

January 2018

## European Market Infrastructure Regulation

### Authorisation of central counterparties (CCPs) and recognition of third-country CCPs

*Impact assessment (SWD(2017) 246, SWD(2017) 247 (executive summary)) of a Commission proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and the requirements for the recognition of third-country CCPs (COM(2017) 331)*

### Background

This note seeks to provide an initial analysis of the strengths and weaknesses of the European Commission's [impact assessment](#) (IA) accompanying its [proposal](#) above, submitted on 13 June 2017 and referred to Parliament's Committee on Economic and Monetary Affairs (ECON). This proposal amends the European Market Infrastructure Regulation (EMIR), which is already in the process of being amended by two proposals currently under consideration in Parliament. The first [proposal](#) focused on the recovery and resolution of central counterparties (CCPs).<sup>1</sup> The second [proposal](#) proposed targeted amendments aiming to meet EMIR objectives in a more effective and efficient way.<sup>2</sup> The current initiative under consideration focuses on the authorisation of CCPs and on the recognition of third-country CCPs.

A key pillar of EMIR is the requirement for over-the-counter derivatives to be cleared through a central counterparty (CCP). Derivatives are financial contracts that constitute an essential building block of a financial system, and are used for redistributing risk having either assurance or speculative scope. The type of derivative usually determines how a derivative is traded: customised derivatives (tailored to the specific needs of a particular user) are traded bilaterally, in other words 'over-the-counter' (OTC). A central counterparty – also known as clearing house – is a market infrastructure which reduces systemic risk and enhances financial stability by standing between the two parties to a derivatives contract.<sup>3</sup> Currently, 17 CCPs are established and authorised under EMIR to offer their services in the EU, with a further 28 third-country CCPs also allowed to operate in the EU.

### Problem definition

Why is there a need to revisit the supervisory arrangement for EU and third-country CCPs, five years after the entry into force of EMIR? The narrative in the IA is two-fold. Firstly, the IA argues that there is a need to act 'in light of the growing size, complexity and cross-border dimension of clearing in the EU and globally' (IA, p. 12 and 33; also similar concepts on p. 42 and p. 70). Secondly, the IA recognises that 'the EU's exposure to third-country

<sup>1</sup> See, C. Collovà, [Recovery and resolution of central counterparties](#), EPRS, European Parliament, March 2017.

<sup>2</sup> See, C. Collovà, [European Market Infrastructure Regulation, Regulatory Fitness and Performance \(REFIT\) proposal](#), EPRS, European Parliament, December 2017.

<sup>3</sup> See, A. Delivorias, [European Market Infrastructure Regulation \(EMIR\): Regulation of OTC derivatives in the European Union](#), EPRS, European Parliament, June 2017.

CCP risks will also be exacerbated by the withdrawal of the UK from the EU in 2019, as this will lead to a shift of risk from within to outside the EU'. (IA, p. 33 and elsewhere). Both issues are substantiated with evidence. For instance, and convincingly, the IA relates that around 75 % of centrally-cleared interest rate derivatives denominated in euros is cleared in the UK (IA, p. 18 and 48). The UK is also home to 4 out of 17 EU CCPs, more than any other Member State (IA, pp. 80-81). As far as the growing systemic importance of central clearing is concerned, the IA provides evidence that the volume of CCP activity — in the EU and globally — has grown rapidly. For instance, centrally cleared transactions have almost doubled in the interest rate OTC derivatives segment, from about 36 % at the end of 2009 to about 60 % at the end of 2015 (IA, p. 7).

Against this background, the IA identifies the following two main sets of problems, respectively for CCPs based within and outside the EU: (1) 'incoherence in arrangements for the supervision of CCPs established in the EU and notably the need for an adequate reflection of the responsibilities of the CBI [Central Bank of Issue, see below for an explanation]', and (2) 'the insufficient mitigation of risks relating to the operation of recognised third-country CCPs' (IA, p. 33).

With regards to EU-based CCPs, the IA identifies the current supervisory arrangements as being problematic and causing inconsistencies. Firstly, national competent authorities have a central and predominant role in the supervisory mechanism, which does not reflect the pan-European nature of EU CCPs and the cross-border impact of a potential failure. Secondly, due to this fragmentation along national borders, growing evidence has emerged of diverging supervisory practices (e.g. different condition for authorisation of a CCP) and interpretation of rules across the Union. Thirdly, according to the European Securities and Markets Authority (ESMA) and the IA, there is room for improvement in the supervisory colleges, the bodies created by EMIR to improve cooperation among relevant authorities. These authorities include ESMA, national competent authorities, the national central banks overseeing the CCPs and 'the central banks of issue of the most relevant Union currencies of the financial instruments cleared'.<sup>4</sup> The central bank of issue is the European Central Bank for the 19 EU Member States which have adopted the euro. It is the national central bank for the nine Member States whose currency is not the euro (currently Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Poland, Romania, Sweden, and the United Kingdom). The IA considers that the role of central banks of issue in EMIR lacks clarity.

Outside the EU, ESMA in particular has highlighted several shortcomings in the current regime under which EU institutions supervise third-country CCPs. For instance, ESMA claimed it has no grounds to exercise discretion in denying the recognition of a third-country CCP in presence of significant risks, as the conditions for recognition only cover the fitness of the legal framework in the third country, the EU having to rely completely on third-country rules and supervisory arrangements (IA, p. 90). In addition to this, the central banks of issue are not involved at all in the ongoing supervision of third-country CCPs, even when a sizeable amount of OTC cleared outside the EU are denominated in any EU currency. The IA argues that this could lead to 'a potential misalignment between the actions undertaken regarding CCPs and the associated effects on the monetary policy for the currency involved' (IA, p. 41). Finally, EU CCPs operating in third countries face more stringent requirements than third-country CCPs operating in the EU.

These problems are closely related to, and partly overlapping with, two of the drivers – or causes. One is 'diverging CCP supervisory practices and architecture in the EU: fragmentation of supervisory powers within the EU amongst several authorities'; the second is 'suboptimal implementation of equivalence and recognition regime for third-country CCPs'<sup>5</sup> (IA, p. 50). A third driver is 'lack of clarity regarding the scope of supervisory and

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<sup>4</sup> EMIR Article 18(2)(h). See EMIR Article 18 for a more detailed composition of supervisory colleges, which is also in the IA, pp. 96-97.

<sup>5</sup> Under EMIR, the recognition of CCPs based outside the EU is based on equivalence decisions, adopted by the Commission, confirming that the legal and supervisory framework for CCPs of a third country is equivalent to the EU regime. A CCP established in

CBI powers over CCPs: suboptimal allocation of responsibilities between supervisors and CBIs' (IA, p. 50). This last cause is linked to each of the problems both logically and in the 'problem tree' (IA, p. 50). As a result, it seems that this initiative deals with three main problems, instead of two. The consequences of the problems relate to 'potential risks to the efficiency and safety of EU CCPs', as well as 'increased risks to financial stability' (IA, p. 50). As far as the central bank of issue is concerned, the IA argues that 'price stability [...] is closely related to financial stability' (IA, p. 68).<sup>6</sup>

According to the Better Regulation Guidelines, '[t]he problem description in the IA report should be clear and specific. It should focus on the issues to be addressed by the initiative under consideration, avoiding lengthy presentations of general issues and/or Commission objectives in the relevant policy area' (Better Regulation Guidelines, p. 20).<sup>7</sup> The problem definition section (IA, pp. 33-50) is clear and, to some extent, specific. However, it refers to additional, more detailed sub-problems, which deserved a more central role in the analysis. For example, other shortcomings related to the composition, voting rights and competences of supervisory colleges, and their operations, are dealt with in an annex (Annex 6, pp. 96-101). Finally, the introduction and background sections (IA, pp. 7-33) are rather lengthy and general.

## Objectives of the legislative proposal

The general objectives of the initiative are broadly defined as the **safeguard of the safety and efficiency of EU CCPs** and **the enhancement of financial stability in the EU**. More specifically, the IA identifies two specific objectives (pp. 51-52), aimed at addressing the shortcomings highlighted above, as follows:

- Specific objective 1: Enhance CCP supervision and CBI role at EU level (S1);
- Specific objective 2: Enhance the EU's ability to monitor, identify and mitigate third country risks (S2).

These are further broken down in a few operational objectives, against which the policy options, including the preferred ones, are assessed (see also p. 74).

- For **S1**, the proposed options should ensure (i) a streamlined CCP supervision in the EU, as well as ensure that (ii) the mandates of ESMA, CBIs and national supervisors are adequately reflected in the supervisory mechanisms (IA, p. 60).
- For **S2**, the proposed options should ensure (i) that mechanisms are put in place for EU supervisors and CBIs to address third-country CCP risks; (ii) that a level-playing field exists between CCPs established in the EU and third-country CCPs; and (iii) that provisions are adopted for improved continuing enforcement and compliance of third-country CCPs (IA, p. 70 and elsewhere).

This hierarchy of objectives is specific and measurable, but it is not time-dependent, i.e. it is not 'related to a fixed date or precise time period to allow an evaluation of their achievement' (Better Regulation Toolbox, p. 80).

## Range of options considered

The IA considers only two sets of policy options, quoted verbatim in the two tables below, one for each of the specific objectives. The Commission's preferred policy options are marked in **bold**.

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this country can then apply to obtain EU recognition from ESMA. Once recognition has been granted, the CCP can be used by market participants to clear OTC derivatives as required by EMIR.

<sup>6</sup> The 2006 [speech](#) by the ECB's Vice President, Lucas Papademos, quoted as a source, provides additional references.

<sup>7</sup> Commission's Better Regulation Guidelines and Toolbox of 19 May 2015, still in force when this IA was published, in June 2017.

**Table 1: options to improve the consistency of supervisory arrangements for EU central counterparties (S1)**

Policy option	Description
1. No policy action	The baseline scenario applies.
<b>2. Establishment of enhanced EU supervisory arrangements for CCPs established in the EU</b>	<b>National supervisors would largely retain their existing supervisory powers. However, a European supervisory mechanism in an appropriate decision-making formation would be introduced. This formation would handle areas of a common interest on a more centralised basis. In a limited number of areas, CBIs would be able to issue a binding opinion on decisions taken by the executive session.</b>
3. Establishment of an EU-level supervisor for CCPs established in the EU	A single EU supervisor for CCPs would be established. CCP supervision would no longer be conducted at national level.

Source: IA, p. 56.

**Table 2: options to mitigate third-country central counterparty risks (S2)**

Policy option	Description
1. No policy action	The baseline scenario applies.
2. Location policy	Third-country CCPs would be required to be established and authorised in the EU in order to provide services to EU counterparties or trading venues or to provide clearing services in EU currencies.
<b>3. Supervision based on criteria or thresholds</b>	<b>The degree and intensity of EU supervision would be proportionate and depend on the risks posed by third-country CCPs to the EU. Different criteria or thresholds could be set: low-impact CCPs could be subject to an enhanced implementation of the EMIR equivalence and recognition regime; medium to high-impact CCPs could be subject to a sliding scale of additional supervisory requirements.</b>

Source: IA, p. 60.

The Commission does provide additional details about the options. However, the options still remain fairly general and open to different developments. For instance, focusing on the preferred options:

- The 'executive session' is the mechanism created to centralise the decision-making process on matters of common interest. This mechanism within ESMA would be composed of 'a limited number of permanent members [...] with adequate voting rights' (IA, p. 57). Central banks of issues would also be able to issue a binding opinion on decisions taken by the executive session, in a limited number of areas, 'such as liquidity risk controls or collateral mechanism' (IA, p. 57). All these issues, and additional ones, are left open in the IA and only detailed in the proposal.
- The criteria and the thresholds that are to be used to differentiate third-country CCPs between Tier 1 (low impact) and Tier 2 (medium to high impact) could be introduced either publicly or through internal decisions of the authorities. As a last resort, where risks to EU financial stability cannot otherwise be mitigated, a Tier 2 CCPs could be required to be established and re-authorised in the EU (IA, p. 69). This requirement can be considered a milder version of the location policy.
- The discarded general location policy, which would entail a requirement for (all) CCPs to be located within an EU Member State, could also be implemented in at least three different ways (IA, p. 66).

Therefore, the IA compares general, rather than detailed, alternatives. Having said that, the IA appears to provide sufficient element and coherent reasoning explaining why the other two policy options for each specific objectives were discarded. It provides, in both textual and tabular form, an assessment of both positive and negative impact of the measures considered, comparing them against their effectiveness towards the

attainment of the respective objective. The IA also evaluates the options according to their efficiency, by assessing the potential costs associated with each of them. It is worth noting that the IA considers the discarded location policy and the selected two-tier system equally *effective* in achieving all operational objectives. What changes is their *efficiency*, as the location policy is expected to entail higher overall costs (IA, p. 70).

## **Scope of the impact assessment**

The IA assesses all options for their economic impact, represented mainly by compliance costs, administrative burden and overall positive impacts on financial stability. The IA focuses at length on the drivers behind costs that could be faced by market participants should a location policy for all third-country CCPs be pursued. On the other hand, since the Commission's preferred policy option envisages an incremental range of supervisory requirement and actions that are specific to each CCP (and depend ultimately on its systemic relevance), the IA states that it would be difficult to quantify the costs that will have to be borne by CCPs ex-ante (IA, p. 71). As far as CCPs registered in the EU are concerned, the Commission estimates that, by centralising supervisory activities, CCPs could benefit from a reduction in the administrative burden (IA, p. 71). However, the IA recognises that the necessary supervisory fees may result in CCPs passing additional costs onto users. The costs for EU and national authorities appear to be more quantifiable: at a national level, the IA envisages more economies of scale and a reduction in duplication of tasks and resources allocated to supervisory activities.

The IA expects the preferred options to deliver a positive social impact for the following reasons: firstly, attaining the two specific objectives should result in increased financial stability, which in turn helps economic growth and job creation and secondly, lowering the probability of CCP failure helps maintain continuity of financial services, with benefits for individuals and SMEs' customers (IA, p.73).

In terms of territorial impacts, undoubtedly, the withdrawal of the UK from the EU will greatly alter the proportion of derivatives denominated in EU currencies being cleared outside the EU, a claim that is well-substantiated in the IA. The IA presents how inaction (policy option 1, baseline scenario) would fail to address the concerns arising from such a potential future exposure of the EU financial system. In its opinion, the Commission Regulatory Scrutiny Board, recommended further clarity on whether and how the UK withdrawal would increase systemic risks in the EU. The impact assessment, for its part, admitted that it would not cover 'the contingency considerations related to the interim period' between the UK withdrawal and the moment that any equivalence decision is taken with regard to the UK's future supervisory framework for CCPs (IA, p. 61).

## **Subsidiarity/proportionality**

The IA argues with clarity that changing the supervision of EU-based central counterparties is justified; on one hand, by the cross-border nature of CCP business and their high degree of interconnectedness; on the other hand, by the evidence of diverging supervisory practices at Member State level, which may create the risk of regulatory arbitrage. With regards to proportionality, the IA argues that the preferred policy options would meet the objectives of the initiative at a minimum cost for market participants (and supervisory entities). For instance, an outright location policy is discarded because of its lower efficiency. According to the IA, it would present high and unpredictable costs resulting from possible relocation and market fragmentation (IA, pp. 62, 67).

The subsidiarity deadline was 16 October 2017. The Swedish Riksdag submitted a reasoned opinion with remarks on the efficiency of the proposed policy option to enhance supervisory arrangements, the advisability of involving central banks of issue more closely, as well as the proportionality of a location requirement for tier 2 third-country CCPs. It is worth noting that the type of location policy retained by the IA is to be understood as an instrument of last resort (IA, p. 68). Moreover, the IA and its annexes analyse the functioning of the supervisory colleges and the need to involve both competent authorities and CBIs.

The German Bundesrat has started a political dialogue with the Commission and forwarded an opinion in which it welcomes elements of the proposal such as the greater involvement of central banks in the authorisation and supervision of third-country CCPs. The Bundesrat referred to the analysis accompanying the proposal as it reiterated that EU CCPs, when operating abroad, should not face more stringent supervisory frameworks than third-country CCPs operating in the EU. Finally, it also wished for clarification as to how supervisory requirements would apply to UK-based CCPs once the United Kingdom itself has withdrawn from the Union.

## **Budgetary or public finance implications**

The IA estimates that the Commission's preferred policy options would have no long-term impact for the EU budget. However, for ESMA to be able to perform the additional planned tasks, the Agency would require additional staff. These additional costs would be offset by collecting fees from the supervised entities (IA, pp. 72-73). The proposal adds that additional budget would be needed to cover for these costs until the system is fully operational (p. 72). To the contrary, establishing a single EU supervisor – one of the discarded options – 'would have major budgetary consequences for the EU' (IA, p. 59).

## **SME test/Competitiveness**

The Commission argues that, if the general objectives of the proposals are attained, small and medium-sized enterprises will also benefit from increased CCP stability. The IA however does not rule out the possibility that the cost associated with increased supervision may be passed onto SMEs, which are among the ultimate customers of the financial service provided by EU and non-EU CCPs. In the Commission's opinion, these potential costs will be offset by the benefits associated with enhanced crisis prevention, a more efficient and competitive EU CCP market, and ultimately the increased ability of SMEs to access funding and to invest (IA, p. 72).

## **Simplification and other regulatory implications**

The IA analyses the consistency of this initiative with other EU policies, such as the two proposals amending EMIR quoted above (IA, pp. 52-54). In addition, the preferred policy option for EU-based CCPs will require an amendment to the Statute of the European System of Central Banks (IA, p. 57). To this end, on 22 June 2017, the ECB submitted a [recommendation](#) (ECB/2017/18) for a decision of the European Parliament and of the Council amending this Statute. This decision is currently under consideration in Parliament.

## **Quality of data, research and analysis**

This impact assessment was prepared under the leadership of the Directorate-General for Financial Stability, Financial Services and Capital Markets Union. The department led a small Impact Assessment Steering Group, composed of the Directorates-General for Competition (COMP), Economic and Financial Affairs (ECFIN), Trade, as well as the Task Force for the Preparation and Conduct of the Negotiations with the United Kingdom under Article 50 TEU (TF50). Since no inception impact assessment was released beforehand, it is difficult to estimate the direct preparation time. It appears, from the timing of the internal meetings, submission to the Regulatory Scrutiny Board, and from the sources cited, that the preparation of the IA occurred within a rather limited time span between March and May 2017.

The analysis relies on the Commission's expert knowledge, backed by a broad range of recent and reliable sources, primarily reports from the European Securities and Markets Authority. For instance, although no formal evaluation was carried out for the purpose of this initiative, the IA builds on the outcome of two peer reviews on the functioning of the supervisory colleges under EMIR conducted by ESMA in 2015 and 2016.<sup>8</sup> Publications by the European Systemic Risk Board, the European Central Bank, as well as from the Financial Stability Board and the Bank of International Settlements complement these sources. The IA provides a wealth of data especially

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<sup>8</sup> ESMA, [Review of CCP colleges under EMIR](#), January 2015, and [Peer Review under EMIR Art. 21/Supervisory activities on CCPs' Margin and Collateral requirements](#), 22 December 2016.

when underscoring the systemic relevance of some CCPs and the trend whereby the volume of transactions centrally cleared is increasing. In some cases, the IA could have provided concrete figures, for instance, when highlighting how long it takes for the Commission to issue a decision of equivalence (IA, p. 36).

## Stakeholder consultation

The following table provides an initial appraisal of the timeliness, relevance and transparency of the inputs to the consultation strategy, as described within the compulsory annex on consultation (IA, pp. 87-88).

**Table 3: Initial analysis of the consultation strategy**

Type of consultation	Date	Relevance	Are responses and a feedback statement referenced in the IA?
Commission communication on responding to challenges for critical market infrastructures and further developing the capital markets union	4 May 2017	Very relevant	No
Consultation on the operations of the European Supervisory Authorities	21 March to 17 May 2017	Relevant, within a broader consultation: there are comments specific to EMIR and CCP supervision	Yes
Staff working document on EU equivalence decisions in financial services policy: an assessment	27 February 2017	Very relevant	No
Consultation on the capital markets Union mid-term review	20 January 2017 to 17 March 2017	Relevant, within a broader consultation: some comments focused on supervisory convergence	Yes
Consultation on the European market infrastructure regulation review	From May to August 2015	Relevant, within a broader consultation	Yes

Sources: IA, authors' compilation.

The table above shows that the Commission has carried out a number of recent and relevant consultations, in some cases as part of a broader consultation. The most recent consultation took place after 29 March 2017, when the UK notified its intention to withdraw from the EU. Three additional consultations were carried out after the UK referendum on EU membership of 23 June 2016. The first consultation took place before both events. Against this background, the fact that no online public consultation was carried out for the specific purpose of contributing to the IA and examining the related legislative proposal is to some extent understandable, as it could have caused consultation fatigue. Most consultation documents are available online and the IA provides some consultation results. However, the degree of transparency would have benefited from referencing in the IA written responses and a feedback statement, if available, on the two most relevant consultations: on EU equivalence decisions in financial services, and on responding to the challenges of critical market infrastructures. The Commission sought stakeholder feedback following publication of the proposal, from 14 June to 30 October 2017. Some 18 responses are [published](#).

## Monitoring and evaluation

The Commission estimates that an evaluation should be performed no less than five years after the entry into force of the proposed regulation. The IA, the explanatory memorandum and the legislative financial statement accompanying the proposal provide a list of indicators that could be used to evaluate EMIR in its entirety,

against its original objectives.<sup>9</sup> It seems, however, that a new review clause containing these indicators is not included in the text of this proposal. Indicators include the estimated costs to EU counterparties and the absence of CCP that have entered into recovery or resolution within the five-year timeframe. A further indicator not mentioned by the IA but listed in the explanatory memorandum,<sup>10</sup> is the number of times the proposed dispute resolution mechanism has been used by national competent authorities.

## Commission Regulatory Scrutiny Board

The Regulatory Scrutiny Board made a number of recommendations for improvement, when delivering an overall [positive opinion](#) on the draft IA. One of the main considerations of the RSB is that the draft IA did not develop the specific situation of the UK withdrawal from the EU and the consequent impact of CCP-related risk for the rest of the EU sufficiently. The RSB also recommended more clarity in describing how the instrument of last resort envisaged by the preferred policy option for third-country CCPs (location policy) would work in practice. These points appear to have been only partially addressed by the Commission in the final IA.

## Coherence between the Commission's legislative proposal and the IA

The legislative proposal of the Commission reflects and is coherent with the analysis carried out in the impact assessment. However, some other elements briefly touched upon in the IA are developed in more detail in the proposal. This applies for instance to the proposed amendments which detail the criteria and the procedures that are to be used to differentiate third-country CCPs between Tier 1 and 2 and the additional requirements for systemically important (Tier 2) CCPs. These general principles are listed in the IA on pages 67-68 and are developed into the amendment 9(b), which adds the paragraphs 2a, 2b and 2c to Article 25 of the Regulation. The overall approach is further explained in the explanatory memorandum (pp. 24-25). Additional examples are the supervisory powers of ESMA towards third-country CCPs, including the possibility to impose fines and other measures aimed at bringing infringements to an end. The IA mentions regulatory consequences for threshold breaches and the possibility to apply sanctions to EU clearing members conducting business with such CCPs (IA, p. 69). This regime is developed into the rather detailed new Articles 25g to 25n.

## Conclusions

The impact assessment clearly identifies the problems that require EU action, as well as their drivers and consequences. The objectives of the initiative appear to be coherent with the analysis, and are relevant and measurable. The IA analyses a limited number of alternatives to the status quo in depth: two for each of the objectives, which deal respectively with EU and third-country central counterparties. These options are phrased in rather general terms and are left open to further development. The analysis is based on relevant sources and the Commission's expert knowledge in the field. However, the IA appears to have been prepared in a rather limited time-span and could have benefited from further work.

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*This note, prepared by the Ex-Ante Impact Assessment Unit for the European Parliament's Committee on Economic and Monetary Affairs (ECON), analyses whether the principal criteria laid down in the Commission's own Better Regulation Guidelines, as well as additional factors identified by the Parliament in its Impact Assessment Handbook, appear to be met by the IA. It does not attempt to deal with the substance of the proposal. It is drafted for informational and background purposes to assist the relevant parliamentary committee(s) and Members more widely in their work.*

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<sup>9</sup> See IA, p. 75 and COM(2017) 331, p. 18 and 65.

<sup>10</sup> COM(2017) 331, p. 18.