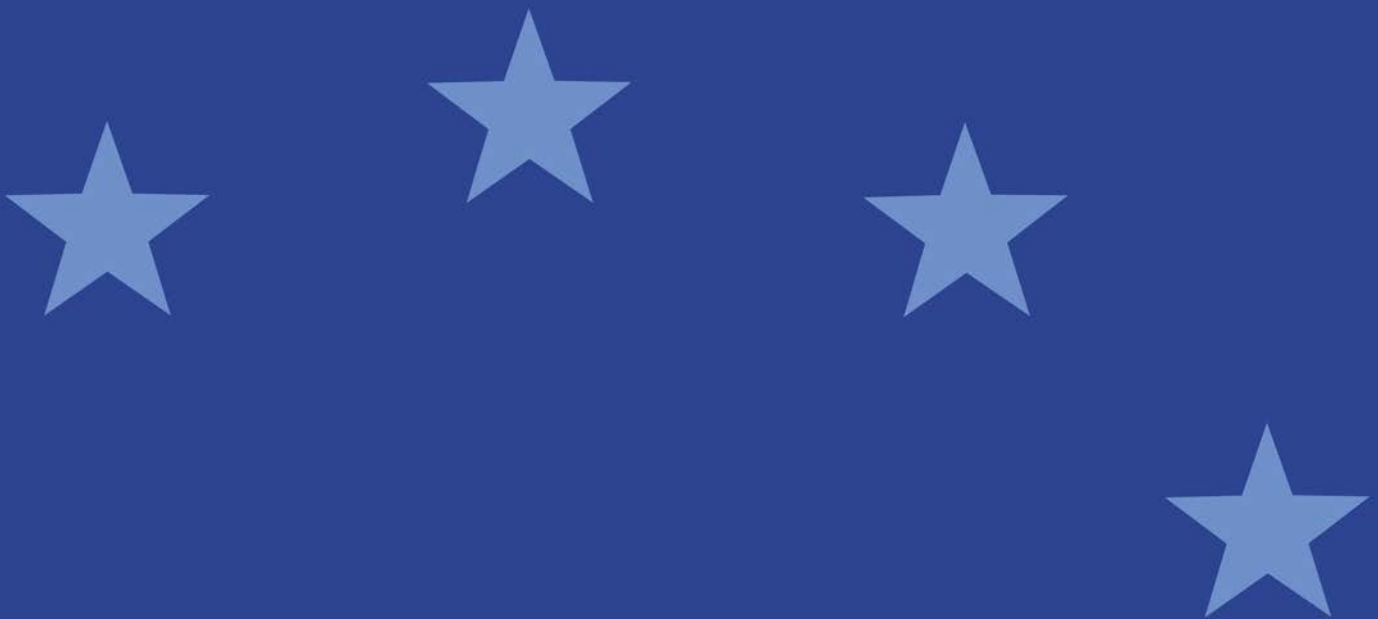




European Securities and
Markets Authority

Reply form for the Discussion Paper on Review of Article 26 of RTS 153/2013



26 August 2015

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the ESMA Discussion Paper on Review of Article 26 of RTS 153/2013, published on the ESMA website.

Instructions

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

- use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
- do not remove the tags of type <ESMA_QUESTION_RTS_153_26_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
- if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

- if they respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternatives that ESMA should consider

Naming protocol

In order to facilitate the handling of stakeholders responses please save your document using the following format:

ESMA_RTS_153_26_NAMEOFCOMPANY_NAMEOFDOCUMENT.

E.g. if the respondent were XXXX, the name of the reply form would be:

ESMA_RTS_153_26_XXXX_REPLYFORM or

ESMA_RTS_153_26_XXXX_ANNEX1

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

Deadline

Responses must reach us by **30 September 2015**.

All contributions should be submitted online at www.esma.europa.eu under the heading ‘Your input/Consultations’.



Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the headings 'Legal notice' and 'Data protection'.



Introduction

Please make your introductory comments below, if any:

< ESMA_COMMENT_RTS_153_26_1 >

LCH.Clearnet Group¹ ('LCH.Clearnet') is a leading multi-asset class and multi-national clearing house, serving major international exchanges and platforms as well as a range of OTC markets. It clears a broad range of asset classes including securities, exchange-traded derivatives, commodities, energy, freight, foreign exchange derivatives, interest rate swaps, credit default swaps and euro, sterling and US dollar denominated bonds and repos. LCH.Clearnet works closely with market participants and exchanges to continually identify and develop innovative clearing services for new asset classes. LCH.Clearnet is majority owned by the London Stock Exchange Group, a diversified international exchange group that sits at the heart of the world's financial community.

LCH.Clearnet appreciates the opportunity to provide input to ESMA and fully supports the current regulatory efforts to reach agreement on equivalence between EMIR and the CFTC rules as this will ensure that financial markets operate in a more efficient, secure and competitive manner. However, in delivering these objectives, it is critical that a set of balanced incentives for CCP operators, as well as their participants (clearing members and clients), are in place in order to maintain financial stability and ensure fair competition and a level playing field for international CCPs.

LCH.Clearnet understands that the equivalence determination is one of the most important issues currently before the CFTC and the EU Commission. However LCH.Clearnet considers that an equivalence agreement based on a separate analysis of House and Client accounts does not approach the question from a stability and risk management perspective.

In considering the calibration of initial margins, the CFTC and EU Commission have chosen to focus on the distinction between the two regimes in the calculation of gross and net accounts. As a reminder, CFTC rules require that the full amount posted by the clients to the clearing member be posted to the CCP; this is the "gross account structure". In Europe, EMIR requires that the CCP and its clearing members offer clients the choice between an omnibus account structure (or "OSA", which allows for the positions and collateral of a group of clients to be held net or gross at the CCP level) and an individually segregated account structure (or "ISA", which will ensure the positions and collateral of each client are held gross at the CCP level).

LCH.Clearnet supports the principle of a liquidation-based minimum holding period by asset class with the ability for CCPs, if required per contract, to increase it if the liquidity analysis proves it insufficient. The holding period should be determined by the predicted length of time it actually takes to neutralise the risk of the defaulting clearing member (considering both observable liquidity and the practicalities of porting clients, e.g. operational logistics, of the CCP, the clients, and clearing members; and the bankruptcy laws of the relevant jurisdictions) and not the structure of the account or whether it is house or client.

From a risk management perspective, LCH.Clearnet considers that 1-day holding period (for non-OTC) is not enough, for all products, either to facilitate the close out of a defaulter's proprietary positions, or the actual porting or liquidation of clients' positions. At the point of default of a clearing member, in a regulatory environment where CCPs apply the 1-day holding period for clients, the CCP may decide to close out the positions of the clients and liquidate them in order to effectively manage the risk to which the mutualised Default Fund and its own capital are exposed.

Nonetheless, if ESMA considers the reduction of minimum requirements to 1-day holding period for CCPs authorised under article 14 or recognised under article 25 of EMIR is appropriate, the CCPs wishing to

¹ LCH.Clearnet Group Limited consists of three operating entities: LCH.Clearnet Limited, the UK entity, LCH.Clearnet SA, the Continental European entity, and LCH.Clearnet LLC, the US entity. Link to Legal and Regulatory Structure of the Group: http://www.lchclearnet.com/about_us/corporate_governance/legal_and_regulatory_structure.asp

offer clearing services to European clients on this basis should be subject to additional safeguards from those suggested in this discussion paper. For example:

- Application of pro-cyclicality buffers;
 - Requirement to size the default fund on the basis of the exposure posed by the largest two members (i.e. Cover 2);
 - EU process for new product and services approval (to ensure consistency with Article 15 of EMIR);
 - EU process for changes to a CCP's risk models (to ensure consistency with Article 49 of EMIR).
- < ESMA_COMMENT_ RTS_153_26_1 >

Q1. ESMA welcomes views on the assumption that client margins maintained at CCP level on a OSA gross margining with one-day liquidation period would generally be higher than margin held at the CCP under an OSA net with a two-day liquidation period. Please, provide quantitative analysis on the effect of the reduction of margin on the basis of 2 vs. 1 day MPOR and of the net (between clients' positions) margining vs gross margining. Please also consider the potential impact of the case in which a one-day OSA gross is considered equivalent to the EU system and the RTS are not changed and the impact for the whole system if the MPOR at CCP level is reduced.

<ESMA_QUESTION_RTS_153_26_1>
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Q2. If the RTS were modified to allow one-day gross margin collection for ETDs, should this be extended to financial instruments other than OTC derivatives? What are the costs and benefits of either approach?

<ESMA_QUESTION_RTS_153_26_2>
In principle, and as detailed in our response to question 5, LCH.Clearnet does not support the reduction of minimum holding period to 1-day collection for either ETDs or any financial instruments other than OTC derivatives. Nonetheless, if ESMA concludes that an equivalence agreement may be reached on the basis that CCPs may be able to apply 1-day gross margin collection, we believe that additional safeguards should be applied, consistent with EMIR, as we elaborate further in this response.
<ESMA_QUESTION_RTS_153_26_2>

Q3. If a differentiation of MPOR is made for ETDs depending on the gross or net collection of margins, should this differentiation be made for OTC derivatives as well? Would seven days MPOR for OTC derivatives be appropriate for net OSA? Please, provide quantitative analyses in support of your answer.

<ESMA_QUESTION_RTS_153_26_3>
LCH.Clearnet considers that 7-day margin period of risk (MPOR) for OTC derivatives would be appropriate for net OSA and would ensure consistency of ESMA's proposal. LCH.Clearnet already applies this standard for both gross and net client accounts.
<ESMA_QUESTION_RTS_153_26_3>

Q4. Should ISA and gross OSA be treated equally in terms of MPOR? Please provide quantitative evidence to support your arguments.

<ESMA_QUESTION_RTS_153_26_4>
In the case of an ISA, the porting of clients is significantly more probable than in the case of a gross OSA. Indeed, under an ISA account structure one client is facing one back-up clearing member, facilitating the porting of its positions. Under a gross OSA, all clients belonging to the same account either nominate the same back-up clearing member or decide to be ported individually to different clearing members implying a heavier operational procedure to transform their collateral into cash (porting is less probable than under an ISA). In terms of pure risk management, if ESMA decides to allow the offering of a lower minimum requirement for the margin period of risk (MPOR) (i.e. from 2 to 1-day) for gross OSA, the same should also be possible for ISA account structures. There would be no logical reasons for which ISA account structures, which afford higher protection to clients, should be subject to higher minimum standards for MPOR.
<ESMA_QUESTION_RTS_153_26_4>

Q5. Do you consider that specific conditions should apply in order to ensure that margins are called intraday in case the MPOR is reduced to 1-day under a gross client margins collection?

<ESMA_QUESTION_RTS_153_26_5>

The MPOR should be the actual time needed for the CCP to port the clients' positions as part of the default management/liquidation process and should be independent from the account structure (i.e. net or gross). The ability to port client positions within a 1-day period (for non-OTC) raises concerns under the European model as discussed at length in our response to Q7.

In relation to liquidation of a portfolio, LCH.Clearnet considers that, operationally, two days is the minimum timeframe for an effective liquidation. In practice – as informed by LCH.Clearnet's experience of default management – the first day is dedicated to confirming the default (official declaration, inform authorities, etc.), freezing accounts at the CSD, converting collateral into cash and liaising with the CSD to make sure that no failed settlement occurred (i.e. confirm the final portfolio to liquidate). In addition, a number of external participants need to be involved in the process (Default Management Group, brokers, auction participants, etc.). One day to complete these tasks is a minimum in practice, and cannot be reduced in the case of client portability. The effective liquidation process is then performed starting on the second day.

If the default management process is performed via an auction, the portfolio can be liquidated as a whole. If the execution is performed via direct brokers, the liquidation is likely to last even longer.

Consequently, and taking the above as a baseline, a 1-day (net or gross) MPOR is insufficient, for most products, to provide the market the safety CCPs should bring, and reducing the standard is a form of race to the bottom.

This being said, in the case where ESMA would choose to authorise the reduction of MPOR to 1-day for gross client margins collection, LCH.Clearnet considers that two distinct areas have to be adapted in order to mitigate the risk to the market of such decision:

- Client portability (as discussed further in our response to Q7)
- The efficiency of real time monitoring and intraday margin calls

In order to increase the likelihood of an effective liquidation process on a single day, LCH.Clearnet considers that all processes and operational procedures would need to be of the highest standards, meaning:

- Monitoring of prices and positions must be reliable: CCPs authorised under article 14 or recognised under article 25 of EMIR choosing to apply a 1-day MPOR should be in a position to demonstrate real time monitoring of positions and prices, including intraday price updates. This would be necessary in order for the CCP to keep a close eye on intraday profit and loss and ensure that an actual "full day of risk" will be consistently available.
- In addition, as opposed to a 2-day MPOR, where the potential slippage can be mitigated, the 'soft default period' (i.e. the time between the last margin payment and effective default declaration) needs to be reduced to a minimum. This can only be done by increasing the number of intraday margin calls. Therefore, CCPs authorised under article 14 or recognised under article 25 of EMIR choosing to apply a 1-day MPOR, should have to perform a specific number of intraday margin calls. Taking as a baseline a margin run (not call) every hour, the following setup could be proposed:
 - 4 margin calls / day: 1 morning call (based on last EOD positions and prices), 1 at 11AM, one at 1PM, one at 3PM. Also, ESMA could decide to ask for prefunding, (i.e having the

first margin call performed at COB and not in the morning). The time between the calculation of margin and final payment to the CCP should be very short (less than 1 hour).

- Threshold based additional margin calls: any other margin run will need to be turned into a margin call if above a predefined threshold.
- Another safe practice would be to floor the margin to a quantile (e.g. 99%) of observed each member's observed VM moves over a given look back period (e.g. 1 year). This would help ensuring that regular activity would immediately be prefunded, in other words, that the margins are sufficient to cover a 99% backtest of member's historical VM.

Finally, for CCPs authorised or recognised under EMIR choosing to apply a 1-day MPOR, backtesting and sensitivity analysis would need to be extended intraday to ensure Initial margin remain accurate during the trading day.

<ESMA_QUESTION_RTS_153_26_5>

Q6. Do you agree that entities of the same group as clearing members should not be allowed to benefit from a lower MPOR even if they chose an OSA gross or ISA account? What are the costs and benefits of either approach?

<ESMA_QUESTION_RTS_153_26_6>

As noted in the LCH.Clearnet's response to the consultation on EMIR review, we encourage the EU Commission and ESMA to clarify that the positions and collateral of affiliates should not be included in clients' accounts and allow them to be either included in the clearing member's proprietary account, in line with the US regime, or in a separate dedicated account. This approach would provide increased protection to clients, which are otherwise exposed to the potential failure of entities belonging to the clearing member's group. In addition, LCH.Clearnet Group includes CCPs which are dual registered under both the US and the EU regimes, it would, therefore, be beneficial to have the definition and treatment of affiliates aligned between the two regimes as part of this equivalence debate.

While LCH.Clearnet understands that the purpose of the current consultation is not to discuss the house account structure, under the above proposal affiliates would no longer be treated as clients, solving the issue, raised by ESMA, that clearing members may use affiliates to benefit from a lower MPOR in a gross margin account. <ESMA_QUESTION_RTS_153_26_6>

Q7. Do you consider that specific conditions (e.g. compulsory pre-existing arrangement with a back-up clearing member) should apply in order to enhance the portability of client positions in order to benefit for the gross margining with one-day liquidation period? What conditions in your view would enhance the portability of client accounts? What are the costs and benefits of the suggested condition? Is it feasible that each client in an OSA would nominate a back-up clearing member or could this be a practical impediment to the establishment of gross margining? Is it feasible to expect an alternative clearing member to guarantee to accept porting of a client's positions in the event of the primary clearing member's default?

<ESMA_QUESTION_RTS_153_26_7>

LCH.Clearnet considers that for CCPs authorised or recognised under EMIR choosing to apply a 1-day MPOR, pre-existing arrangement should be in place in order to reduce the porting period to the minimum and to ensure a backup solution is set in case of a primary clearing member's default.

Prior to defining the conditions that could enhance the portability of clients, LCH.Clearnet would like to draw ESMA's attention to the wide range of situations that client porting can cover:

Within the US, several specific elements around CFTC rules and the role of the CCP make a 1-day MPOR more feasible and the role of the CCP significantly different:

- Exchange traded derivatives are cleared by DCOs and only Futures Commission Merchants (FCMs) registered with the CFTC are allowed to be clearing members;
- FCMs are all subject to the CFTC regulations and supervision;
- The FCMs are usually set up for the purpose of client clearing activities and subject to a whole set of specific rules around calling and posting of margin to CCP, custody, etc.
- Most if not all FCMs are incorporated in the US and, as such, subject to US insolvency rules;
- Clients of an FCM are all part of the same account structure which means that the CCP/DCO is only dealing with one account structure and one pool of collateral at the time of an FCM's default; This is on a product by product basis – one for swaps, one for futures etc.
- DCOs (CFTC registered CCPs) are not allowed to unilaterally take steps to move the assets and positions of the defaulter's clients to a back-up clearing member. The trustee or receiver which is appointed is in charge of finding a back-up clearing member and will request the US Court to produce an order imposing the porting of the non-defaulting clients to the designated back-up clearing member;
- FCMs will still have to accept the transfer but this will most likely be done for a group of clients, not on an individual client basis.
- For exchange traded derivatives, the rules on segregation are less stringent than for OTC swaps, so a loss of a defaulting client can be allocated to a surviving client if the capital of the FCM is not sufficient.

The European situation is significantly different:

- As per EMIR, an EMIR authorised CCP can admit clearing members incorporated in any jurisdiction (subject, of course, to risk and other eligibility criteria);
- As such, there are various laws, insolvency regimes, regulations and supervisory authorities to be taken into account by the CCP in assessing the legal and other risks associated with a clearing member default;
- Unlike the FCM model, clearing members of an EMIR authorised CCP are therefore not subject to harmonised regulatory or insolvency regimes. Nor are there necessarily the same regulatory requirements as in the US to obtain consent from the courts in order to permit the movement of assets and positions to a back-up clearing member (or to the extent there was that would be inconsistent with EMIR);
- Rather, an EMIR authorised CCP is required to obtain (i) client consent to the appointment of a back-up clearing member to accept the ported position and the actual transfer to the back-up clearing member at the time of the default as well as (ii) the consent of the back-up clearing member to accept the ported position. The CCP is not empowered to unilaterally determine a back-up clearing member or port client positions.

We therefore do not consider that the US regime (1-day MPOR) is equal to the European regime (2-day MPOR) to the extent that the 1-day MPOR in the US is part of a global comprehensive regime in which the Trustee and the US Court takes control and ensure timeliness of the liquidation/porting.

Therefore, in considering the reduction of the MPOR for clients, it is essential to verify that the modified holding period would be sufficient to ensure that the CCP could robustly port client positions from an operational perspective, including having regard to the need to obtain numerous approvals from clients and back-up clearing members, many of which are required to be obtained at the time of the default itself.

LCH.Clearnet is of the opinion that a shorter MPOR i.e 1-day for client positions can only be considered under a stringent set of conditions:

- A pre-arranged backup solution should be defined, in case of a primary clearing member's default, which assures that the backup member will take on the client position within a very short period (less than 0.5 day) notwithstanding the stressed market conditions coinciding with a member default.

- The CCP should have the operational capacity, including obtaining multiple client consent, which has been appropriately stress tested and evidenced in order to perform a client transfer of all assets and liabilities on an intraday basis.
- The liquidation of the (entire) client portfolio should be able to be consumed by the available liquidity in the market under stressed conditions within less than 1 day.

If the above conditions are not met, under a 1-day holding period regime,

- The likelihood of a failed transfer is increased, and subsequently, the likelihood of liquidating the portfolio increases
- or the mutualisation of losses increases having a pro cyclical effect.

Is it feasible to expect an alternative clearing member to guarantee to accept porting of a client's positions in the event of the primary clearing member's default?

As outlined above, a pre-arranged back up agreement - with a high degree of assurance/commitment of a receiving clearing member that it will accept the client position in case of a default – is an important requirement for the application of 1-day MPOR.

A back-up member arrangement can be successful under the following conditions:

- The client has already passed the Know-Your-Client and compliance checks of the backup clearing member;
- The client meets all the relevant rating requirements, internal to the CCP;
- The backup clearing member can and is willing to support the market and liquidity risks relating to the portfolio subject to transfer.

Nevertheless, LCH.Clearnet expects that a guarantee for the porting of a client within a short timeline will put an important burden on client and clearing members. The liabilities undertaken under such agreements are difficult to assess as the situation could change significantly in a short timeline:

- The situation of a client that meets all the internal rating requirement & compliance criteria could quickly change in the case of a clearing member default (assets of the client could be impacted);
- The capability of a clearing member to absorb the liquidity and market risk depends on the overall financial position and regulatory capital requirements.

LCH.Clearnet is of the opinion that having multiple operational back up agreements and the option for client and clearing members to arrange client porting at the time of a default is the best way for the market to deal with the pressure of a clearing member default. A transfer period in addition to the minimum holding period is instrumental to ensure that client and clearing member can make the appropriate arrangements.

<ESMA_QUESTION_RTS_153_26_7>

Q8. Is there any other aspect or concern that ESMA should consider when reviewing Article 26 with respect to client accounts?

<ESMA_QUESTION_RTS_153_26_8>

As outlined above, there are concerns that the current EU regulatory framework does not allow CCPs to perform porting and liquidation of non-transferred clients within a 1-day holding period and that watertight contract with a back up members assuring a client transfer at all time is difficult to set up.

An MPOR of 1-day gross has, for most products, several pro-cyclical implications that might affect the resilience of CCPs and their role in mitigating the systemic risk in a cleared environment. This in turn can adversely impact the financial system as a whole.

Indeed, the key concerns around pro-cyclical implications are coming from the following considerations:

- Overall the net account structure model reduces the liquidity pressure on the clearing member in case of shocks.

- A 1-day MPOR would reduce the time that CCP can allow clients to find a new clearing member, leading to lower likelihood of porting and larger portfolios to be liquidated. This may lead to higher systemic impact of a clearing member's default.
- The CCP may not have sufficient collateral available to accommodate the clients' request to be ported or the CCP may not be able to perform the liquidation within 1 day. In this case, losses are much more likely to be carried by the default fund.
- The CCP is the benchmark for the risk management of the clearing members. CCPs holding less collateral effectively means that less collateral will be available in the total system, thus increasing the likelihood of a clearing member default.
- Under the CFTC rules there is no equivalent to the pro-cyclicality buffer required by EMIR.

The introduction of 1-day margining without adjustments to broader risk management standards, including the regime for clients' portability, is likely to result in adverse pro-cyclical effects, exacerbating the impact of a clearing member default on the broader economy.

LCH.Clearnet believes that if the positions of the defaulted member (House plus Client) makes up a significant share of the exchange volume, it is hard to believe that the close out and porting of all positions will be completed in 1 day, regardless of account structure. Hence we would propose a threshold of at least 25% (linked to cover 2 consideration) beyond which an extra day should be added to the MPOR to deal with concentrations. While one might argue for a lower MPOR, we don't consider that the final MPOR agreed could be independent of concentrations.

Hence, in addition and in order to improve the resiliency of 1-day MPOR, all CCPs, authorised or recognised under EMIR choosing to apply this option, should have to demonstrate practical ability to run the default management process in one day to declare, port and liquidate the remaining positions within a single day. All relevant steps from declaration of a default to final liquidation of non-transferred clients should be included in this exercise.

Finally, for CCPs applying an MPOR of 1-day, LCH.Clearnet suggests that margin back-testing and stress testing be performed at client portfolio level. <ESMA_QUESTION_RTS_153_26_8>