

### **ISDA Commentary on Indirect Clearing - Council Text of EMIR (29 July 2011)**

The International Swaps and Derivatives Association, Inc.<sup>1</sup> ("ISDA") is pleased to have the opportunity to comment on the European Market Infrastructure Regulation ("EMIR"), the proposed EU Commission regulation on OTC derivatives, central counterparties and trade repositories. ISDA is writing this letter to explain and emphasise the importance of EMIR having sufficient flexibility so as to accommodate indirect clearing and provide scope for guidance and practice from the European Securities and Market Authority ("ESMA") in due course.

#### **Current status: uncertainty on recognition of indirect clearing**

Article 3(2) of the Polish Presidency text of 18 July 2011 Council text (the "Council Text") envisages that an entity can satisfy its clearing obligation either by being a clearing member or a client. A "client" is defined as "an undertaking with a contractual relationship with a clearing member which enables that undertaking to clear its transactions with that CCP". In other words, this text does not recognise the ability for an entity to satisfy its clearing obligation in any way other than being a direct client of a clearing member.

However, the European Parliament Text adopting the Langen amendments (the "Parliamentary Text") envisages that an entity can satisfy its clearing obligation either by becoming a clearing member or by clearing through an investment firm or credit institution subject to the requirements of MiFID (Article 3(2)). There are also potentially helpful revisions to Recital 19, providing that market participants "... should have the possibility to access CCPs as clients or through investment firms or credit institutions that are themselves clients. In addition, the definition of "client" envisages both direct and indirect contractual relationships with a clearing member or one of its affiliates. ISDA favours the approach taken in the Parliamentary Text. Given the importance of indirect clearing in the market infrastructure, ISDA suggests that the permissive language in the Parliamentary Text could be strengthened and clarified in this respect.

#### **Meaning of "indirect clearing"**

A crucial point is to clarify what is meant by "indirect clearing". The term "indirect clearing" broadly refers to a structure where the client does not have a direct relationship with the clearing member and instead the client faces a broker who is not itself a clearing member (an "intermediary broker")

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<sup>1</sup> Since 1985, ISDA has worked to make the global over-the-counter ("OTC") derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, CCPs and other service providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

and such an intermediary broker then passes the client's trade onto the clearing member for clearing. The legal structure of such a relationship could be structured in various ways. The intermediary broker could clear the client's trades by acting as agent on behalf of the client. Under this structure the intermediary broker would enter into to a clearing agreement with the clearing member as agent on behalf of its clients - this is often referred to as the "non-member broker model". Alternatively, indirect clearing could be structured as a four-tier arrangement, where the client would have a direct principal to principal relationship with an intermediary broker who in turn enters into a clearing arrangement with a clearing member (so that the contractual chain would be CCP-CM-client 1-client 2). These are just two possible indirect clearing models and other models may develop that fit somewhere in between these two models.

Having clarified what indirect clearing means, it is important to recognise that the precise way in which these indirect clearing models are structured is a separate concern from the central issue of this letter, namely that EMIR should recognise indirect clearing. There is no need to be prescriptive in EMIR as to the structure of indirect clearing. We believe it is better that EMIR is drafted in a way that recognises the importance of facilitating indirect clearing and is sufficiently flexible so as to allow different models to evolve in the market (subject to ESMA supervision and oversight).

### **Recognition of indirect clearing is crucial for client access to European and global markets**

The availability of indirect clearing is crucial in ensuring that European clients will have access to CCPs outside of Europe. Taking the U.S. for example, access to U.S. CCPs will generally be through U.S. based Futures Commission Merchants ("FCMs"). Licensing issues in many European jurisdictions will prevent FCMs from transacting directly with European clients. If indirect clearing is not available clients in many European jurisdictions will not be able to clear on U.S. CCPs.

Even where there are no European licensing issues prohibiting FCMs from facing European clients directly, it is likely that clients would, where possible, prefer to deal with brokers or other investment firms or credit institutions based in their own or another European jurisdiction and who may also provide clearing services in relation to CCPs based in Europe instead of having to clear through different clearing members for different CCPs.

Limiting access of European clients to CCPs in certain jurisdiction could also limit the types of products European clients can clear. Taking cleared credit derivatives products for example, currently no credit derivative referencing a U.S. name is being cleared at a CCP outside of the U.S. From a market infrastructure perspective, providing clients with access to and choice of CCPs outside of Europe could also improve the competitiveness of CCPs generally. Such global access is crucial in the context of establishing global harmonisation in the approach to clearing.

Indirect clearing is a well understood and well tested model in the futures markets where a European client transacts with a European broker who then opens an omnibus client account with a U.S. FCM (often but not always an affiliate) who then clears on the U.S. CCP. It would therefore be an unnecessary divergence from current market practice if EMIR did not accommodate indirect clearing.

## Recognition of indirect clearing is crucial for competition and client choice in derivatives business

The indirect clearing model allows financial institutions in the EU that do not wish to become clearing members of a particular CCP themselves, to pass on the benefits of clearing to their own clients. If this were not possible, institutions (such as generally large regionally focussed banks) would be forced to pass clients to their larger, global competitors. This unintended consequence will lead to poor competition, and restricted access to clearing services. Smaller or more focussed institutions will lose the ability to service their clients effectively, and those clients without credit relationships with the clearing member's global banks might find themselves unable to access clearing at a reasonable cost.

### Client protection in indirect clearing

From a policy perspective, provided that EMIR is sufficiently flexible in contemplating indirect clearing, arrangements to ensure that clients remain sufficiently protected can be addressed by ESMA, working together with the industry, through the Level 2 implementing regulations.

### Suggested wording:

The following amendments to the Regulation – some of which mirror wording adopted in the Parliament text - are intended to allow similar arrangements to be used in relation to OTC derivatives that are cleared through a third country or EU CCP.

Amend article 4(2) of the EC proposal as follows:

For the purposes of complying with the clearing obligation under paragraph 1, financial counterparties and the non-financial counterparties referred to in Article 7(2) shall become either a clearing member or a client or shall clear their transactions in the CCP through an investment firm or credit institution subject to the requirements of Directive 2004/39/EC,<sup>1</sup> or a third country investment firm, which is a client of a clearing member and which segregates in accounts with the clearing member the assets and positions held for the account of third parties for whom it is clearing transactions from its own.<sup>2</sup>

Introduce a new definition in article 2:

(12a) 'third country investment firm' means an undertaking established in a third country that, if it were established in the Union, would be covered by the definition of investment firm in Directive 2004/39/EC and is authorised in a third country;

Third country investment firms may act as intermediaries through branches established in a Member State or cross-border where permitted by national law.

Amend recital 19 as follows:

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<sup>1</sup> Credit institutions providing investment services are subject to MiFID (article 1(2) MiFID).

<sup>2</sup> Compare article 37(2) of the proposed Regulation.

(19) As not all market participants that are subject to the clearing obligation are able to become clearing members of the CCP (or clients of clearing members), they should have the possibility to access CCPs as clients or through investment firms or credit institutions that are themselves clients.