

MEMO# 29501

November 19, 2015

ESMA Publishes Consultation Paper Regarding Indirect Clearing Arrangements for Over-the-Counter and Exchange-Traded Derivatives

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 82-15

ICI GLOBAL TRADING & MARKETS COMMITTEE No. 57-15

INTERNATIONAL MEMBERS No. 40-15

SECURITIES OPERATIONS ADVISORY COMMITTEE RE: ESMA PUBLISHES CONSULTATION PAPER REGARDING INDIRECT CLEARING ARRANGEMENTS FOR OVER-THE-COUNTER AND EXCHANGE-TRADED DERIVATIVES

Recently, the European Securities and Markets Authority (“ESMA”) issued a consultation paper regarding indirect clearing arrangements for over-the-counter (“OTC”) derivatives under EMIR and exchange-traded derivatives (“ETD”), such as futures, under MiFIR. [\[1\]](#) After the consultation, ESMA intends to submit draft amendments to the regulatory technical standards (“RTS”) for EMIR and MiFIR to the European Commission for endorsement. Comments on the Consultation Paper are due by December 17.

Currently, EMIR RTS permit indirect clearing arrangements [\[2\]](#) for OTC derivatives, as long as the arrangements: (i) do not increase counterparty risk; and (ii) ensure that the collateral and positions of the counterparty are subject to EMIR’s segregation, portability, and default management procedures. Under the EMIR RTS, clients may choose whether to hold their positions and collateral in an individually segregated account or in a client omnibus account.

MiFIR RTS do not presently address indirect clearing arrangements. ESMA has, however, consulted on indirect clearing requirements under MiFIR and, over the course of that process, learned of “serious concerns” regarding the operation of the EMIR RTS on indirect clearing. As a result of these concerns, ESMA is proposing harmonized RTS on indirect clearing arrangements under EMIR and MiFIR.

ESMA’s proposal would remove the EMIR requirement to offer a client the option of an individually segregated account and would instead 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 (which also is available under current EMIR rules), client margin is commingled in an account with the clearing member's margin and the clearing member posts client margin to the central counterparty 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 – in the account would be calculated separately and sent up 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 proposal would permit the client's collateral and positions to be held in a traditional omnibus indirect account. According to the proposal, indirect clearing arrangements could offer clients the option to use account and segregation models in addition to the gross and traditional omnibus accounts, as long as these additional options provide at least the same level of segregation as the traditional omnibus account.

Default Management

The proposal includes a number of provisions designed to protect indirect clients in the event of a default of a client of a clearing member. First, the proposal aims 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. [4] 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 return the liquidation proceeds to the clients of that defaulting client, if known. [5] If the clearing member does not know the identity of the indirect clients, the clearing member would be required to return any balance owed to the defaulting client for the account of the indirect clients. Clearing member clients that provide indirect clearing services would be required to "have the necessary arrangements in place" to ensure that the liquidation proceeds received for the account of one or more indirect clients do not form part of the defaulting client's insolvency estate.

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endnotes

[1] European Securities Markets Authority, Consultation Paper, Indirect Clearing Arrangements under EMIR and MiFIR (November 5, 2015), available at http://www.esma.europa.eu/system/files/2015-1628_-_consultation_paper_on_indirect_clearing_under_emir_and_mifir.pdf ("Consultation Paper").

[2] An "indirect clearing arrangement" is where a client of 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).

[3] A gross omnibus account appears to be different from the legal segregation with operational commingling (“LSOC”) model for cleared swaps, which was adopted by 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 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 could enhance the portability of their accounts by establishing a back-up clearing relationship with a second client of the same clearing member.

[5] 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 all information held by the client in respect of indirect clients.