



FIA AND FIA EUROPE SPECIAL REPORT SERIES: DERIVATIVES UNDER MiFID II - PART 2

4 February 2015

This Special Report is the third in the FIA and FIA Europe's series covering specific areas of the European Securities and Markets Authority's ("ESMA") consultation process for the implementation of the recast Markets in Financial Instruments Directive and Regulation ("MiFIR"), which together are referred to as "MiFID" II. On 19 December 2014, ESMA published Final Technical Advice to the European Commission, together with a Consultation Paper. The Consultation Paper includes draft Regulatory Technical Standards ("RTS") and Implementing Technical Standards ("ITS"), which ESMA is required to produce under MiFID II. This Special Report provides an overview of ESMA's proposals in the Consultation Paper and the draft RTS on (1) post-trading issues for derivatives; (2) indirect clearing; and (3) post-trade transparency requirements.

POST-TRADING ISSUES

Obligation to Clear Derivatives Traded on Regulated Markets and Timing of Acceptance for Clearing ("STP")

The European Markets Infrastructure Regulation ("EMIR") imposes a mandatory clearing obligation. MiFIR extends the scope of the clearing obligation to all derivative transactions concluded on a regulated market. It requires clearing members to ensure that derivatives are submitted for clearing acceptance "as quickly as technologically practicable". ESMA now has produced draft RTS to specify the minimum requirements for systems, procedures and arrangements, taking into account the need to ensure proper management of operational or other risks. ESMA would have on-going authority to update these requirements in the light of changes in the industry.

MiFIR defines "cleared derivatives" as being all derivatives which are to be cleared pursuant to the clearing obligation set out either in EMIR or in MiFIR; and all derivatives which are otherwise agreed by the relevant parties to be cleared. Accordingly, the draft RTS would apply to all derivatives to be cleared, both over-the-counter ("OTC") and exchange traded derivatives ("ETD"), whether or not those derivatives are subject to the clearing obligation.

Certainty of Clearing: Pre-Trade Checks

Respondents to ESMA's discussion paper dated 22 May 2014 ("the May DP") considered that obtaining certainty on clearing at an early stage (and when possible, before trade execution) is a key element in reducing credit and counterparty risks. ESMA agrees with this objective and accordingly, in the draft

RTS, requires that the clearing member would provide the limits for its clients to the trading venue which would check the orders placed against these limits. ESMA comments that this check would limit the situations in which a transaction may be entered into and then rejected by the CCP. The process would also allow for the early identification of any problems and therefore, for corrective action to be taken. ESMA does comment, however, that although the number of post-trade rejections of a transaction by the CCP would be reduced, the proposed pre-check would not be a guarantee that the transaction would be accepted for clearing by the CCP.

In relation to the timing for pre-checks, most respondents made a distinction between whether the order was entered into electronically or not. Respondents were supportive of a shorter period of time for those orders that were entered into electronically. ESMA agrees with the respondents to its May DP that the timeframe for the trading venue to perform pre-checks for derivative transactions subject to the clearing obligation should be different for those that would be entered into electronically, as opposed to those that are not entered into electronically. ESMA proposes in the draft RTS that the pre-check related to derivative transactions subject to the clearing obligation entered into electronically should be performed within 60 seconds from the receipt of the order by the trading venue. In relation to transactions which are not entered into electronically, ESMA proposes that the check should be performed within 10 minutes of receipt of the order. ESMA further suggests that the trading venue should provide the information related to the transaction on a real-time basis for orders to be executed electronically and within 5 minutes following the pre-check for non-electronic orders.

ESMA asks for respondents' views on the pre-check to be performed by trading venues for orders related to derivative transactions subject to the clearing obligation and also asks for comments on the proposed timeframe.

Timeframe for Submission to the CCP

ESMA agrees with the views of respondents to its May DP that the timeframe for the submission of derivative transactions to the CCP should only relate to transactions that are subject to the clearing obligation. Accordingly, the clearing obligation should be considered to be both the clearing obligation under EMIR as well as the obligation for regulated markets to clear all their derivative transactions with a CCP. ESMA's proposal is that a transaction should be submitted to the CCP within 10 seconds of execution when it is concluded on a trading venue in an electronic manner, within 10 minutes of execution when it is concluded on the trading venue in a non-electronic manner and within 30 minutes of execution when it is concluded on a bilateral basis. ESMA asks for respondents' views on the categories of transactions and proposed timeframes.

Timeframe for Clearing Member Acceptance

In the draft RTS, ESMA proposes that in order to allow the clearing member to perform the review, the CCP should provide the information related to the bilateral transactions that they received for clearing to the clearing member. ESMA proposes that the clearing member should receive the information within 60 seconds from receipt by the CCP.

Timeframe for CCP Acceptance

In relation to the timeframe for acceptance by the CCP, ESMA proposes that the CCP should accept or reject a derivative transaction submitted for clearing within 10 seconds from submission, or from the receipt of the clearing member acceptance. It comments that this timeframe is aligned with the CFTC approach in the United States. ESMA seeks respondents' views on the common timeframe.

Rejected Transactions

In relation to the treatment of rejected transactions, ESMA is proposing the following.

- Where a derivative contract, subject to the clearing obligation, is concluded on a trading venue but then rejected by the CCP, the trading venue will void such a contract.
- Where a derivative contract is concluded on a trading venue, voluntarily cleared and then rejected by the CCP, if the contract is submitted to the CCP according to the applicable trading venue rules then these rules will determine its treatment; if it is submitted by the counterparties and then rejected, then its treatment will be determined by the agreement between them.
- Where a contract is concluded on a bilateral basis and rejected by the CCP, again its treatment is determined by the agreement between the counterparties.
- Where a CCP rejection is down to a technical problem, the transaction can be re-submitted again provided it's within 10 seconds of the previous submission.

INDIRECT CLEARING

Article 30 of MiFIR provides that indirect clearing arrangements with regard to ETDs are permissible, provided that those arrangements ensure that (1) the indirect clearing arrangements do not increase counterparty risk; and (2) that the assets and positions of the counterparty benefit from protection with equivalent effect to the provisions relating to segregation and portability and the default procedures in EMIR. MiFIR requires ESMA to specify the types of indirect clearing service arrangements that meet these conditions, consistent with the EMIR Regulatory Technical Standards on indirect clearing arrangements for OTC derivatives under Chapter II of Commission Delegated Regulation (EU) No 149/2013 (the 'EMIR RTS').

ESMA comments on the lack of indirect clearing services for OTC derivatives and the lack of market development in this area. ESMA also acknowledges the fact (highlighted by the responses to the May DP) that indirect clearing structures are widely used in ETD global markets today and that these are well-established and well-functioning markets with the indirect clearing model being a market standard.

ESMA also comments on 'longer chains' which do exist in ETD markets today and which include more than four parties in the clearing chain (that is, when the indirect client has a client of its own and therefore facilitates 'indirect clearing' itself). However, ESMA believes that the definition of indirect client and the

provisions of the EMIR RTS do not apply to additional clients beyond the indirect client. ESMA believes that a counterparty cannot comply with the clearing obligation by being the client of an indirect client, or indeed, a client further down the clearing chain. Therefore, by analogy and given its mandate in Level 1, ESMA proposes to limit the application of the indirect clearing rules under the draft RTS for ETD to four parties in the clearing chain as well.

In relation to the identified legal/insolvency challenges and operational burden to deal with the segregation arrangements under the EMIR RTS, ESMA considers an alternative choice between two segregation models and, in particular, an alternative choice of accounts; a net omnibus account and a gross omnibus account. Accordingly, indirect clients are offered a choice between these two segregation models, with two different levels of protection. The first option, the net omnibus account, is familiar as it is envisaged under the EMIR RTS. However, the gross omnibus account is new. In this option, the margin for each indirect client in the account would be calculated separately and the clearing member would be able to identify the value of collateral held for the benefit of each indirect client, which would increase protection for the indirect client in the case of the direct client's default. A clearing member that offers indirect clearing services will have to transfer to the CCP the value of collateral it received from clients for the benefit of each indirect client that has opted for the gross omnibus account. ESMA believes that the gross omnibus account is simpler in structure than an individually segregated account, as set out in the EMIR RTS and allows the co-mingling of positions and collateral for several indirect clients in a single account, whilst ensuring an equivalent amount of collateral is distinguished between them.

ESMA proposes in the draft RTS to increase the requirements for clients, clearing members and CCPs. In particular, there is now a new obligation on the CCP to calculate the margins of each indirect client choosing the gross omnibus model. This additional CCP requirement, as against the requirements of the EMIR RTS, allows for the amount of collateral held for the benefit of each indirect client to be further segregated at the level of the CCP. The client will be required to put in place a contractual arrangement with indirect clients which will facilitate prompt return to the indirect client of the proceeds from the liquidation of the positions and assets held by the clearing member for the benefit of the indirect client.

ESMA has also tried to deal with respondents' concerns in relation to the impact of insolvency; additionally, ESMA has provided further clarity on the treatment of third country clients who clear for EU indirect clients in the case of conflicting insolvency requirements. Both clarifications still raise more questions than provide answers and are not legally binding as they are included in the draft RTS recitals.

POST-TRADE TRANSPARENCY REQUIREMENTS FOR NON-EQUITY INSTRUMENTS

Content and Timing of Post-trade Transparency Requirements.

MiFIR introduces a pre-and post-trade transparency regime with respect to non-equity instruments (bonds, structured finance products, derivatives and emission allowances). MiFIR requires ESMA to draft the RTS specifying the details of the

new regime and the Consultation Paper and draft RTS set out ESMA's proposals. These include the content and timing of the information to be made public, as well as identifiers for different types of transactions.

ESMA believes that the details, standards and specific content to be made public should be consistent with transaction reporting requirements. It believes that public information is a "minimum sub-set" of those transaction reporting requirements. ESMA suggests that for the purpose of transparency requirements, the systematic internaliser ("SI") identifier could be removed from the list of details. This is due to the risks taken by SIs on certain financial instruments, a risk which ESMA believes could be increased, should the SI identity be revealed to third parties.

ESMA believes that the set of details to be made public should be consistent with the details to be made public for shares. However, ESMA proposes to include currency as an additional field.

ESMA says that it is aware of the operational issues arising from a request for an identifier for many derivatives. It comments that even though there are a number of market initiatives attempting to resolve the identified issues, currently, there is no sufficiently detailed method of identification of the financial instruments across the different derivative classes for transparency purposes. ESMA intends to address this shortly, although does not comment on it further in the Consultation Paper.

Annex II (Table 2) of ESMA's proposed RTS on transparency requirements (RTS 9) contains a list of flags for post-trade transparency in respect of non-equity financial instruments. These include an identifier, the name of the trade flag (such as "agency cross trade flag"; or "technical trade flag"); the venue or publication arrangement (such as regulated market, MTF, or OTF) and in each case, a definition. ESMA comments that these descriptions are in line with the corresponding transaction reporting fields under Article 26 of MiFIR.

In relation to the timing of post-trade transparency, ESMA proposes to set the maximum permissible delay at 15 minutes for real-time post trade transparency publication for a period of three years after the entry into force of MiFIR. Following this three-year period, ESMA proposes to set the maximum permissible delay at 5 minutes for real-time post trade transparency publication, which ESMA believes will allow sufficient time and flexibility for market participants to adapt to the 5 minutes maximum delay. ESMA comments that the maximum permissible delay should only be used by market participants who due to technical problems cannot achieve real-time publication as promptly as a fully automated process.

In the Consultation Paper and draft RTS, ESMA publishes its proposals in relation to the application of post-trade transparency to certain OTC transactions, involving the use of financial instruments for collateral, lending or other purposes where the exchange of financial instruments is determined by factors other than the current market valuation of the financial instrument. ESMA proposes to establish a list of types of transactions determined by factors other than the current market valuation to which Article 21 of MiFIR (which covers post-trade disclosure by investment firms, including systematic internalisers, in

respect of bonds, structured finance products, emission allowances and derivatives) would not apply. ESMA's list includes securities financing transactions; the exercise of options, covered warrants or convertible bonds; primary markets transactions (such as the issuance, allotment or subscription, placements and the exercise of pre-emption rights); give-ups or give-ins; and transfers of financial instruments, such as segregated collateral in bilateral transactions or in the context of CCP margin and collateral requirements. ESMA proposes the introduction of a flag for these transactions, as it believes that they do not contribute to the current valuation of the financial instrument.

NEXT STEPS

The final Technical Advice has now gone to the European Commission and will assist the European Commission in drawing up its own implementing rules. However, the Consultation on the RTS and ITS is currently open and will close on 2 March 2015. ESMA has also announced that it will hold an open hearing on the consultation on 19 February 2015. Additional information on the open hearing is available [here](#).

UPCOMING SPECIAL REPORTS

In the coming days, FIA and FIA Europe will issue additional special reports on the topics addressed in the Consultation Paper:

1. Algorithmic and High Frequency Trading (HFT);
2. Open Access;
3. Transactions Reporting;
4. Commodity Derivatives (including ancillary activities);
5. Definitions and Exemptions; and
6. Safeguarding of Client Assets.

For more information about these reports contact Will Acworth at FIA (wacworth@fia.org) or Emma Davey at FIA Europe (edavey@fia-europe.org)

Additional MiFID II/MiFIR documents are available [here](#).

Disclaimer: This report was drafted by the London office of [Covington & Burling LLP](#) on behalf of FIA and FIA Europe. The report is part of a series of reports intended to provide factual summaries of MiFID/MiFIR on certain topics of interest to the members of FIA and FIA Europe. The reports are provided for general informational purposes only. They do not constitute legal or regulatory advice and should not be relied upon for this purpose.

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