EACH response to the ESMA Consultation Paper 2015/1628 on 'Indirect clearing arrangements under EMIR and MiFIR'

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1. Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of CCPs in Europe since 1992. EACH currently has 20 members from 16 different European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

EACH welcomes the opportunity to respond to the ESMA consultation on 'Indirect clearing arrangements under EMIR and MiFIR'.

Below you will find the responses to the questions of the public consultation paper that we believe are relevant and have an impact on CCPs.

2. Response to specific questions

Q1: Do you agree with the proposed approach to require the choice between an omnibus indirect account and a gross omnibus indirect account with margin at the level of the CCP?

EACH generally supports the proposed structured of gross and net OSAs as a minimum

EACH agrees with the overall objective of providing adequate protection to indirect clients, including those indirect clients that are part of longer chains. We very much appreciate that ESMA has taken into account the concerns raised by different stakeholders and has proposed a solution. We agree with the need for indirect clients to be offered a choice of account types and support the proposed choice of a Net Omnibus Account Structure (NOSA) or a Gross Omnibus Account Structure (GOSA), with collateral held at the CCP, as a minimum. While we understand it is not a minimum requirement, we also believe that the direct client or clearing member should be offered a choice of individually segregated accounts subject to the agreement and request of the indirect client.

EACH has concerns with regard to the degree of application of the NOSA and GOSA structures and proposes an alternative

We however have concerns with regard to the level of depth in the application of the NOSA and GOSA structures and therefore propose two alternatives:

- **Alternative A**: Each clearing member to open a single NOSA and/or GOSA at the CCP for holding the assets and positions of all of its indirect clients.
- **Alternative B**: A single gross omnibus account per member for all its indirect clients.

These two options are described in further detail below.

We believe that the broad impact that these proposals will have on all market participants (indirect clients, direct clients, clearing members and CCPs) and the level of detail required to make them work, merit further discussions between the industry and regulators and EACH remains fully ready to engage in those discussion, potentially through an **ad-hoc implementing working group between regulators and technical representatives from the industry**.

Alternative A - Each clearing member to open a single NOSA and/or GOSA at the CCP for holding the assets and positions of all of its indirect clients

This is our preferred option as we understand it gathers the broadest industry support, including clearing members and CCPs.

Under this option, it should be sufficient for **each clearing member to open a single NOSA and/or GOSA at the CCP for holding the assets and positions of all of its indirect clients**. In exceptional circumstances, and if well justified by the clearing member, the CCP should consider to open additional NOSA and/or GOSA

Alternative B - A single gross omnibus account per member for all its indirect clients

If, despite the broad industry support, Alternative A above was not chosen by ESMA, we believe that a second best alternative would be to offer a second option, in addition to the choice of net and gross OSA described above. This option would be a **single gross omnibus account per member** for all its indirect clients. This option is described below.

One single omnibus gross account would be set up for a member, with the CCP, holding the positions and collateral for all the indirect clients under the member. The account could thus hold positions and accounts for indirect clients belonging to different direct clients, but only those direct clients belonging to the particular member.

The member would be responsible for allocating positions to each indirect client, in the CCP system (e.g. in position sub-accounts). The CCP would calculate a margin requirement for each indirect client and aggregate these requirements to a single gross amount per omnibus account. The member would be responsible for posting this amount to the corresponding collateral account (i.e. one single collateral account per member for its indirect clients). As indicated in the draft RTS, the handling of excess collateral would be regulated in the agreement between the direct and indirect clients, implying that excess would normally not be posted to the CCP for indirect clients. Any excess collateral posted to the member's indirect client collateral account with the CCP would not be automatically allocated to an individual indirect client and would be subject to fellowship risk between the indirect clients belonging to that member.

In the default of a direct client, the indirect clients belonging to the defaulting direct client would have the possibility to attempt to port positions and collateral to another direct client belonging to the member for which the gross omnibus account has been set up. This would be handled by the member and would only need limited support from the CCP in the form of transferring positions between subaccounts. Provided that the member continues to post the required collateral amount for the gross omnibus account, the CCP would have no reason to act.

Porting to a direct client of a different member would also be possible, but the likelihood of this succeeding would be lower than the likelihood of porting to a direct client belonging to the same member. The reason for this is that the porting would be more complex and would require an agreement between the give-up and take-up member on collateral value and unrealised settlement obligations.

EACH is of the view that this model would provide appropriate protection for the indirect client, as both the position and the collateral value of each individual indirect client would be held at the CCP and porting would at least be more likely compared to the alternative involving a net omnibus model. It should still be noted that porting of collateral in any omnibus account is less likely to succeed compared to porting of an individually segregated account.

<u>EACH believes that the final RTS should clarify that one client's collateral value may be at risk from losses on another client's positions at the point the account is liquidated</u>

EACH would appreciate some additional clarification about the nature of the Gross OSA. Most fundamentally, we would like to understand whether one customer's collateral value is at risk from losses on another client's positions at the point the account is liquidated. In our view, this should indeed be the case in order to minimise the possibilities of going further down the CCP's default waterfall and therefore protect the rest of the mutualised risk management structure.

<u>EACH has concerns about the impact of the provisions in Articles 5(1) and 5(4)</u>

In our view, it seems likely that the combination of Articles 5(1) and 5(4) will lead to a proliferation of accounts at the CCP since it seems to envisage that the required level of segregation will be repeated in respect of each link in the chain. The potential impact of these provisions could be as follows:

- The sheer number of accounts will likely increase operational risk, cost and complexity. This may be particularly acute where a CCP has to liquidate the account in the default of a clearing member. If, for any reason, a CCP is unable to hedge or auction the accounts on a net basis then it is likely that default management costs will be increased and the amounts returnable to clients and, therefore, indirect clients will be reduced.

- Splitting the netting sets between a large number of accounts is likely to lead to a big increase in margin requirements at the CCP. This ultimately makes clearing more expensive. There is also a question over whether the financial markets have the capacity to absorb CCP investment of cash margin in an EMIR compliant manner at higher levels.
- It seems likely that such a structure will encourage indirect clients to become direct clients if they can. Obviously the smaller indirect clients may not have access to clearing member services in the same way that larger indirect clients will.

Q2: Do you agree with the proposed approach for the requirements related to default management? Do you think there are alternative level 2 requirements (compatible with the relevant insolvency regime situations and the level 1 mandate) that would achieve better protections?

<u>EACH understands that the requirements related to default management shall not be applicable to CCPs beyond the level of the clearing member</u>

EACH agrees with the requirement that a Clearing Member shall commit to trigger the necessary procedures for transferring assets and positions held by the defaulting client for the account of the indirect client including procedures to allow for a prompt liquidation.

We also believe that it is important to note that the contractual relationships of most CCPs are with the clearing member and, in some cases, only certain direct clients. EACH therefore understands that **the requirements related to default management included in the draft RTS will <u>not</u> be applicable to CCPs beyond the level of the clearing member**. As a consequence, the default of a direct or indirect client of the clearing member is under the responsibility of the clearing member. This holds true for the subsequent default of an indirect client. We support the proposal that a comprehensive legal contractual relationship between the clearing members, client and indirect clients need to be established.

We therefore **question the need for such a large number of accounts to be held at the CCP** when the CCP will not actually be involved in managing the default of any entity in the chain other than the clearing member. We would also appreciate some **clarity about when an ETD indirect clearing chain can be said to be broken** (i.e. when does an entity cease to believe it is getting a cleared ETD and instead get an OTC contract).

In this sense, we would also appreciate that ESMA clarifies in its final report that paragraph 45 of the consultation does not imply that **CCPs will perform the leapfrog payments in respect to any indirect clients at any point in the chain**. Indeed, in the case of a direct client default or any of its indirect clients, the CCP would act under the instruction of the clearing member, with whom it has a contractual relationship.

In the case where both the clearing member and its direct client offering indirect client clearing default, the CCP would act under article 48(7) of EMIR, therefore returning the liquidation proceeds directly to the direct client of the clearing member, if known, for the account of its indirect clients, or otherwise to the defaulting clearing member for the account of both the direct clients and related indirect clients.

Q3: Do you agree that the proposed approach adequately addresses counterparty risk throughout the longer chain by ensuring an appropriate level of protection to indirect clients? If not, are there alternative approaches compatible with Level 1?

Please see our answers to Questions 1 and 6.

<u>EACH assumes that the new definition of 'indirect client' will not impact CCPs as they would proceed according to the instructions of the clearing member, indifferent from the number of levels below it</u>

The definition of indirect clients, under both EMIR and MiFIR, has been revised to include any indirect client in a chain of transactions (so going all levels down to any clients of indirect clients). We assume that this would not impact CCPs as they would proceed according to the instructions of the clearing member, indifferent from the number of levels below it.

The chain of potential clearing arrangements implied by the ESMA Consultation Paper goes beyond the clearing member/client/indirect client relationship including clients of indirect clients as well. As mentioned above the contractual arrangements of the CCP are with its clearing members and, in some cases, certain direct clients. The legal and functional relationships are however key for prudent clearing arrangements and should be addressed in the final RTS also covering obligations of the layer beyond indirect clients.

Q4: For longer chains, what other details (liquidation trigger and steps, flow and content of information, other) should be taken into account or what additional requirements or clarification should be provided in order to avoid potential difficulties when handling the default of a client or an indirect client facilitating clearing services?

Please see answer to Question 3.

Q5: Do you consider that the new provision assigning by default to the indirect client the choice of an omnibus indirect account following reasonable efforts from the client to receive an instruction is appropriate? If not, what other considerations should be taken into account?

No EACH response.

Q6: Do you consider appropriate that the collateral provided on top of the amount of margin the indirect client is called for is treated in accordance with the contractual arrangements?

<u>EACH would request that the RTS clarify that haircuts should be applied 'as agreed between the counterparties'</u>

According to the proposed RTS, Article 4 (4), a clearing member shall transfer to the CCP the collateral value, after applying any haircut as agreed between the counterparties, it received from its client for the account of each indirect client under segregation option from Article 4 (2b).

In our reading, this formulation enables the clearing member to take own haircuts from the collateral offered by the indirect client to cover the margin calls by the CCP (possibly leading to the situation that the collateral value received by the CCP could be lower than called for). In practice, a segregation option with pass-through of collateral as determined in this paragraph does not enable any party to take haircuts despite the CCP.

An unambiguous reformulation of the paragraph in our view would be:
"A clearing member that offers to facilitate indirect clearing services shall transfer to the CCP the full collateral value it received from its client for the account of each indirect client under segregation option in paragraph 2(b), which does not include any additional collateral received above the margin amount called by the clearing member. ***Haircuts should be applied as agreed between the counterparties.***"

The rationale behind this formulation is that the margin amount and collateral value based on CCP given haircuts should be as explicit and clear as possible to avoid any misinterpretation and guarantee timeliness and certainty of clearing.

<u>EACH does not believe that CCPs should be required to allocate excess collateral received from clearing members to each indirect client in the account</u>

We would like to gain clarity around how the CCP is supposed to treat collateral excess received from the clearing member for the account of indirect clients. **We do not believe that the CCP should be requested to allocate such excess to each indirect client in the account**. It would be both costly and complex for the clearing members and the CCP to adopt a 'gross omnibus with excess model' as the clearing member would have to inform the CCP, at least daily, of the collateral value of each indirect client, for the CCP to be able to identify it in an omnibus structure. This model would imply additional information flows between the clearing member and the CCP which does not seem to be in the spirit of ESMA's new proposal to reduce the complexity and costs for indirect client clearing.

In order to address this concern, we would encourage ESMA to add the below wording to paragraph 4 of Article 4 of both draft RTSs.

New 4(a) Any additional collateral value that is transferred by the clearing member to the CCP above the margin amount called by the CCP should be attributed by the clearing member to each indirect client in its records and accounts. The CCP may record such excess as the clearing member resources for the account of indirect clients.

Q7: In view of the different amendments described above, do you consider that this set of requirements ensures a level of protection with equivalent effect as referred to in Articles 39 and 48 of EMIR for indirect clients?

Please refer to our introductory comments and our answer to Question 1.

Q8: Please indicate your answers to the cost-benefit survey?

No EACH response.

Q9: Do you have any comments on the draft RTS under EMIR not already covered in the previous questions?

<u>EACH would require that the RTS clarify that the clearing member will need to provide the CCP with all the necessary information to identify the positions held for the account of each indirect client in a gross omnibus account</u>

We would support the introduction of the requirement in article 4(3) in both the revised EMIR RTS and the draft MiFIR RTS under which the clearing member will need to provide the CCP with all the necessary information to identify the positions held for the account of each indirect client in a gross omnibus account. This is key to allow the CCP to calculate the level of margins for each indirect client on a gross basis. However, we do not believe that the clearing member should provide the CCP with the collateral value for each indirect client, as explained in the response to Q1, Alternative B.

We note that CCPs are required under both the EMIR and MiFIR RTS to 'identify, monitor and manage any material risks arising from indirect clearing arrangements that could affect the resilience of the CCP' (see, for example, MiFIR RTS Article 3(3)).

We would appreciate that ESMA provide clarification on the expectations on CCPs in practice given that the CCP will have little control over indirect clients and will not necessarily know the identity of such indirect clients on the basis there is no direct contractual nexus. The CCP's obligations should be limited to the risk management of the client positions of the clearing member as is performed today.

Q10: Do you have any comments on the draft RTS under MiFIR not already covered in the previous questions?

No EACH response.