



MiFID II

A Bird's Eye View of the Impact on Clearing

January - 2018

INTRODUCTION

*As market participants are busy preparing for MiFID II entering into force on 3 January 2018, **Sernova Financial** highlights certain implications of the Directive in the clearing context that have not, or are rarely discussed elsewhere in the press. This article serves as a quick guide to the main changes brought by MiFID II for derivatives users.*

It is well known that the European Union's second Markets in Financial Instruments Directive (MiFID II) is an extensive piece of legislation that aims to create a more transparent and safer market overall. As such, MiFID II is focused on improving transparency in the financial markets and seeks to move OTC trading onto regulated exchanges or trading platforms. The new directive applies to all market participants, including investment firms, market operators (e.g. trading venues), data reporting service providers as well as certain third country investment firms, and covers any financial instrument that is (or may influence a financial instrument that is) admitted for trading on a trading venue.

MIFID II BACKGROUND TO CLEARING

There is already extensive literature on the Directive's implications in a pre-trade context, but perhaps lesser known are MiFID II's implications in the clearing space. MiFID II brings three significant changes in to clearing with regard to 1) transaction reporting, 2) position reporting and 3) certainty of clearing (amongst others). These changes are introduced across voice as well as four distinct categories of trading venues (See Appendix A) that adds to the practical complexities of such changes.

1) Transaction reporting:

Under MiFID I (the regulation preceding MiFID II), transaction reporting was limited to OTC derivatives linked to financial instruments traded on regulated markets (RMs).

MiFID II, however, broadens the scope of transaction reporting to capture more a) market participants, b) financial instruments and c) reporting details.

a) MiFID II transaction reporting will be applicable to the following players:

- i) European investment firms executing transactions through a European branch;
- ii) European branch of a non-European investment firm executing transactions. Non-European firms with more European-based branches may decide which local regulator will receive their reports.

b) MiFID II adds the following financial instruments into mandatory reporting:

- i) that are admitted to trading or traded on a European trading venue or for which a request for admission to trading at a trading venue has been made;
- ii) whose underlying component is admitted to trading on such venues; and
- iii) whose underlying instrument is an index or a basket composed of financial instruments traded on a trading venue.

c) Report contents

MiFID II reporting almost triples the number of required data fields (from 24 fields to 65), and firms will need to identify the person, entity or algorithm that decided to carry out the transaction.

2) Position reporting:

MiFID II imposes many key changes that aim to reduce speculative activity and systemic risk in the commodity derivatives market through new position limits and reporting requirements.

Under MiFID II, local regulators are responsible for setting a limit on the size of the net position that a firm can hold in each commodity derivative contract traded on a trading venue or OTC, in each EU member state. Member states need to ensure that a trading venue that trades commodity derivatives applies position management controls, and market participants need to follow ESMA's methodology in calculating and setting position limits.

The following derivative instruments need to be reported under the Directive: energy, metal, agricultural and other food, intangible, flow-based delivery, cash-settled and physically-settled, derivatives for any of the other instruments covered e.g. baskets, indexes, swaps.

Firms must report the details of their commodities positions on a daily basis to national authorities to ensure that firms do not exceed the position limits of the total amount of a commodity or contract for a given month. Investment firms trading in commodity derivatives must also provide, for both on- and off-venue transactions, details of their and their end clients' positions.

Moreover, a weekly report should be made public detailing the aggregate positions held by the different categories of position holders for the different contracts traded on a trading venue. The report must specify the number of long and short positions by different categories, any changes since the previous report, percentage of the total open interest represented by each category and the number of position holders in each category.

3) Certainty to clear:

Any instrument traded on a regulated market (venue) must be cleared. In order to facilitate clearing, trade venues must conduct pre-execution credit checks, whereby the clearing member would provide credit limits for all of their clients to the venue and the venue would perform the checks.

Changes to the certainty of clearing introduce significant challenges for clearing brokers and their clients. It is therefore this area we will focus on further below.

In Europe, prior to the introduction of MiFID II, clearing brokers and CCPs were required to credit check their clients/members as transactions were submitted. Limits were centralised either at a CCP or at a clearing broker and trades were considered for limit checks only when they had been requested to be cleared by both the executing broker and client/end user. This meant that CCPs and clearing brokers could have one limit per client and could include portfolio effects across all currently cleared transactions. Additionally, neither timeframes were set, nor rules existed, for the acceptance and rejection of a trade to clearing.

MiFID II reforms this position. The regulation introduces both strict timeframes around credit checks and rules around how to accept or reject a trade for clearing. Both of these elements are important, as they result in the introduction of more limit locations, which inevitably leave the door open for a greater risk of rejection of trades and highlight the need for heightened transparency.

The new trade acceptance process and timeframes are as follows:

- a) Off-venue OTC transactions mandated to clear:
 1. Execution takes place between client and executing broker;
 2. Executing broker submits trades to affirmation platform in less 30 minutes;
 3. Client affirms transaction in affirmation platform;
 4. Affirmation platform sends transaction to CCP;
 5. Accept or reject transactions:
 - a. CCPs have 60 seconds to credit check Clearing Members;
 - b. Clearing brokers hold the credit limits and have 60 seconds to credit check their clients;
 6. CCP sends back to back cleared confirmation messages sent to:
 - a. Clearing broker; and
 - b. Executing broker;
 7. Clearing broker books back to back transaction against the client and CCP.

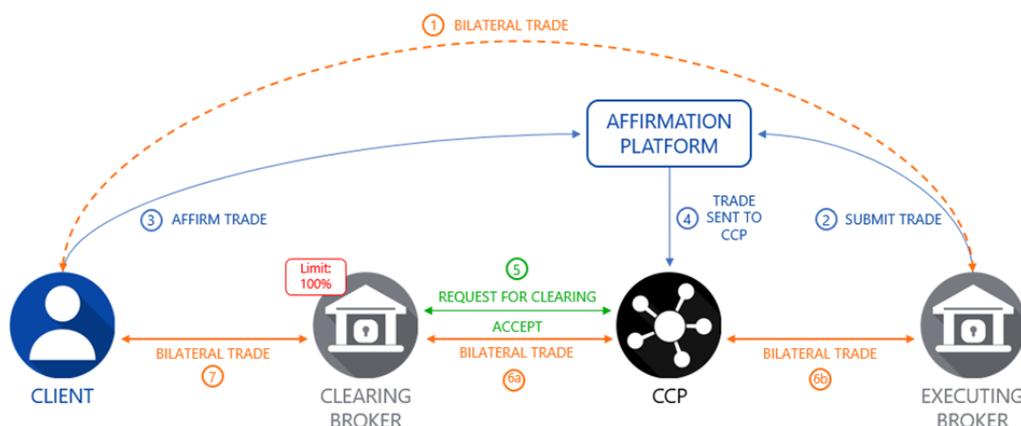


Diagram 1

- b) On-venue OTC transactions:
1. Client places order at trading venue;
 2. Trading venue credit checks electronic orders in 60 seconds and non-electronic orders in 10 minutes;
 - a. PUSH - Limit is held and checked at the trading venue but determined by the clearing broker;
 - b. PING - Trading venue requests consent per trade from Clearing broker for trade/order acceptance;
 3. Executing broker fills order;
 4. Trading venues send trades to the CCP in 10 seconds for electronic trades and 10 minutes for non-electronic trades. CCP then has to accept/reject the trade in 10 seconds;
 5. CCP sends back to back cleared confirmation messages to:
 - a. Clearing broker; and
 - b. Executing broker;
 6. Clearing broker books back to back transactions against the client and CCP.

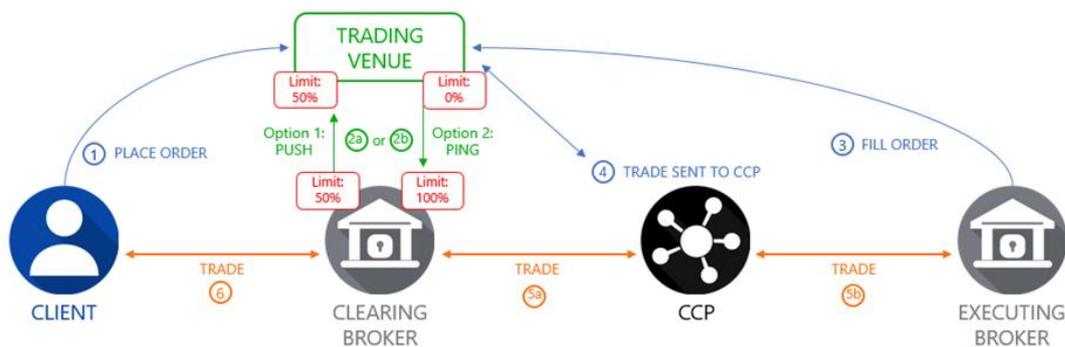


Diagram 2

Connectivity for clearing brokers, however, is complicated and harder to manage, given that clients are likely to use multiple trading venues:

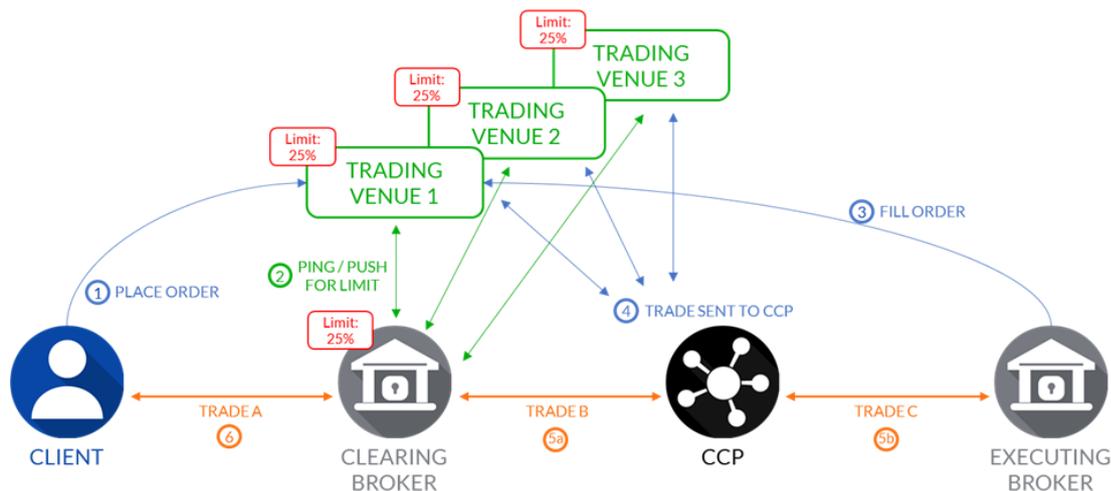


Diagram 3

These new MiFID II requirements introduce three significant implications to the way the clearing has been operating.

1) Bifurcation of limits

Limits are split across multiple trading venues under MiFID II, calling in to question how intra-venue limit allocation should be arranged and how credit limits now have the potential to be wrongly allocated within different CCPs and trading venues.

Steps 2a and 2b in Diagram 2, as well as Step 2 in Diagram 3 demonstrate the complexity of the bifurcation of limits and outline the two solutions that are currently available for market participants for carrying out credit checks. In 2a, the PUSH solution refers to a 'shared' method for checking credit limits between the clearing broker and the trading venue. In this scenario, a clearing broker establishes and allocates two sets of position limits for a client, one for on-venue execution and the other for voice execution purposes. The allocation of these limits would vary depending on the likely method and venue of the execution for each client. Once an order is placed at the trading venue, they would check whether the order is within the limit set by the broker. The broker thus 'pushes' some of its credit appetite to be tested by the trading venue. Having limits in multiple locations leads to significant inefficiencies in the credit checking process and creates a substantial maintenance effort (as is shown in Diagram 3).

An alternative shown in 2b, Diagram 2 is a solution named 'PING'. Once the client places an order at the trading venue, they would communicate real-time with the clearing broker that holds an overall position limit (combined across venue and voice execution) for its client, to check the order. The broker can use its own risk methodology and infrastructure in order to credit check the order and include portfolio effects with the currently cleared portfolio. Diagram 3 shows the challenge of connectivity as the client gains access to more trading venues.

Undoubtedly, there is a need to provide clearing certainty for orders placed on a trading venue. Due to the nature of a trading venue, it is impossible for a clearing broker to make the same assumptions about the portfolio effects of an order with a client's existing cleared portfolio, as some or all of the orders might not get executed. When an order request is received by a clearing broker from a trading venue, the clearing broker has to calculate a standalone limit allocation (e.g. excluding portfolio affects). When the order is executed, cleared and received by the clearing broker, the clearing broker will be required to remove the pre-allocated capacity for the order and re-calculate the cleared portfolio risk exposure. This will free up capacity for the client to continue placing orders and executing transactions.

Under MiFID II, therefore, position limit checking becomes a highly complex and almost real-time exercise, especially for clearing brokers that are placed in the centre of carrying out the checks. Clearing brokers will therefore need to set up a robust automated infrastructure that is able to provide a solution for the timely and real-time checks. Clearing brokers could potentially develop their own infrastructure solutions, or use a standardized system across the market for more efficient limit checks.

2) Uncertainty in case of rejection to clear

The complexity involved in the credit checking solutions is highly likely to result in more trade rejections by clearing brokers and CCPs.

Article 5 of RTS 21 tells us that, in the case of a rejection by a CCP by reason of a technical problem, a trade can be re-submitted within 1 hour from the previous submission as a new transaction, on the same economic terms with the consent of both counterparties.

On the other hand, if non-acceptance of an electronic trade executed on a venue happens due to a non-technical reason, the contract becomes void. This means that a client needs to re-execute the transaction on new economic terms which could be significant depending on market movements that have occurred. In this case, there is a possible economic cost of the rejection the ownership of which needs to be negotiated between the different parties. As a result, avoiding trade rejection becomes much more important for clients and clearing brokers.

3) Transparency of limit and exposure

The best way to avoid orders/trades being rejected is to ensure that clients have limit and exposure transparency. This means that clients will need the ability to predict, at pre-execution stage, if a trade is to be accepted or not, in order to avoid any cost of re-execution. In addition, the ability to monitor the limit capacity available in real-time and act to increase it (e.g. post additional collateral to the clearing broker) if required, as it will become much more important as soon as the MiFID II rules start to bite.

Many clearing brokers, however, do not have the capability to credit check transactions/orders in a manner that is transparent to clients and will need to invest heavily in their infrastructure to enable this.

CONCLUSION

In conclusion, this article argues that the changes applicable to clearing under Mifid II will result in a bifurcation of position limits, and this will likely result in more trade rejections. More rejections could mean elevated costs for all market participants as well as more disputes around who bears the cost of re-execution.

Separately, the changes brought by MiFID II call for a re-assessment on how clients would use clearing brokers going forward. On one hand, this paper argues that, as a result of the regulation entering into force soon, there are additional arguments for clearing brokers to outsource their risk management and clearing services to third parties. Clearing brokers will need to implement new systems that would enable limit transparency. CCP initial margin is fast becoming the standard for credit checking and as such, there are substantial economies if multiple clearing brokers use the same outsourced provider.

Furthermore, as demonstrated in the above section, market participants will need to implement more sophisticated solutions and systems for real-time risk management and credit checks in the MiFID II regime in order to comply with their requirements. As a result of these evolving solutions, intra-day funding of collateral (used by clearing brokers until now) could slowly disappear as this method would mean higher costs for brokers and demand more collateral or intra-day trades.

Finally, clients who are active derivative users should consider becoming direct members to CCPs to avoid a significant amount of execution uncertainty that has now been introduced.

APPENDIX A

Table – Different trading venues as categorised under Mifid II

	RM	MTF	OTF	SI
Full Name	Regulated Market	Multilateral Trading Facility	Organised Trading Facility	Systematic Internaliser
Products	ETD, Equities	All	All excluding equities	OTC Bi-lateral Instruments
Order matching and Execution	Non-discretionary CLOB	Non-discretionary CLOB	Some discretion CLOB, RFQ, RFS	Full Discretion RFQ, RFS
Users	All	Regulated Only	Can be unregulated	Clients of SI only
Can trade against proprietary capital	No	No	Yes	Yes
Examples	LSE, CME, Eurex, ICE	Bloomberg, Tradeweb	Tradition and ICAP for commodities	BNP, MS, DB

CONTACT US

Ulf Bacher – Frankfurt

Email: ulf.bacher@sernovafinancial.com

Tel: +49 6174 9403902

Roland Sapsford - London

Email: roland.sapsford@sernovafinancial.com

Tel: +44 203 813 3101

Kirit Bhatia - Singapore

Email: kirit.bhatia@sernovafinancial.com

Tel: +44 203 880 6231

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