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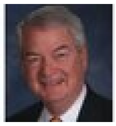

THOUGHT PIECE

INDIRECT CLEARING – IS IT REALLY CLEARING AT ALL?

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As derivatives reform spreads out from Washington to places like Europe, some of the subtle, and not so subtle, differences in regulation are starting to make waves, if not tsunamis. One of the biggest areas of change is the clearing of derivatives contracts, and one of the most interesting, if not troubling, developments is EMIR's rules allowing indirect clearing.

What is Indirect Clearing?

At its most basic, clearing involves the interposition of a clearinghouse, or central counterparty (CCP), between two parties who have agreed to a trade. Thus the CCP becomes the counterparty to each of the original parties, and accepts their credit risk going forward. Because the CCP's positions are always exactly balanced, it never undertakes market risk, only counterparty risk.

That is a simple and efficient way to handle trades in derivatives, where counterparty risk can run for years and notional amounts into the hundreds of millions. The CCP collects initial margin (IM), which is a good-faith deposit against the variation margin (VM) that will be collected or paid out as the value of the contract fluctuates over its life. IM has become a subject of considerable discussion recently as everyone realized that, by concentrating counterparty risk into a small number of CCPs we were exposing market participants to the risk of loss of their IM, especially when such a loss is explicitly provided for by the regulators.

The world gets slightly more complicated when some market participants can't or won't establish clearing accounts at a CCP, or self-clear. All CCPs allow for a clearing agent, called an FCM in the US, to clear on behalf of clients, allowing firms to trade in cleared products without becoming members of a CCP. Obviously, this opens the market up to many more participants, but it also introduces some significant complications and dangers.

Among those dangers is the safety and soundness of the FCM, as the demise of MF Global reminded everyone. And large FCMs can hold massive amounts of customer collateral. For example, here are the top 10 FCMs in terms of customer assets held, from a July CFTC report:

GOLDMAN SACHS & CO	20,224,499,514
JP MORGAN SECURITIES LLC	18,491,769,848
NEWEDGE USA LLC	15,268,797,966
DEUTSCHE BANK SECURITIES INC	14,413,644,531
UBS SECURITIES LLC	9,721,861,179
MORGAN STANLEY & CO LLC	8,840,514,746
CREDIT SUISSE SECURITIES (USA) LLC	8,644,321,517
MERRILL LYNCH PIERCE FENNER & SMITH	8,504,057,100
CITIGROUP GLOBAL MARKETS INC	6,807,249,807
BARCLAYS CAPITAL INC	6,687,455,002

This arrangement also complicates certainty of clearing, the requirement that trades done on exchanges must be clearable before they are allowed to occur, since any trade that can't be cleared will have to be broken. Finally, in EMIR there is a provision that clearing can be provided to the public by the client of an FCM, and this is what is called indirect clearing. It is not apparent to me what problem the EU thought they were solving with this arrangement, but it raises lots of questions.

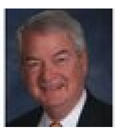
The Implications of Indirect Clearing

Before we get into indirect clearing, let's look at some factors in clearing itself and the role of the FCM. The true value of clearing in futures, for example, is that every trade abides by a uniform set of rules relating to valuation, collateral, termination and novation, because the CCP sets the rules. However, in swaps the advent of multiple CCPs for the same product, which isn't the case in futures, means that we may have slightly (or even markedly) different rules for the same products. In particular, we might have different IM requirements for the same product. In addition, the CCPs may have different levels of protection for customer collateral in the case that the CCP itself has financial difficulty.

Beyond those factors, we need to be aware of the implications of the FCM role. If the FCM operates in an omnibus mode, it means that the CCP has no visibility to the actual parties to its cleared trades; it only knows the FCM as a party. In addition, many CCPs require that FCMs segregate customer collateral, although in the US that process is less than ironclad. The CFTC has adopted a principal called LSOC, which stands for Legally Segregated but Operationally Commingled. The CFTC trumpeted this arrangement as an improvement in customer protection, but the legal status of customer funds wouldn't appear to help much in the case of a disorderly FCM default. Thus customers have been tightening up their clearing agreements with FCMs recently.

The CFTC has, as a matter of course, relied on the CCPs to police the FCMs, although they are taking a hard look at that reliance in light of some aforementioned oversight failures. The CFTC has instituted a practice of monitoring the bank accounts of CCPs and FCMs to "make sure the money is where it's supposed to be," but they have precious little staff to do that job, and the kind of chaos that led to the MF Global collapse would make that monitoring almost impossible just when it is needed the most.

However, all these oversight arrangements, which are primarily in the US, rely on the CCP/FCM/Customer arrangement. There is no such provision for the required oversight in a CCP/FCM/Indirect Clearer/Customer arrangement. Obviously, that arrangement puts the customer, with his IM and cash at risk, one more step removed from the CCP. Unless the CCP has regulatory authority over the indirect clearer, we have a totally unregulated entity out there purporting to offer clearing services. If both the FCM and the indirect clearer operate on an omnibus basis, there is no way the CCP knows who holds the actual positions. In other words, the indirect clearer is in exactly the same position vis-a-vis its customer as a swap dealer is in an uncleared transaction. Someone may call those transactions cleared, but the CCP has no knowledge of who the parties are, where they are domiciled, how creditworthy they are, or whose money is whose. They are the functional equivalent of an uncleared trade. Anyone dealing with an EMIR-approved CCP should keep that in mind.



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