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## **EU proposals for OTC derivatives clearing — Segregation protection is winner but should MTFs be worried about possible anti-competitive behaviour by exchanges?**

**Dec 16 2010** [Pierre Labuschagne](#)

On November 17, 2010 the European Commission published a Presidency Compromise to the proposed new regulation on over-the-counter derivatives, central counterparties and trade repositories, also known as the European Market Infrastructure Regulation. The Presidency Compromise has made some sound new proposals about many of the articles of EMIR such as full segregation by a central counterparty clearer to the underlying clients of its clearing members. One of the more controversial proposals, however, is to art 5, which will allow CCPs to refuse clearing of a derivative contract if the "venue of execution" does not comply with the operational and technical requirements set out by the relevant CCP.

### **The proposed amendment to Article 5**

Article 5 explicitly states that a CCP should clear contracts on a "non-discriminatory" basis regardless of the venue of execution, which clearly envisages execution of such contracts by multilateral trading facilities. The requirement that contracts executed by a MTF should comply with the minimum technical and operational requirements of a CCP should certainly alert many MTFs to the possible misuse of these requirements by a CCP in favour of its own execution services. A possible justification for including the minimum requirements amendment can be found on page 68 of the EU's Impact Assessment working document on EMIR. The argument used is that MTFs may prefer to use the clearing services of new incoming CCPs in order to compete with established exchanges (many of which also provide CCP clearing services). The incoming CCPs provide more competitive prices which in turn also drive down the clearing fees of established CCPs. The concern is that such lowered prices will result in lower standards of risk management among CCPs, specifically in requiring lower initial margin from their clearing members. This race-to-the-bottom competition is not in line with the general policy of EMIR, which is to reduce systemic risk, but is perhaps related more to the specific objective of reducing the counterparty credit risk associated with OTC derivatives. The minimum requirements amendment will therefore allow incumbent CCPs to refuse clearing services to an MTF on risk management grounds, but in doing so it could also favour its own execution services by eliminating possible competition from that MTF. There are clearly arguments for and against the amendment to art 5 and it will be interesting to see how the EU

will finalise its approach on this apparent dichotomy of "non discrimination" versus "refusal based on minimum standards".

**Segregation and portability** Two of the weaknesses exposed by the demise of Lehman Brothers were:

the absence of clearing client segregation at clearing house level; and

difficulties in transferring positions held at a clearing house to a new clearing member without the consent of the defaulting clearing member.

It is now proposed that a CCP must:

Be able to distinguish between assets of various clearing members and the CCP's own assets, including assets that were provided via a title transfer financial collateral arrangement.

Provide the option of "full" segregation to underlying clients of a clearing member.

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The choices of additional levels of segregation protection should be welcomed but will come at an extra cost and it is further proposed that a CCP shall make public the levels of protections and the associated costs. Another important proposed amendment is where counterparties to an OTC derivative, which falls outside the scope of CCP (i.e., does not exceed the clearing threshold) will have the option to request segregation protection for initial margin from one another.

### **Proposed amendments to the approval processes of a CCP**

In the bottom-up approval approach, whereby a CCP applies for approval, more powers have been given to the European Securities Markets Authority (which apparently will be created on January 1, 2011) to review its decisions regularly, with additional powers to amend, suspend or revoke CCP approvals granted. In turn, additional requirements have been set out concerning the top-down approval process, when ESMA imposes clearing of OTC derivatives, so that ESMA must also:

Take into consideration the degree of standardisations and operational processes.

Consider whether more than one CCP could offer clearing services for the same class of derivatives.

Consult with the European Systemic Risk Board (which has yet to be created) in addition to the public consultation period.

**Proposed amendments to the default fund** A CCP must now also be able to demonstrate that its default fund can withstand extreme but plausible market conditions. A CCP must develop such scenarios by taking in account the most volatile periods experienced by the markets in which the CCP provides services. The commission will also be able to specify technical standards for extreme plausible market conditions on advice from the overseeing bodies to be created, namely the European Banking Authority, ESMA and the European System of Central Banks. A CCP must now also have access to pre-funded or unconditionally committed financial resources which have to be separate from funds used for its capital requirements. **Implementation on track** The Presidency Compromise included very commendable proposals and is also now starting to reflect the realities of various interests, as can be seen from the proposed art 5. It will be interesting to see how many more proposed amendments emerge before the expected finalisation of the EMIR proposals in April 2011; implementation still seems to be on track for the end of 2012.