEU[10]. If the United Kingdom also leaves the European Economic Area, it will thus qualify as a third country.

But the United Kingdom has so far applied "only" for withdrawal from the European Union in accordance with article 50 TEU but not from the European Economic Area in accordance with article 127 EEAA[11]. A complaint lodged with the British High Court was rejected as being premature, since the British government can still submit the application until twelve months before the intended withdrawal.[12] Only once this has happened, as announced, will the United Kingdom become a third country.

All non-EU/EEA Member States are classified as third countries in EU law. It would then be necessary to verify in many individual cases whether particular EU provisions have a third-country regime and whether this is applicable in the specific case. For all other areas, World Trade Organization (WTO) rules would govern trade relations between the United Kingdom and the European Union.

A large portion of the international but also European financial groups which have hitherto used London as a hub to Europe have already started to relocate partially to locations elsewhere in the European area or at least announced that they plan to do so. Bearing in mind the regulatory and business risks associated with Brexit, these companies cannot and must not await the outcome of the Brexit negotiations. The question that arises on the German side is as to how these companies can and wish to be offered support, for example with the new service offer of the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) for UK providers.[13]

[10] TEU: Treaty on the European Union of 26 December 2012.
[11] EEAA: European Economic Area Agreement of 2 May 1992.
[12] Cf. The Guardian, Fresh Brexit legal challenge blocked by high court, 3 February 2017, at https://www.theguardian.com/politics/2017/feb/03/fresh-brexit-legal-challenge-blocked-high-court-article-127.
[13] Cf. BaFin, FAQs on Brexit, 2017, at https://www.bafin.de/DE/Aufsicht/Uebergreifend/Brexit/brexit_node.html.

Furthermore, similar questions arise for EU credit institutions and investment firms which operate a branch in the United Kingdom. Due to cessation of the notification procedure via the supervisory authorities ("EU passporting") following Brexit, they must either apply for a permit to open a third-country branch or establish a subsidiary, which itself would then have to apply for a British licence. The British supervisory body (Prudential Regulation Authority, PRA) recently signalled that banks could not automatically assume that an application for a third-country branch would be granted.

If the European Central Bank (ECB) and national supervisory authorities do not recognise reciprocity, PRA might not permit the third-country branch since it would require information from ECB and/or national supervisory authorities for its effective supervision. This means that the EU credit institutions and investment firms in question would have to transform their branches in the United Kingdom into subsidiaries, which would involve a much greater effort and would not be possible in time given the tight timetable for Brexit.

These representations show the urgency of and need for an adequate agreement between the European Union and the United Kingdom.

3.2 THIRD-COUNTRY REGIMES

Third-country regimes are intended to give companies from non-EU/EEA Member States uniformly regulated access to EU markets so that cross-border transactions can be concluded more securely and efficiently. Third-country regimes exist in a very wide range of forms and in a large number of regulatory texts. So far there is no harmonised regime in place covering all areas of regulation. The regulatory landscape here is rather comparable to a large patchwork of individual solutions.[14]

Given the level of payment and business flows between the United Kingdom and other Member States of the European Union, the EU third-country regimes which currently exist are neither appropriate nor sufficient. Around 8,000 financial companies from the EU27 Member States use EU passporting for their activities in the United Kingdom and just under 23,500 EU passports for their financial services and products.[15] In the opposite direction, 5,500 British companies use EU passporting for their activities in EU27 countries and no fewer than 335,000 EU passports for their financial services and products.

Accordingly, a harmonisation and extension of the scope of third-country regimes must be a decisive point in the Brexit negotiations. To this end, the existing third-country regimes can serve as the basis for a more comprehensive, individual equivalence regime between the United Kingdom and the European Union. In this regard, the extension of

[14] Cf. European Commission, Commission staff working document - EU equivalence decisions in financial services policy: an assessment, 27 February 2017, at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/international-relations/recognition-non-eu-financial-frameworks-equivalence-decisions_en#documents.

[15] Cf. Financial Conduct Authority, Letter to House of Commons, 17 August 2016, at http://www.parliament.uk/documents/commons-committees/treasury/Correspondence/AJB-to-Andrew-Tyrie-Passporting.PDF.

third-country regimes which also benefit providers from the United Kingdom should be made dependent on comparable rules in the United Kingdom which benefit EU providers (reciprocity). A broad scope, adequate security – including transition periods in the event of equivalence being revoked – and "easy" implementation of such an agreement are key factors of a functioning bilateral agreement.

However, also independent of Brexit, we recommend that the issue of third-country regimes is addressed, in particular in the framework of the EU's "Better Regulation" and "Capital Market Union" projects.[16] Uniform, easily-to-understand and easily implementable rules with a broad scope would enhance the attractiveness of the EU financial and capital market overall and hence increase the interest of third-country companies. Consequently, it is important not only to cover new areas of application but also to structure the existing third-country regime more efficiently.

Building on Deutsches Aktieninstitut's first position paper, the issue of licensed activities in the context of Brexit is examined in the subsequent paragraphs, taking further European directives and regulations as examples. In addition, based on the EU-wide passporting and licencing regime, reference is made to existing third-country regimes and highlighted where they are still absent or fall short. Moreover, annex 1 contains an overview of various EU passporting and third-country regimes in European financial and capital markets law.

3.3 USE CASE: (EURO) CLEARING

3.3.1 Overview

The topic of clearing is being discussed intensively in connection with Brexit[17] – with the term "clearing" often being used colloquially as an abbreviation for "clearing with euro-denominated interest-rate derivatives". This sometimes gives the impression that the entire discussion in this regard revolves around clearing in general and not primarily on euro clearing, although the latter is mostly the case. The complex issue of clearing is explained in the greater detail in the following paragraphs and the question of third-country regimes for central counterparties (CCPs) is examined.

[16] Cf. European Commission, Better Regulation Agenda, 2016, at http://ec.europa.eu/info/law/law-making-process/better-regulation-why-and-how_de and Kapitalmarktunion, 2015, at http://ec.europa.eu/finance/capital-markets-union/index_de.htm.

[17] Cf. Inter alia Die Welt, EU sichert sich Milliarden-Argument für den Brexit-Poker, 13 June 2017, at https://www.welt.de/finanzen/article165514603/EU-sichert-sich-Milliarden-Argument-fuer-den-Brexit-Poker.html; WirtschaftsWoche, Wie die EU das Clearing neu regelt, 13 June 2017, at http://www.wiwo.de/politik/europa/finanzmarkt-nach-dem-brexit-wie-die-eu-das-clearing-neu-regelt/19929642.html; CityAM.com, European Parliament could push for stronger euro clearing reforms, putting London dominance further at risk, 7 August 2016, at http://www.cityam.com/269863/european-parliament-could-push-stronger-euro clearing.

1. What is clearing, and what function does clearing play in financial markets?

Clearing of transactions is not a new phenomenon but has existed since the very beginning of commercial activity. In the first instance, clearing was still known exclusively as a pure settlement of reciprocal payment claims. This bilateral clearing still operates today. After a financial transaction between two parties has been agreed by telephone or via an electronic trading venue (execution), this agreement is followed by a confirmation. Clearing and settlement then takes place, i.e. payment claims are settled and money or securities are exchanged in line with the agreement made.

Alongside bilateral clearing, clearing via central counterparties has developed over time. Depending on the financial product, central counterparties are securities exchanges with affiliated clearing house, clearing houses with affiliated depositories or pure derivative clearing houses. The clearing house becomes involved in the financial transaction concluded bilaterally between two parties and hence becomes the central counterparty for both sides. Within this role, the clearing house establishes the payment claims arising from the financial transaction, calls in these claims from one party and releases them to the other party. As a rule, clearing houses work independently or at arm's length from the securities exchanges or markets which they support.

Clearing houses are differentiated by the asset classes they clear. Clearing of simple monetary transactions generally takes place via payment systems such as TARGET2 for euros or BACS and CHAPS in the United Kingdom. Important international clearing houses for securities transactions (bonds and shares) are Euroclear in Belgium and Clearstream in Luxembourg. London dominates the European derivatives clearing business.

Both clearing forms (i.e. bilateral clearing between buyer and seller and that via CCPs) have been common for many years and are used by market participants. However, clearing of over-the-counter (OTC) derivatives[18] via central counterparties has increased in importance[19] since the 2008 financial crisis.[20] New laws and regulations such as the US Dodd Frank Act (DFA)[21] or the European Market Infrastructure Regulation (EMIR)[22] have contributed to this trend introducing a broad requirement of central clearing for OTC derivatives.

An important advantage of OTC derivatives being cleared via CCPs as compared to bilateral clearing is that the counterparty risk is transferred.[23] If a party is unable to meet its obligations – which match the other party's claims – the central counterparty takes on the

[18] Over-the-counter derivatives are derivatives which are not traded on an exchange but directly between market participants. An overview of various financial products that are cleared on and off exchanges is illustrated in diagram 2.

[19] Cf. European Central Bank, Monetary and fiscal policy during and after the crisis, 2010, at https://www.ecb.europa.eu/press/key/date/2010/html/sp101015.de.html.

[20] Cf. Deutscher Bundestag, Verlauf der Finanzkrise, 2009, at https://www.bundestag.de/blob/409652/69ed4dc7fa37c7fa3158d8b5ce274584/wd-4-075-09-pdf-data.pdf.

[21] Dodd Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, H. R. 4173.

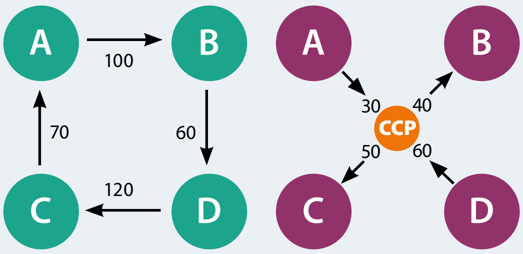
[22] EMIR: European Market Infrastructure Regulation: EU Regulation No. 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

[23] Counterparty risk is the risk that a counterparty fails to meet an obligation either on the due date or at a later point in time.

counterparty risk. To this end, market participants post collaterals with the CCP, which are subdivided into an initial margin[24] and variation margins[25] that are adjusted daily to smooth out market fluctuations. The CCP evaluates the level of these collaterals, functioning as a "golden record" for the two original parties involved. In other words, it is responsible for a reliable assessment of the transaction and the collaterals posted by the two parties.

This advantage has also been recognised by the legislator and taken into consideration with reduced risk weightings for capital requirements as compared to unsecured transactions (article 302 paragraph 1 CRR[26]).

Example – Number of transactions in the case of bilateral or CCP clearing



Party	Liability	Debt	Net
A	100	70	-30
B	60	100	**40**
C	70	120	**50**
D	120	60	-60

The example shows the reduction in the number of market participants' individual transactions with clearing via a CCP (right) as compared with bilateral clearing (left). Because individual counterparties' claims and obligations are settled via the CCP, the risk positions (exposure) and hence the counterparty risk are reduced.

Diagram 1: Number of transactions in the case of bilateral or CCP clearing (example)

Market participants from the financial sector in particular have started to clear further OTC derivatives in addition to their clearing obligation. This has led to an increase in liquidity within the cleared OTC derivative market. Conversely, OTC derivatives which are not cleared via CCPs are burdened with higher capital requirements, which makes clearing more attractive. Under some circumstances, this can result in a situation in which hedging against individual risks, e.g. OTC derivatives in "exotic" currencies, is only possible at a much higher cost or not at all. Because capital requirements would be too high without clearing. But clearing would also become more expensive or might not be offered at all, since the risks involved require banks and/or clearing houses to offer special, non-standardised service which would be too risky or costly.

[24] Calculated at portfolio level to hedge against fluctuations in the market participant's overall portfolio.
[25] To hedge against daily market fluctuations of the individual transaction.
[26] CRR: Capital Requirements Regulation: EU Regulation No. 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and [...].

On the one hand, CCPs increase market transparency and hence financial stability through their central position in the market. According to an evaluation by Deutsche Bundesbank, CCPs had a stabilising effect during the global financial crisis whereas transactions cleared bilaterally constituted a factor of uncertainty.[27] On the other hand, a new risk concentration in just a few market participants is created, which can lead to new destabilisation risks. Future rules on CCP recovery and resolution are therefore of decisive importance for the long-term functioning of clearing systems.[28]

2. Which financial products are subject to clearing?

Essential cases of clearing include

- Clearing of cash
- Clearing of securities
- Clearing of derivatives contracts listed on a securities exchange (listed derivatives) or traded in the over-the-counter market (OTC derivatives).

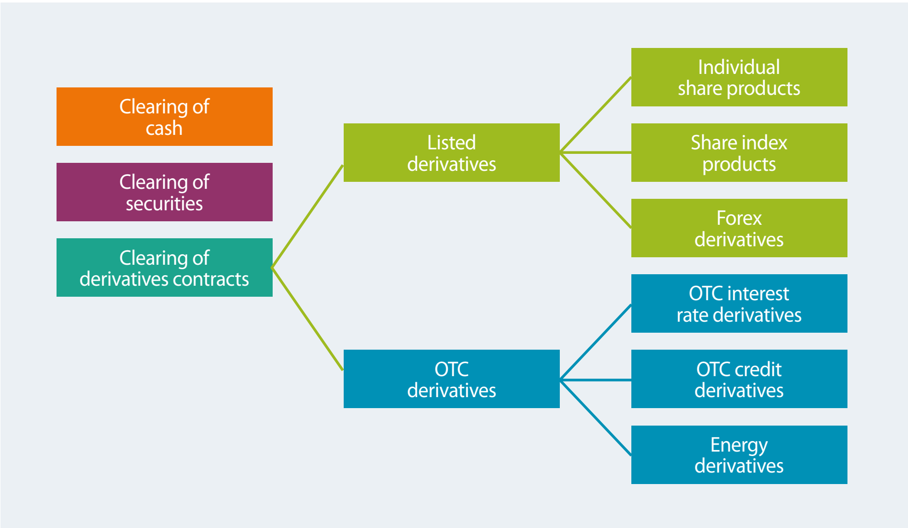


Diagram 2: Selection of cleared financial products

[27] Cf. Deutsche Bundesbank, Überwachung des Zahlungsverkehrs und der Wertpapierabwicklung: Zentrale Kontrahenten, 2017, at https://www.bundesbank.de/Redaktion/DE/Dossier/Aufgaben/ueberwachung.html?docId=324470&notFirst=true.

[28] Cf. European Commission, Recovery and resolution of central counterparties (CCPs), 2017, at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/post-trade-services/recovery-and-resolution-central-counterparties-ccps_en.

The volumes of the various cleared financial products are illustrated in the following pie chart. The outstanding nominal value[29] of OTC derivatives worldwide was 483 trillion US dollars at the end of 2016.[30] The lion's share of this was accounted for by interest-rate derivatives (cf. diagram 3).

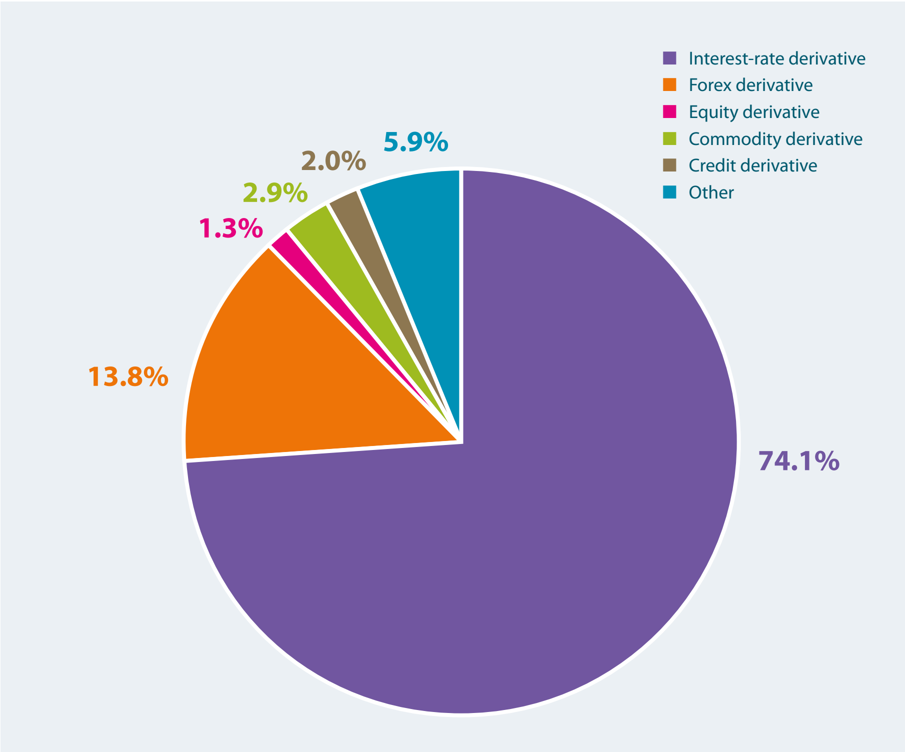


Diagram 3: Share of different OTC derivatives at 31 December 2016

Around 58 percent of the total value of all OTC derivative contracts were cleared centrally via CCPs in December 2016. This corresponds roughly to an amount of 279 trillion US dollars. The share of OTC interest rate derivatives cleared centrally via CCPs was 76 percent,[31] around 43 percent for credit derivatives. The total share of OTC derivatives cleared via CCPs continues to increase, which was the stated political objective when EMIR was enacted in 2012.

Around 90 percent of clearing of euro-denominated interest rate derivatives as well as 40 percent of clearing of euro-denominated credit derivatives issued by banks from the eurozone are carried out by British CCPs.[32] In this regard an important position is occupied by the London Clearing House (LCH). It clears 90 percent of all global interest rate derivatives, of which around 28 percent are euro-denominated interest rate derivatives. Brexit therefore inevitably means that a large share of clearing, in particular of euro-denominated interest rate derivatives, will in future be regulated and supervised outside the EU jurisdiction (i.e. outside the eurozone and outside the EU/EEA).

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29 In the case of derivatives, the nominal value is a calculated value of the derivative denominated in a particular currency.

30 Cf. Bank for International Settlements, Global OTC derivatives market, 6 June 2017, at http://www.bis.org/statistics/d5_1.pdf and http://www.bis.org/statistics/d5_2.pdf.

31 Cf. Wooldridge. Philip, Central clearing makes further inroads, in BIS Quarterly Review, June 2017, 6 June 2017, at http://www.bis.org/publ/qtrpdf/r_qt1706y.htm.

32 Cf. European Central Bank, European CCPs after Brexit, 20 June 2017, at https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170620.en.html.

3. How is clearing regulated in the European Union?

At the 2009 G20 summit in Pittsburgh, Heads of State and Government of the Member States agreed that all standardised derivative contracts should be settled via CCPs by the end of 2012. In addition, large portions of OTC business should be secured and notified in central trade repositories.[33] Exemptions apply inter alia to nonfinancial counterparties. In the European Union this is regulated through EMIR, which entered into force in 2012.

Among other things, the EMIR regulation sets out the supervisory framework for CCPs established in the European Union as well as provisions for third-country CCPs which provide clearing services in the European Union. It also specifies an obligation for contracting parties of standardised OTC derivatives[34] to clear via a CCP and for non-clearable transactions to be secured.

The clearing obligation under EMIR applies to all financial counterparties supervised in the European Union as well as to nonfinancial counterparties whose OTC derivatives volumes exceed a certain threshold excluding risk-hedging activities.[35] In this way, the counterparty risk and operational individual risk is being reduced. Since only sufficiently standardised and liquid derivatives business is suited to central clearing from an economic standpoint, contracting parties to OTC derivatives which are not subject to the central clearing obligation must meet high requirements on operational risk management (including an obligation to secure transactions in some cases).

But first and foremost, all OTC and other derivatives defined in MiFID must be notified under EMIR in trade respositories supervised by ESMA. This is intended to ensure that existing positions, risks and activities of the various participants in the OTC derivatives market are entirely captured and unforeseen chain reactions cannot occur as it happened in the wake of the insolvency of Lehman Brothers. Enhanced market transparency shall minimise unexpected consequences on markets and hence the need for state intervention in the future. Nevertheless, adequate data quality has not been achieved yet, a situation which regulators are trying to remedy with a range of amendment proposals.

[33] Cf. Deutsche Börse AG, How central counterparties strengthen the safety and integrity of financial markets, July 2014, at http://deutsche-boerse.com/blob/2532348/37fbffb2a577d8e43d52d19223b49c63/data/how-central-counter-parties-strengthen-the-safety-and-integrity-of-financial-markets_en.pdf.

[34] Exchange-traded transactions were already cleared vis CCPs before EMIR.

[35] OTC derivatives are derivatives listed in annex I section C numbers 4 to 10 MiFID which are not executed on a regulated market within the meaning of article 4 paragraph 1 number 14 or on a market in third countries which is not deemed to be a regulated market within the meaning of article 19 paragraph 6 MiFID.

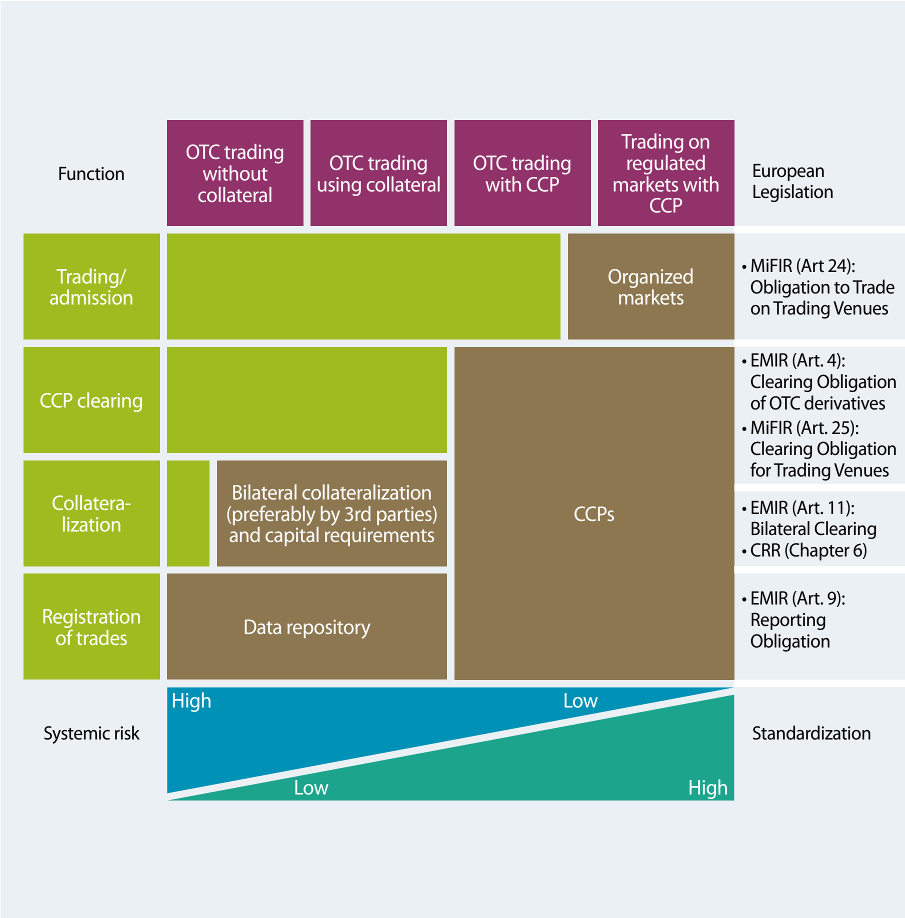

Diagram 4: Overview of regulatory requirements for clearing

3.3.2 Third-country regime

EMIR also sets out the supervisory framework for third-country CCPs which provide clearing services in the European Union. Under these provisions, it is possible for CCPs established outside the European Union to offer clearing business also to EU market participants insofar as the European Commission recognises the equivalence of the foreign supervisory regime. However, like most third-country regimes, the equivalence regime under EMIR is not designed for large volumes, a situation which ESMA, ECB and the European Parliament have already highlighted. To this is added that the European Union has in the past been comparatively open with regard to equivalence and granting access to the EU market whereas other countries, in particular the USA and Japan, pursue clearly more restrictive approaches.

In May 2017, the European Commission published its proposal for the EMIR Review.[36] In addition, in June 2017 the European Commission presented a supplementary draft for revision of EMIR[37], in which it proposes a new framework in relation to the equivalence of CCPs from third countries. In this regard, European Commission Vice President Valdis Dombrovskis underlined that, due to the loss of the EU's largest financial centre London, an effective third-country regime is necessary so that the security and stability of financial markets can be safeguarded in the future.[38]

Above all, this draft regulation provides that systemically relevant CCPs not established in the European Union should in future be subject to additional ESMA supervision. This process runs in parallel to the ongoing revision of the framework for the three European Supervisory Authorities (ESAs) whereby ESMA shall be assigned in future to exercise direct supervision of clearing houses.[39] ESMA supervision of third-country CCPs seeks to improve monitoring and the information situation for the EU authorities. Furthermore, the enforceability of regulatory measures with a view to financial market stability must be ensured, in particular in times of crisis – when rapid action is needed in coordination with bank supervisory bodies.[40] If ESMA and the competent central banks conclude that regulatory measures cannot be enforced outside the European Union, the option is even created for these CCPs no longer to be recognised (cf. diagram 5).

The draft is currently being negotiated in the Council and the European Parliament. Among other things, critics find that it does not go far enough. Thus, Members of the European Parliament,[41] Deutsche Bundesbank[42] and Banque de France are calling for more far-reaching rules in order to ensure that euro clearing falls under EU law and within the competence of ECJ. Meanwhile, others hold the view that the possibility of a clearing ban for certain CCPs overshoots the objective. ECB has proposed that its own powers in relation to the monitoring of clearing through an addition to article 22 of the ESCB/ECB statutes. This political "wrangling" shows how complex and political the issue of clearing is.

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36 EMIR Review: Proposal for a Regulation amending EU Regulation No. 648/2012 as regards the clearing obligation […], 2017/0090 (COD) of 4 May 2017.

37 Proposal for a Regulation amending EU Regulation No. 1095/2010 establishing a European Supervisory Authority […], 2017/0136 (COD) of 16 June 2017, at https://ec.europa.eu/info/law/derivatives-emir-regulation-eu-no-648-2012/upcoming_en.

38 Cf. European Commission, Press release: Commission proposes more robust supervision of central counterparties (CCPs), 13 June 2017, at http://europa.eu/rapid/press-release_IP-17-1568_en.htm?locale=en.

39 Cf. European Commission, Public consultation on the operations of the European Supervisory Authorities, 2017, at https://ec.europa.eu/info/consultations/finance-2017-esas-operations_en.

40 This issue has not yet been addressed in the legislation of recovery and resolution of CCPs but is being examined by the competent rapporteur of the European Parliament Jakob von Weizsäcker and by the European Commission in the framework of the EMIR Review. Cf. European Commission, Recovery and resolution of central counterparties (CCPs), 28 November 2016, at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/post-trade-services/recovery-and-resolution-central-counterparties-ccps_en.

41 Cf. Financial Times, MEPs seek tougher rules on London euro clearing after UK quits EU, 7 August 2017, at https://www.ft.com/content/6f2c5982-75cf-11e7-a3e8-60495fe6ca71.

42 Cf. inter alia Deutsche Bundesbank, Das Euro-Clearing ist für Europa von zentraler Bedeutung, guest article in Börsen-Zeitung, 19 May 2017, at https://www.bundesbank.de/Redaktion/DE/Standardartikel/Presse/Gastbeitraege/2017_05_19_wuermeling_boersen_zeitung.html; Bundesbank-Vorstand für Kontrollrechte über Euro-Clearing nach Brexit, 18 August 2017, at https://de.reuters.com/article/bundesbank-euro-clearing-idDEKCN1AY1U0.

Amendments to Regulation (EU) No 648/2012; Art. 25 (2b), (2c)		
No systemic importance	Systemic importance	
Tier 1 CCP	Tier 2 CCP	Tier 2+ CCP
Classic equivalence	Enhanced equivalence	Non-recognition
Tier 1 CCPs will continue to be subject to current arrangements and conditions for 3rd country equivalence – i.e. EC decision on 3rd country jurisdiction plus ESMA recognition of CCP. The proposal tasks ESMA with some new responsibilities in relation to the supervision over these recognised Tier 1 CCPs.	Tier 2 CCPs will have to: • Comply with the relevant and necessary prudential requirements for EU27-CCPs. • Provide consent for regulator access to information and a written confirmation (within 180 days) from the relevant EU central banks that the third-country CCP complies with any requirements imposed by those central banks in the carrying out of their monetary policy tasks. • Provide a written consent by the 3rd country CCP that ESMA may access any information held by the CCP and may access any of its business premises upon request.	ESMA, in agreement with the relevant central banks and commensurate with the degree of systemic importance of the CCP in accordance with paragraph 2a, may conclude that a CCP is of such substantial systemic importance that compliance with the conditions set out in paragraph 2b does not sufficiently ensure financial stability and therefore should not be recognized. The Commission may adopt an implementing act declaring that that CCP shall not be recognized and that it may only provide clearing services in the Union after it has been granted authorization in accordance with EMIR.

Diagram 5: Proposed third-country regime for CCPs under the EMIR Review

In the debate on an obligatory transfer of euro clearing into the European Union, it should be borne in mind that joint supervision of CCPs already happens elsewhere. For instance, CFTC (Commodity Futures Trading Commission) which is responsible for supervision in the USA does not insist that dollar clearing takes place exclusively within national borders. Rather, the supervisory authority assigns a high value to CCPs outside the USA, which are used in particular by non-American customers, and has repeatedly come out against the regulator specifying where dollar clearing may be carried out.[43]

[43] Cf. CFTC, What future for global regulation of financial markets?, 5 April 2017, at http://www.cftc.gov/PressRoom/SpeechesTestimony/opabowen-15.

The largest portion of OTC derivatives is currently cleared in the United Kingdom. Under the European Commission's proposals, recognition of systemic relevant third-country CCPs (which will in future also include CCPs in the United Kingdom) as qualified CCPs (QCCPs) is possible in principle. The decision would fall to ESMA with the involvement of the ECB and national central banks. However, as with all equivalence regimes, recognition could be withdrawn at short notice and therefore offers little certainty. Without recognition, third-country CCPs would have to transfer their business into the European Union in order to be able to continue clearing with EU market participants.

In the context of Brexit and the question of relocating clearing operations, it is essential to make a distinction between new business and existing business.

- In the case of doubt, it is probably simpler to minimise the negative consequences of non-recognition for new business – e.g. by transferring clearing to a recognised EU CCP. Nevertheless, more costly clearing could be expected at least in the short term due to reduced liquidity and restructuring activities.

- By contrast, major changes would be needed for existing business with contracts extending beyond Brexit, if no arrangements or grandfathering are agreed. The risk-weighted assets (RWA) to be set aside for existing contracts would increase significantly since the risk position of a QCCP will become the risk position of a non-qualified CCP following Brexit. It is argued that the RWA with an overall risk position of 10 billion euro could increase more than 16-fold (see calculations in annex 2). Other studies come to the conclusion that a possible increase in the initial margin could cause further additional costs.[44] However, there are also studies which come to precisely the opposite conclusion and assume a decline in costs.[45] In particular long-term transactions such as interest rate and forex contracts would be affected. On the basis of the new regulatory proposals, the question also arises as to whether it continues to be possible to clear financial products through a non-recognised CCP from a third country at all. The question of how then to proceed with existing contracts causes even greater uncertainty. Protection which enables market participants to let their contracts run to term would offer a remedy here.

The financial sector in particular would be affected by deliberations and changes in relation to clearing. Nonfinancial companies would hardly feel the effects or only indirectly since EMIR mostly exempts them from the clearing obligation.

Given the meagre progress in the Brexit negotiations and the increasing probability of a hard Brexit – without a timely agreement between the negotiating parties and without transitional arrangements – many financial market players can no longer postpone their emergency planning. The Brexit negotiations and the EMIR Review will take time. At the same

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[44] Cf. inter alia Clarus, Moving Euro Clearing out of the UK: the $77bn problem?, 31 May 2017, at https://www.clarusft.com/moving-euro-clearing-out-of-the-uk-the-77bn-problem/; ISDA, Brexit – CCP Location and Legal Uncertainty, August 2017, at http://www2.isda.org/attachment/OTU5Mw==/Brexit%20paper%201%20FINAL1.pdf.

[45] Cf. BVI, BVI position on Euro clearing by systemically important third country CCPs, 12 July 2017, at https://www.bvi.de/fileadmin/user_upload/Regulierung/Positionen/Euro-Clearing/2017_07_12_BVI_position_euroclearing.pdf.

time, supervisory authorities have invited major banks to present scenarios for a hard Brexit. ECB and the Bank of England have made clear that market participants must be prepared for this scenario.[46] This also becomes clear by a partnership programme between Eurex Clearing and several major banks launched in early October 2017 and which is intended to accelerate development of an alternative service offer for clearing of interest rate derivatives in the European Union. The programme has been constructed in close cooperation with market players which jointly want to move ahead with the development of a liquid clearing market.[47]

3.3.3 Recommendations

Access to the clearing infrastructure which is currently concentrated in the United Kingdom is of central importance for numerous market participants established in the European Union. Changes to this infrastructure in the short term, in particular in the event of a hard Brexit in March 2019, entail considerable risks. These risks are in particular a disproportionate cost increase for market participants and/or negative consequences of an unduly marked fragmentation, if they lead to a decline in market liquidity or impair the efficiency of the clearing market. In addition, changes could have an impact on the hedging costs of nonfinancial companies.

In particular in the case of a hard Brexit, the risk potential would be especially high since British CCPs would no longer be recognised from one day to the next or the recognition process would not have been concluded. Irrespective of this, it is not clear whether such recognition will still be possible at all following the EMIR Review. Market disruptions and inefficiencies are therefore very much to be feared in the short term.

These risks need to be weighed up objectively in the framework of the current political discussion about a transfer of euro clearing into the European Union, inter alia in the framework of the EMIR Review. The overarching objective must be to safeguard European financial stability but also to preserve the efficiency of the market and to take the interests of market participants into account. In this connection, there is also a discussion ongoing as to how and whether effective supervision can be ensured for systemic relevant third-country CCPs. Not only for reasons of financial stability but also to prevent the European Union being financially liable in a crisis even though it has no possibility to exercise regulatory control and monitoring over these CCPs.

The upcoming process will not be easy since there are many open questions which directly influence the risks and opportunities associated with revision of the regulatory and supervisory framework. For example, can the EU clearing ecosystem manage the trade in question? How would a relocation impact on costs and liquidity? Will this create disadvantages for EU market participants in international competition? Might a relocation even possibly bring

[46] Cf. City A.M., ECB urges banks to speed up Brexit relocation planning: „The clock is ticking", 16 August 2017, at http://www.cityam.com/270375/ecb-urges-banks-speed-up-brexit-relocation-planning-clock.

[47] Cf. Deutsche Börse Group, Eurex Clearing announces partnership program, 9 October 2017, at http://deutsche-boerse.com/dbg-en/media-relations/press-releases/Eurex-Clearing-announces-partnership-program/3199210.

advantages? Where will market participants clear in future? Can dual supervision such as for clearing in dollars function? The great uncertainty makes it difficult to make a reliable assessment of the actual consequences and how serious or not they will be. This can also be seen in the range of predictions for the consequences of a relocation of clearing.

Whatever solution the negotiators and or the legislator choose, it is of decisive importance that they are conscious of the possible risks and consequences and seek out the best possible solution for all concerned. A purely political decision on an issue with such great relevance for the international financial market is out of place.

Deutsches Aktieninstitut therefore recommends that the following viewpoints and objectives should feed into the decision-making process:

- Appropriate transitional arrangements need to be implemented in parallel with grandfathering of existing risk positions of EU financial institutions vis-à-vis third-country CCPs, even if their status is set to change following Brexit.

- Possible negative consequences of a hard Brexit and a regulator-driven transfer of new business to the European clearing market should be taken into consideration.

- A stable clearing ecosystem with the requisite clearing houses and sufficient liquidity needs to be developed in the European Union, and a competitive and supportive framework needs to be created.

- The same conditions for all market participants, including international market participants, must be enforced in order to avoid competition disadvantages for EU companies.

3.4 USE CASE: BENCHMARKS

3.4.1 Overview

Alongside current EU regulatory initiatives such as MiFID II[48] or the PRIIPs regulation[49], accusations of manipulation in the setting of reference interest rates, e.g. the London Interbank Offered Rate (LIBOR) in 2013, have drawn the European legislator's attention to the urgent need for regulation of reference values and indices. The resulting Benchmark Regulation[50] will be applicable in full from 1 January 2018.

[48] MiFID II: Revised Markets in Financial Instruments Directive: Directive 2014/65/EU of 15 May 2014 on markets in financial instruments and [...].

[49] PRIIPs: Packaged Retail and Insurance-based Investment Products: Regulation 1286/2014/EU of 26 November 2014 on key information documents for packaged retail and insurance-based investment products.

[50] Regulation (EU) 2016/1011 of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds [...].

The Benchmark Regulation specifies rules for indices which are used as reference values for financial instruments or to measure the performance of an investment fund. Since indices are used in many areas of the capital market, their regulation affects a broad range of market participants including banks, insurance companies, securities exchanges and funds. The objective of the Benchmark Regulation is better investor protection and stronger investor confidence in a transparent and stable capital market. It is intended to improve the benchmarking process and to ensure that benchmarks defined and used in in the European Union are robust, reliable, representative and fit for purpose, and are not susceptible to manipulation.

To achieve this objective, the European legislator has imposed requirements on three groups of market participants:

- In the first line, the regulation addresses "administrators" domiciled in the European Union, providing or creating benchmarks.

- In addition, "contributors", which supply the input data needed by administrators to create benchmarks, will in future also be regulated. For instance, they must comply with the relevant administrator's code of conduct.

- Lastly, the rules also relate to the users of benchmarks, for instance users which issue a financial instrument that refers to a benchmark. The reference to a benchmark will in future only be allowed, if the benchmark administrator in question is registered in the public register held by ESMA and meets the associated conditions.

The Benchmark Regulation applies for the following constellations: A benchmark within the meaning of the regulation is an index that is published. However, this is not the case, if the benchmark is made available only to a very restricted group of persons. Furthermore, a financial instrument (traded on a trading venue), a financial contract within the meaning of the EU Consumer Credit Directive[51] or the EU Residential Property Credit Directive[52], or an investment fund reference this benchmark.

If a benchmark meets the above criteria, it has to be qualifieded by the value of the referring investments and by the importance of the benchmark for the capital market in the individual Member States. Dependent on this, a distinction is made between critical, significant and non-significant benchmarks. The catalogue of obligations is graduated accordingly. A further subdivision addresses the input data (for example, whether the benchmark covers raw material data or reference interest rates). The more important a benchmark, the more comprehensive and stringent the obligations for the benchmark administrator.

If an administrator domiciled in the European Union creates a benchmark fulfilling the above criteria, it must apply to the competent authority in advance for an authorisation and is then included in ESMA's public register.

[51] Directive 2008/48/EC of 23 April 2008 on consumer credit agreements […].
[52] Directive 2014/17/EU of 4 February 2014 on credit agreements for consumers relating to residential immovable property […].

3.4.2 Third-country regime

It is only possible to use a benchmark, if the benchmark administrator is listed in ESMA's register. As a result, the Benchmark Regulation applies not only to administrators domiciled in the European Union but also to those in third countries.

Since Brexit will become effective only after entry into force of the Benchmark Regulation, it will initially also be applicable in the United Kingdom. It must be clarified by spring 2019 at the latest, whether and what consequences Brexit will have on the benchmarks of British administrators or contributors covered by the regulation.

The question that an administrator domiciled in the United Kingdom, the relevant contributor, and the user within the European Union must ask is (i) whether the administrator falls within the scope of the regulation in the first place, (ii) how its benchmarks and the associated obligations are to be classified and (iii) what risks (if any) could arise as a result of Brexit.

For administrators from third countries, there are three different possibilities for registering in the ESMA register:

- First, the European Commission can reach a positive decision on the equivalence of the third country's system (equivalence decision).
- Second, the competent authority of the reference Member State can recognise the third-country administrator, if the latter proves to the competent authority of the reference Member State[53] that its indices meet the IOSCO principles as a global standard for the provision of benchmarks and it has a legal representative in the EU reference Member State (recognition).
- As a third possibility, an EU registered administrator can apply to its competent authority[54] for endorsement of benchmarks of an administrator from a third country (endorsement).

For registration in the ESMA register and compliance with the associated obligations, the Benchmark Regulation provides in principle for a transition period until 1 January 2020. At this point, the United Kingdom will in practice already have implemented the provisions of the Benchmark Regulation so that an equivalence decision by the European Commission would appear to be self-evident. Once such an equivalence decision is in place and the relevant UK administrators are registered in the ESMA register, they can continue to offer their benchmarks beyond 1 January 2018, users can use them as a reference, and contributors can supply input data to registered administrators. It is problematic that even if the European Commission can reach an equivalence decision, registration still requires a cooperation agreement between the competent British authority and ESMA. There is a risk that no

[53] In future, it might be possible to provide this proof to ESMA since article 8 of the European Commission's current draft for the ESA Review makes provision for an amendment to the Benchmark Regulation such that the proof no longer has to be provided to the competent authority of the reference Member State but to ESMA.

[54] Here too, article 8 of the European Commission's current draft for ESA reform makes provision for the application to be lodged with ESMA and no longer with the competent authority of the Member State of the EU-registered administrator in question.

cooperation agreement exists and hence no registration attesting the equivalence of the British benchmarking legal system when Brexit becomes operational.

There is also a critical time element with regard to recognition of the UK benchmark administrator by the competent authority in the reference Member State in question. The competent authority has 90 days to examine the application and this period can be extended to get ESMA's opinion. Alongside this, a cooperation agreement between the reference Member State and the British supervisory authority also has to be concluded.

Benchmark administrators, which are not registered in the ESMA register when Brexit becomes operational, have until 1 January 2020 to organise this registration and to offer new benchmarks. However, users can only partially rely on these transitional rules.

For benchmarks of a UK administrator which have been used prior to 1 January 2020, a distinction should be drawn between two constellations:

- On the one hand, a UK administrator can apply for registration of benchmarks already in use prior to spring 2019. However, a registration of the administrator domiciled in the European Union does not automatically constitute recognition when an EU Member State becomes a third country.[55]
- On the other hand, a UK administrator can plan for registration between Brexit and 1 January 2020. If Brexit happens before the planned registration, this would be void, since such a registration is only permissible for benchmark administrators domiciled in the European Union.

Consequently, in both constellations, the benchmark administrator domiciled in the United Kingdom could be registered in the public ESMA register, if the conditions for equivalence, recognition or endorsement were met. Here, article 51 paragraph 5 of the Benchmark Regulation creates a facilitation for benchmarks of third-country administrators already used as a reference. Under this provision, benchmarks to which none of these three options applies and which were already used as a reference prior to 1 January 2020 for investments in the European Union may continue to be used as a reference for the same investments. This transitional provision relates expressly and exclusively only to existing investments. These transitional provisions do not cover newly undertaken investments, neither benchmarks put in place on or directly after 1 January 2020. They do not benefit from any earlier authorisation or registration of the benchmark administrator in the European Union.

3.4.3 Recommendations

It will not longer be possible to undertake new investments, which use benchmarks of UK administrators as a reference and for which no recognition, endorsement or equivalence exist, following Brexit. Article 51 paragraph 4 of the Benchmark Regulation does create a possibility to use benchmarks beyond 1 January 2020, even if they do not meet the requirements of the Benchmark Regulation. However, as with article 51 paragraph 5, this is applicable only

[55] Cf. ESMA, ESMA issues principles on supervisory approach to relocations from the UK, 31 May 2017, at https://www.esma.europa.eu/press-news/esma-news/esma-issues-principles-supervisory-approach-relocations-uk.

to “old” benchmarks. Neither is it applicable to an EU benchmark which becomes a third-country benchmark. This means that article 51 paragraph 4 of the Benchmark Regulation offers users no protection in these cases.

The risk of non-registered benchmarks of UK administrators over many months would lead to millions of products either having to turn to fallback solutions, not being able to be structured as originally planned or not being placed on the market before registration in the ESMA register. Furthermore, financial instruments sometimes also serve to hedge a range of other investments. Should this hedging no longer be possible, new risks could arise. In addition, administrators could no longer continue/initiate their licensing contracts. Contributors would also be negatively affected, since the benchmarks supplied by them could suddenly no longer be used as in the past.

Current administrators of benchmarks with their seat in third countries have 42 months to adjust to the new situation. However, a provision on transition periods for Member States which become third countries by the time the Benchmark Regulation becomes applicable is lacking. This would serve not only to protect users and the capital market but also to encompass consumers, who ought to be protected following the LIBOR manipulation case.

In order to enable the use of UK benchmarks also into the future, we recommend a consistent implementation of the Benchmark Regulation’s third-country regime. Under the condition that the United Kingdom continues to ensure a supervisory and legislative framework equivalent to the European requirements.

The most used index in practice is the LIBOR family. However, it is the wish of the British regulator FCA (Financial Conduct Authority) to suspend it by 2021 and supersed it by other, national indices (e.g. the Sterling Over Night Index Average (SONIA) for British pounds). The changes resulting from Brexit could therefore take place simultaneously with the LIBOR changeover problems and increase the complexity even further. One more reason to examine this thematic area carefully and to create appropriate arrangements early enough.

3.5 3.5 USE CASE: RATING

3.5.1 Overview

To meet regulatory requirements, market participants regulated in the European Union require data on third parties supplied by credit rating agencies (CRAs) in the form of ratings (e.g. to calculate risk capital). Regulation of the rating market in the European Union has been thoroughly overhauled in recent years via three regulations.[56] For instance, the requirements allow EU financial institutions to use only ratings registered with ESMA to meet their regulatory obligations. Such registration is possible only for EU CRAs.

In addition, CRAs occupy a special position in the financial services sector, since they are regulated and supervised on a pan-European level and not by individual Member States. On the basis of this central regulation, CRAs have not been obliged by the regulatory regime

[56] CRA I, II and III: Regulations (EC) No. 1060/2009, No. 513/2011 and No. 462/2013 on rating agencies.

to bundle their operational activities in a specific country. The structures of the rating market have been shaped first and foremost by the objective of involving as many customers as possible and gaining the best possible access to the relevant specialist labour market. This constellation has prompted a number of CRAs to centralise the administration of their operational business activity in London, whereas their analysts are located in a number of countries of the European Union. Others in turn have created stand-alone subsidiaries in individual Member States. CRAs in the European Union are therefore organised in very different ways, which has led to a heterogeneous structure in the rating market.

As a result of Brexit, there is a danger that ratings issued in the United Kingdom may in future no longer be used in the European Union. This would lead to unforeseeable changes in the EU financial sector but also in other sectors.

3.5.2 Third-country regime

The CRA regulatory framework also comprises a third-country regime, which, however, makes the use of third-country ratings in the European Union only possible to a limited extent. EU market participants can use the rating of a third-country CRA for regulatory purposes only, if (i) this rating is endorsed by an ESMA-registered EU CRA (endorsement), or (ii) the third-country CRA is certified by ESMA (certification).

- Endorsement: Endorsement of ratings from EU rating agencies is subject to enhanced requirements. Thus, among other things, the third-country CRA needs to be registered and supervised in the third country, the local requirements must be just as stringent as they are in the European Union, and there must be a cooperation agreement between the competent authorities. Rating agencies which endorse such a third-country rating are unreservedly responsible for the rating as well as for compliance with the conditions contained therein.

- Certification: A third-country CRA can be certified by ESMA. The condition is that the European Commission has recognised the third country's legislative and supervisory framework for rating agencies as being equivalent to the EU requirements and there is a cooperation agreement between the competent authorities. Moreover, the rating must not be of systemic relevance for the financial stability of the European Union. However, certification allows EU market participants to use a rating of this third-country CRA only for companies with their seat in third countries.

These two rules imply that rating agencies will be supervised by two supervisory authorities once Brexit becomes effective. ESMA will continue to be responsible for the EU27 countries while the United Kingdom must develop its own supervision.

Independently of Brexit, ESMA is presently conducting a consultation on significant changes to the current endorsement regime. These changes would disrupt the current endorsement process, which broadly runs seamlessly, and create uncertainty as to when and to what extent an endorsement continues to be possible. In this context, ESMA also verifies what it deems to be an "objective justification" for an EU CRA to issue a rating issued by a business unit in another EU country. ESMA's recommendations on the basis of the preceding consultation are expected for the end of 2017.

3.5.3 Recommendations

The success of many European companies depends on them not being worse placed than their competitors, for example in relation to worldwide connectivity or access to capital and investors. Without mutual recognition of the equivalence of the legislative and supervisory framework for rating agencies in the Brexit negotiations, EU companies will be able to use British ratings for regulatory purposes only to a limited extent and with more stringent requirements. This would disadvantage them compared to international competitors.

An efficient rating industry is a key element of liquid and efficient capital markets, which make capital available for companies and hence help to create jobs and growth. Consequently, frictions in the availability and/or use of ratings in the European Union can lead to a disruption in the general economy and should therefore be avoided.

The need for adjustments in individual rating agencies varies considerably based on different structures. Thus, it must be ensured that CRAs currently registered with ESMA continue to be recognised after Brexit or at least that transitional arrangements are agreed allowing sufficient time for restructuring. In addition, the long-term aim should be that mutually recognised CRA standards based on international requirements are developed, thereby enabling cross-border use of ratings.

Recognition that also allows EU27 issuers to be rated outside the European Union and third-country issuers to be rated in the EU27 will also strengthen global markets. Among other things, reasons for such constellations are proximity to investors and other market participants, such as issuing houses, advisers and intermediaries, intellectual capital and/or analytical competence centres.

Furthermore, Brexit raises the question of access to talent from third countries and the possibility of carrying out business in the European Union or the United Kingdom via establishments. Ratings are drawn up via a network of analytical hubs. This network needs access to rating experts in a wide range of jurisdictions in order to produce globally consistent ratings which are simultaneously based on local detailed knowledge. A core element of high-quality ratings is therefore the possibility to set up cross-border branches and to manage them efficiently and in a coordinated way.

4 CONCLUSION

The United Kingdom's departure from the European Union will have a major impact on the European economy and society – that means also on companies, consumers and investors. In this regard, the concrete consequences depend on the outcome of the Brexit negotiations.

The objective of this second position paper is to highlight further possibilities as to how negative consequences for the affected economies can be minimised. To this end, attention has once again been drawn to the importance of transitional arrangements, which buy more time for the negotiators and affected parties. In addition, complementing the thematic areas already analysed in the first position paper, three further critical aspects in capital and financial markets law are analysed and recommendations are made for the negotiations: clearing, benchmarks and ratings.

It is up to the negotiators to reach objectively substantiated and rational decisions, which achieve the best possible outcome for all affected parties taking into account all consequences. Deutsches Aktieninstitut and its members are available to act as competent discussion partners at any time.

Annex

ANNEX 1:

EU passporting and third-country regimes in EU financial and capital markets law

Legal basis/ issue	EU passport	Other provision	Equivalence regime with EU passport	Other third-country regimes
MiFID II/MiFIR	Yes, for financial and investment services and branches (of investment firms).		Yes, but only investment services for professional and selected clients; this comprises no private client business and only a small portion of corporate client business.	Establishments optional for EU countries.
	Yes, for trading venues (inter alia clearing/trade in shares and derivatives).	Trading venues have non-discriminatory access to CCPs, and benchmarks.	Yes, but restrictions are expected through the EMIR Review.	
	Yes, for data provision services.		No.	
CRDs	Yes, for banking services as well as branches (of banks).		No, not for banking services or branches. For investment services compare MiFID II/ MiFIR.	Third-country equivalence for special aspects (e.g. risk weighting) possible, but contains no market access or EU passport.
PSDs	Yes, for payment services.		No.	
EMIR	Yes, for CCPs.		Yes, but restrictions are expected through the EMIR Review.	
	Yes, for TRs.		Yes.	
		CCPs and trading venues have non-discriminatory access to each other.	No, but compare MiFID II/ MiFIR.	
CSDR	Yes, for services and branches (but national regulator has to be informed).		Yes.	
UCITS	Yes, for management and marketing of collective forms of investment.		No.	
AIFMD	Yes, for the management and marketing of alternative funds to professional clients.			Non-EU providers can manage alternative funds EU-wide and market them to professional clients via ESMA recommendation and authorisation by the European Commission.
Prospectus Directive/ Regulation	Yes, for issuers' securities prospectuses.		Yes.	
Transparency Directive		Applies for all issuers with EU listing.		Yes. Applies independent of the seat for all issuers with EU listing.
Market Abuse Regulation		Applies for all issuers with EU listing.		Yes. Applies independent of the seat for all issuers with EU listing.

Benchmark Regulation	Yes, for benchmark providers.		Yes.	Temporary recognition of third-country benchmarks until equivalence decision is taken, if compliance with IOSCO principles is equivalent to those of the regulation.
Solvency II Directive	Yes, for insurers and reinsurers.		Yes, but only for reinsurers.	
CRAs	Yes, for rating agencies.		Yes, but only for third-country companies and if no systemic relevance for EU financial stability (certification).	CRAs which cooperate closely with an EU CRA and are subject to a com-parable regime can be endorsed by an EU CRA (endorsement).

ANNEX 2:

Comparison of risk-weighted assets for business with QCCP and non-QCCP

The example below calculates, how the risk-weighted assets (RWA) to be set aside by an EU bank could increase significantly, if the exposure vis-à-vis a QCCP becomes an exposure vis-à-vis a non-QCCP. In sum, the RWA for a total exposure of 10 billion euro could increase more than 16-fold. The values of the variables needed to determine the RWA (e.g. minimum involvement in the default fund and risk factor) are based on values applicable for the British CCP LCH SwapClear.

Risk position of bank vis-à-vis third-country CCP	RWA wenn QCCP	RWA wenn Nicht-QCCP
Share of total exposure (TE)[1]	• 2% of TE • EUR 10 bn * 2% = **0,2 billion euro**	• 20% of TE[2] • EUR 10 bn * 20% = **2 billion euro**
Pre-funded default fund contributions to CCP default fund (FDF)[3,4]	• Minimum of (1250% * C-Faktor * FDF; 1250% * FDF; 18% * TE) • Min (1,250% * 25.86% * EUR 170m = EUR 0.55 bn; 1,250% * EUR 170m = EUR 2.125 bn; 18% * EUR 10 bn = EUR 1.8 bn) = **0,55 billion euro**	• 1500% * FDF • 1500% * EUR 170m = **2,55 billion euro**
Unfunded default fund contributions to CCP default fund (UDF)[5]		• 1500% * UDF • 1500% * 3 * FDF • 1500% * 3 * EUR 170m = **7,65 billion euro**
RWA total	**0.75 billion euro**	**12,2 billion euro**

Assumptions:

[1] Total exposure = 10 billion euro

[2] Risk weight using standard approach for credit risk: here 20 percent, because the external credit rating for LCH SwapClear is between AAA and AA-.

[3] Funded default fund contributions (FDF) = 200 million euro

[4] C factor for LCH is 25.86 percent.

[5] UDF is three times as high as FDF for LCH SwapClear.

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