

ESMA Consults on Indirect Clearing Arrangements under EMIR and MiFIR

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Financial Services and Regulation

Introduction

The European Securities and Markets Authority (“ESMA”) has published a Consultation Paper (ESMA/2015/1628) on draft regulatory technical standards (“RTS”) relating to indirect clearing arrangements under the European Markets Infrastructure Regulation (“EMIR”) and the Markets in Financial Instruments Regulation (“MiFIR”). Published on November 5, 2015, the Consultation Paper seeks views on the draft requirements on indirect clearing arrangements for OTC derivatives and exchange-traded derivatives (“ETD”). ESMA was previously mandated under EMIR and MiFIR to develop RTS on indirect clearing arrangements for OTC derivatives and for ETD respectively, with the shared objective of ensuring an appropriate level of protection. Accordingly, the Consultation Paper covers the draft RTS on indirect clearing arrangements for ETD under MiFIR as well as the draft amendments to Commission Delegated Regulation No. 149/2013, with regard to the RTS on indirect clearing arrangements for OTC derivatives under EMIR. ESMA states that the objectives of the consultation are to:

- consider certain amendments to the EMIR RTS in order to address specific issues raised in the context of the previous consultation for the draft MiFIR RTS on indirect clearing for ETDs; and
- consider a new version of the draft RTS that takes into account the feedback from the consultation on MiFIR. ESMA is also mindful of the requirement imposed upon it under MiFIR to ensure consistency.

Following the consultation, ESMA will develop a revised draft of the EMIR RTS and will finalise a draft MiFIR RTS in relation to indirect clearing arrangements to be submitted together to the European Commission for endorsement in the form of Commission Delegated Regulations, which will be legally binding and directly applicable in all Member States of the European Union.

Background

In October 2015, ESMA wrote to the European Commission explaining that during its consultation on draft MiFIR RTS on indirect clearing for ETDs, a number of important concerns had been raised relating to the EMIR RTS contained in Delegated Regulation (EU)

No 129/2013. ESMA explained that in order to address these concerns, it needed to develop alternative requirements for both OTC derivatives and ETDs, which would entail making amendments to the current EMIR RTS.

Key issues addressed by the Consultation Paper are as follows.

Accounts structure and segregation models

A number of respondents to the MiFIR Discussion Paper raised the issue of the operational burden of the individually segregated indirect account of the EMIR RTS. In response to this, a new set of accounts and segregation models were introduced in the MiFIR Consultation Paper, the objective being to reduce this operational burden, whilst still aiming for a level of protection with equivalent effect to that required by EMIR.

The choice of accounts was changed from being a choice between an omnibus indirect account and an individually segregated indirect account (in the MiFIR discussion paper), to being a choice between an omnibus indirect account and a gross omnibus indirect account with additional requirements (in the MiFIR Consultation Paper). The new proposal made the distinction between net and gross, with the intention of reflecting the account models that have been developed and implemented by industry since EMIR was drafted, whilst at the same time staying within the framework and definitions of EMIR.

In the MiFIR Consultation Paper, the first account choice remained the same (an omnibus indirect account), whilst the change proposed related to the second account choice, the new gross omnibus indirect account. Alongside the gross omnibus indirect account, the MiFIR Consultation Paper discussed additional requirements, such as the requirement to pass through margin collected from the indirect clients to the Central Counterparty ("CCP"), as an alternative to the individually segregated indirect account of the EMIR RTS.

Having considered all the responses, ESMA is proposing that the amendments of the EMIR RTS and for the new version of the draft MiFIR RTS are to follow the same approach as set out in the MiFIR Consultation Paper. The proposal is the requirement to offer an omnibus indirect account (as in the current EMIR RTS) and a gross omnibus indirect account, with certain related additional requirements.

Article 39(5) of EMIR provides that clearing members should offer a choice at least between the two types of required accounts and segregation models. ESMA observes that this means that other types of segregation models may be offered in addition. ESMA similarly observes that in the case of the requirements for indirect clearing arrangements, the minimum choice should be at least between the types of accounts described, but additional types of account structures and segregation models could be offered, provided that they offer at least the level of segregation offered by the omnibus indirect account. Although ESMA proposes not to require individually segregated indirect accounts to be part of the minimum set of accounts, this type of account may still be offered if solutions are found by market participants to address the challenges which are currently preventing its development.

Default management requirements

ESMA observes that the biggest issue encountered by the two draft standardson indirect clearing requirements has been with regard to the requirements relating to the management

of a default and there have been many responses commenting on this aspect. Of particular concern are the many situations under which there could be a conflict of law between these requirements and the local insolvency regimes. ESMA observes that indirect clearing arrangements involve many entities and jurisdictions, with many permutations and situations where there may be a conflict of law.

ESMA is proposing that the requirement around porting is re-introduced in the proposed amendment to the EMIR RTS and in the new version of the draft MiFIR RTS, not only as it could be the right solution in certain scenarios, but also because it is envisaged in Article 48 of EMIR. ESMA comments, however, that the requirement on porting is drafted in such a way that focuses on the “obligation of means”, via the procedures and not on an “obligation of results”, guaranteeing porting, so the appropriate steps can be taken in the case of a default and in the case that porting cannot be achieved.

ESMA comments on the requirement relating to the “leapfrog payment”, commenting that the approach was modified in the MiFIR Consultation Paper to take into account the fact that contractual arrangements can assist in protecting the liquidation proceeds owed to the indirect client. Initially, a new requirement was introduced which required the indirect client to be provided with information on how and when the liquidation should be conducted, to enable the indirect client to better manage the risk of its portfolio. In addition, new provisions were introduced requiring contractual arrangements between the direct and indirect clients, so that the direct client would look to protect the return of the liquidation proceeds to the indirect client from its own insolvency, to the extent it was able to do so.

ESMA believes that the liquidation is the most likely scenario and says that in view of the possible circumstances where the “leapfrog” payment may not be immediately possible, the proposed amendments to the EMIR RTS and the new version of the draft MiFIR RTS “continue in the direction taken in the MiFIR Consultation Paper”. This will allow for greater visibility to the indirect client on when and how the liquidation is going to be conducted in order for the indirect client to better manage its risk and thus its assets; and the requirement for contractual arrangements to protect to the extent possible what is owed to the indirect client from the insolvency of the direct client. ESMA comments that the requirements on the “leapfrog payment” are centered on the procedure and its initiation, thus constituting more an “obligation of means”.

Article 48(7) of EMIR requires liquidation proceeds to be “readily returned to those clients when they are known to the CCP or, if they are not, to the clearing member for the account of its clients”. ESMA comments that, as a result, in the case of the gross omnibus structure with the additional requirements envisaged, indirect clients should be identified and the proposed amendments include provisions to that end. However, this would not likely be the case with the first omnibus account structure. ESMA is therefore proposing to remove the requirement related to the leapfrog payment for the first omnibus account structure and make it only applicable in the case of the gross omnibus indirect account. In the case where indirect clients cannot be identified, liquidation proceeds must be returned to the direct client for the account of its indirect clients (thus mirroring the approach of Article 48(7) of EMIR).

ESMA believes that as a result, the requirements set for the management of a default take into account the difficulty of achieving porting as well as the circumstances under which the prompt and direct return to the indirect client of the liquidation proceeds of the collateral and positions held for the account of this indirect client which may not be feasible. The proposed requirements instead emphasise having procedures in place in order to be ready to execute

these measures, as well as an emphasis on establishing contractual arrangements to protect that which is owed to the indirect client in relation to the indirect clearing services from the insolvency of the intermediary providing clearing services. This “obligation of means” (as opposed to an “obligation of result”) will allow for the appropriate measures to be taken in a default situation including liquidation, where applicable. ESMA believes that the proposed requirements would contribute to providing indirect clients with a high level of protection in the event of a default and an equivalent level of protection to that provided under EMIR.

Longer chains involving more than one indirect client

The feedback relating to longer chains from the industry is related more to ETD and not OTC derivatives. This is because indirect clearing solutions for OTC derivatives have not developed significantly at all, let alone solutions involving longer chains with more than one indirect client.

ESMA is proposing not to define different requirements depending upon the number of intermediaries in the indirect clearing chain. Instead, it is proposing to consider that the indirect client at the end of the chain is the one that needs to be provided with an appropriate level of protection. This means that the requirements applicable to a direct client would need to be extended to all the intermediaries between the clearing member and the counterparty at the end of the chain. In particular, the result of this is that the provisions relating to default management will apply throughout the chain, including the requirement to provide protection via contractual arrangements. ESMA also considers that in order to give intermediaries more visibility and to manage the risk of these longer chains, sufficient information would need to be included in the contractual arrangements and communicated throughout the chain. In particular, sufficient information would need to be communicated throughout the length of the indirect clearing chain and those jurisdictions where each intermediary is established. ESMA believes that each intermediary should know their position in the chain.

Additional draft provisions

ESMA also asks for responses on two further items, which were not included in the original MiFIR Consultation Paper. These are as follows:

- the introduction of a new provision to allow the direct client to assign by default to the indirect client the choice of an omnibus indirect account. This will apply if after reasonable efforts to secure the election choice of the indirect client, the indirect client has still not communicated its choice within a reasonable amount of time; and
- a distinction is made between collateral that is called from the indirect client in order to meet the margin requirements and collateral that is provided on top of the collateral for the margin requirements in order to facilitate the acceptance for clearing of transactions. ESMA is proposing the latter type of collateral should be treated in accordance with the contractual arrangements between the relevant parties, as against a complete pass through of the full collateral value.

Next steps

The Consultation closes on December 17, 2015. After the Consultation closes, ESMA will analyse the responses and then the finalised draft amendments to the EMIR RTS and the finalised draft MiFIR RTS will be submitted to the European Commission for endorsement.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Financial Services and Regulation practice group:

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