

MEMO# 29972

June 10, 2016

ESMA Publishes Final Draft Standards Regarding Indirect Clearing Arrangements for Over-the-Counter and Exchange-Traded Derivatives

[29972]

June 9, 2016

TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 29-16
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 26-16
INTERNATIONAL COMMITTEE No. 32-16
SECURITIES OPERATIONS ADVISORY COMMITTEE RE: ESMA PUBLISHES FINAL DRAFT STANDARDS REGARDING INDIRECT CLEARING ARRANGEMENTS FOR OVER-THE-COUNTER AND EXCHANGE-TRADED DERIVATIVES

The European Securities and Markets Authority (“ESMA”) recently issued final draft regulatory technical standards (“RTS”) regarding indirect clearing arrangements for over-the-counter (“OTC”) derivatives under the European Market Infrastructure Regulation (“EMIR”) and exchange traded derivatives (“ETD”), such as futures, under the Markets in Financial Instruments Regulation (“MiFIR”). [\[1\]](#) The European Commission has until late August to endorse the draft RTS or propose amendments. Subsequently, the European Parliament and Council will have an opportunity to review the Final Draft RTS.

An “indirect clearing arrangement” is where a client of a clearing member of a central counterparty (“CCP”) (e.g., a dealer that itself is not a clearing member) provides clearing services to its own clients (e.g., funds). [\[2\]](#) The Final Draft RTS would provide a consistent standard for the regulation of indirect clearing arrangements for ETD and OTC derivatives.

The Final Draft RTS generally would give clients the choice of holding their positions and collateral in one of two types of omnibus account:

- Traditional Omnibus Indirect Account. In this arrangement, client margin is commingled in an account with the clearing member’s margin and the clearing member posts client margin to the CCP on a net basis.
- Gross Omnibus Account. This arrangement would be a new account structure in which the required margin for each indirect client—a client of a client of a clearing member, e.g., a fund—would be calculated separately and sent to the CCP. Client margin would

be commingled in an account of all indirect clients of a clearing member. [3] Any margin in excess of the margin required by the CCP would be treated as provided in contractual arrangements between the relevant parties and would not necessarily be passed directly to the CCP.

If an indirect client does not select a form of omnibus account, the Final Draft RTS would permit the indirect client's collateral and positions to be held in a traditional omnibus indirect account.

The Final Draft RTS would not require indirect clients to be offered an individually segregated account. [4] The RTS, however, permit indirect clients to be offered the option to use other account and segregation models in addition to the gross and traditional omnibus accounts—including an individually segregated account—as long as these additional options provide at least the same level of segregation and protection as the traditional omnibus account.

Default Management

For indirect clients that use a gross omnibus account, the Final Draft RTS first aim to achieve porting of indirect client collateral and positions by requiring each clearing member to have procedures to facilitate the transfer of the account of a defaulting client to an alternative, non-defaulting client. [5] If porting does not occur within a contractually specified "transfer period," a clearing member should have procedures in place to liquidate the collateral and positions of its defaulting client and attempt to return the liquidation proceeds to the clients of that defaulting client. [6] If the clearing member cannot pay the liquidation proceeds to the indirect client directly, the clearing member would be required to return any balance owed to the defaulting client for the account of the indirect clients.

The Final Draft RTS would offer comparatively fewer protections to indirect clients that elect to use a traditional omnibus account in the event of a default of a clearing member client. In these circumstances, the clearing member would be required to follow procedures designed to allow the prompt liquidation of the assets and positions of indirect clients following the default of a client. The clearing member also would be required to communicate details regarding the default of the client to indirect clients, including details regarding the period of time during which the portfolios of the indirect clients would be liquidated. After the completion of the default management process for the default of a client, the clearing member would be required to return to the client for the account of the indirect clients any balance owed from the liquidation of assets and positions of the indirect clients.

Longer Chains

Typically, an indirect clearing arrangement consists of a chain of four entities: the CCP, the clearing member, the client, and the indirect client. Theoretically, however, an indirect clearing arrangement could have a chain of more than four entities. ESMA appears not to favor longer chains and the Final Draft RTS limit these indirect clearing arrangements in two principal ways. First, the RTS require the indirect client at the end of a longer chain (i.e., the "end client") to use traditional omnibus account segregation—so the greater protections offered in the gross omnibus account would not be available for an end client in a longer chain. Second, the Final Draft RTS permit longer chains only if the entity that extends the chain beyond four entities is affiliated with the entity that precedes it or follows it in the chain. The Final Draft RTS would not permit more than two affiliated entities to

occupy consecutive “links” in an indirect clearing chain. In addition, the entity farther up the chain (i.e., closer to the CCP) would be responsible for managing the default of its affiliate and the affiliate would be required to ensure that appropriate segregation and protection is offered the end client. For example, in a chain that involves a CCP, a clearing member, a client, an affiliate of the client (e.g., an indirect client), and a fund (e.g., an end client), the client would be required to have procedures in place to manage the default of its affiliate, and the affiliate would need to offer appropriate segregation to the assets of the fund.

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endnotes

[1] European Securities Markets Authority, Final Report, Draft regulatory technical standards on indirect clearing arrangements under EMIR and MiFIR, available at <https://www.esma.europa.eu/sites/default/files/library/2016-725.pdf> (“Final Draft RTS”). For more details regarding the consultation process for these RTS, see ICI Memorandum No. 29501, available at <https://www.iciglobal.org/iciglobal/pubs/memos/memo29501>.

[2] Under the Final Draft RTS, only authorized credit institutions, investment firms, or equivalent third country credit institutions or investment firms would be permitted to offer indirect clearing services.

[3] A gross omnibus account appears to be different from the legal segregation with operational commingling (“LSOC”) model for cleared swaps, which was adopted the Commodity Futures Trading Commission, in that a CCP would not be prohibited from using one indirect client’s assets for the losses of another indirect client.

[4] The Final Draft RTS would replace existing RTS for ETD that require that indirect clearing arrangements offer clients the option of using an individually segregated account. ESMA has determined that the gross omnibus account structure finds the right balance between ensuring protection of client assets and minimizing the operational burden associated with offering indirect clearing arrangements.

[5] The alternative client would be required to accept indirect client collateral and positions only where it has previously entered into a contractual relationship that commits it to do so. This suggests that funds that use indirect clearing arrangements and hold their positions and collateral in a gross omnibus account could enhance the portability of their accounts by establishing a back-up clearing relationship with a second client of the same clearing member.

[6] To increase the likelihood that a clearing member would know the identity of an indirect client, clearing member clients that provide indirect clearing services would be required to have arrangements in place designed to let the clearing member know any information necessary to identify the positions held for the account of each indirect client on a daily basis.

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