FINANCIAL MARKETS LAW COMMITTEE

ISSUES OF LEGAL UNCERTAINTY ARISING IN THE CONTEXT OF INDIRECT CLEARING OF EXCHANGE TRADED DERIVATIVES UNDER MIFIR

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FINANCIAL MARKETS LAW COMMITTEE[1]

This paper has been drafted by the FMLC Secretariat.[2]

[1] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

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1. INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

1.1. The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty or misunderstanding, present and future, in the financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. This paper identifies issues of legal uncertainty which arise in the context of the draft regulatory technical standards ("Draft RTS 38") issued by the European Securities and Markets Authority ("ESMA") under a Consultation Paper (2014/1570) published on 19 December 2014 (the "Consultation Paper"), which concerns the implementation of the Markets in Financial Instruments Directive (2014/65/EU) ("MiFID II") and Regulation (EU) 600/2014 on Markets in Financial Instruments ("MiFIR"). The focus of this paper is on Section 9.2 (*Indirect Clearing*) of the Consultation Paper.

1.3. MiFID II and MiFIR were adopted by the European Parliament on 15 April 2014 and by the Council on 13 May 2014 as part of a review of the Markets in Financial Instruments Directive (2004/39/EU) ("MiFID I"). The revision of MiFID I formed part of the Commission's ongoing structural reform in the aftermath of the financial crisis of 2008.[3] Among other things, MiFID II and MiFIR aim to strengthen high standards of investor protection throughout the EU.[4] This objective is reflected in, *inter alia*, the provisions on indirect clearing of exchange traded derivatives ("ETDs") under MiFIR.

1.4. Indirect clearing requirements were previously developed by ESMA in the context of over-the-counter ("OTC") derivatives under Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("EMIR").[5] MiFIR

[3] The FMLC has published the following papers in respect of the review of implementation of the Markets in Financial Instruments Directive (2014/65/EU). The most recent publications include: (i) a report entitled "Issues of Legal Uncertainty Arising in the Context of Provisions on Non-discriminatory Access to Central Counterparties and Trading Venues – Response to Consultation Paper (2014/1570) by the European Securities and Markets Authority on MiFID II and MiFIR", dated 15 May 2015, available at http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_paper_responding_to_esma_consultation_paper_on_mifid_ii_and_mifir.pdf; and (ii) a report entitled "Response to the European Securities and Markets Authority Consultation Paper on the Revised Markets in Financial Instruments Directive, dated 14 August 2014, available at http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_paper_on_mifidmifir.pdf.

[4] See "Markets in Financial Instruments Directive (MiFID): Frequently Asked Questions", European Commission, 8 December 2010, available at: http://europa.eu/rapid/press-release_MEMO-10-659_en.htm?locale=en.

[5] Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives not cleared by a CPP ("EMIR").

provides ESMA with a mandate to prepare similar provisions to EMIR in the context of indirect clearing of ETDs.[6]

1.5. Article 30(2) of MiFIR provides that ESMA shall develop regulatory technical standards to specify the types of indirect clearing service arrangements, where established, that meet the conditions referred to in Article 30(1). In accordance with Article 30 of MiFIR, ESMA published the Draft RTS 38 on indirect clearing in Annex B of the Consultation Paper.

1.6. On 28 September, ESMA submitted final draft RTS under MiFID II and MiFIR.[7] No final draft RTS was submitted for indirect clearing arrangements. In a subsequent letter to Commissioner Jonathan Hill of the European Commission (dated 2 October 2015), however, Steven Maijoor (Chair of ESMA) stipulated that the draft MiFIR RTS will be submitted following a new consultation on possible amendments to the EMIR RTS. [8]

Executive Summary

1.7. This paper examines in detail the requirement in Article 4(7) of the Draft RTS 38 for a clearing member to establish procedures for the default of a client which include "steps… to initiate the return of the liquidation proceeds to the indirect client". The effect of this provision is to require a clearing member to make payments of collateral to an indirect client ("leapfrog payments") in the event of a default by a direct client. The FMLC is concerned that the requirement may conflict with existing insolvency laws of Member States, as well as any insolvency rules in third countries to which a direct client may be subject.

1.8. ESMA has sought to deal with potential conflicts of law by virtue of Recital 5 of the Draft RTS 38, which provides that the provisions of the Draft RTS 38 will prevail

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6 Article 30(1) of the Markets in Financial Instruments Regulation ("MiFIR") provides:

> [i]ndirect clearing arrangements with regard to exchange traded derivatives are permissible provided that those arrangements do not increase counterparty risk and ensure that the assets and positions of the counterparty benefit from protection with equivalent effect to that referred to in Articles 39 [Segregation and Portability] and 48 [Exposure Management] of Regulation (EU) No 648/2012 [EMIR.]

7 The final draft regulatory technical standards ("RTS") can be accessed at: http://www.esma.europa.eu/systm/files/2015-esma-1464_-_final_report_-_draft_rts_and_its_on_mifid_ii_and_mifir.pdf.

8 The letter is available at: http://www.esma.europa.eu/system/files/2015-1498_-_letter_to_european_commission_-_technical_standards_on_indirect_clearing_under_emir_and_under_mifir.pdf.

over any conflicting laws of a Member State. It is uncertain, however, whether the provisions of regulatory technical standards can effectively override conflicting laws of a Member State. It is unclear in respect of the requirement to make leapfrog payments of whether it is mandatory in all circumstances or whether it is subject to exceptions, such as where there are conflicting insolvency laws applicable to the direct client. This uncertainty gives rise to the risk that leapfrog payments could be susceptible to challenge by insolvency practitioners appointed in respect of the direct client, resulting in a negative impact on wholesale financial markets. The FMLC therefore requests that the relevant provisions of the Draft RTS 38 are clarified in these respects.

2. INDIRECT CLEARING ARRANGEMENTS AND LEAPFROG PAYMENTS

2.1. A central counterparty ("CCP") will deal directly with a market participant it has accepted as a clearing member to provide clearing services. As set out in Article 30,[9] MiFIR also allows indirect access to the CCP through the services of the clearing member. An indirect client is "a client of a client of a clearing member".[10] An indirect clearing arrangement or indirect clearing service means:

> …the set of contractual relationships between the central counterparty (CCP), the clearing member, the client of a clearing member and the indirect client that allows the client of a clearing member to provide clearing services to an indirect client.[11]

2.2. The parties in an indirect clearing arrangement chain are, therefore, as follows: CCP, clearing member, client of the clearing member (the direct client) and indirect client of the clearing member (the client of the direct client).[12] The client holds an

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9 See footnote 6 above.

10 Article 1(1) of the Draft RTS 38 of Consultation Paper (2014/1570) (thereafter referred to as "the Draft RTS 38" and "the Consultation Paper"). Article 2(1) of MiFIR defines a client in accordance with MiFID (Article 4(9)) as "a natural or legal person to whom an investment firm provides investment or ancillary services". An investment firm can act as a general clearing member for counterparties (see Article 2(1) of the Draft RTS 38). Article 29(2) of MiFIR defines a clearing member as "an undertaking which participates in a central counterparty ("CCP") and which is responsible for discharging the financial obligations arising from that participation", by reference to the definition provided in EMIR under Article 2(14).

11 Article 1(2) of the Draft RTS 38.

12 Recital (2) of the Draft RTS 38 provides that, pursuant to EMIR, CCPs are required to be designated systems under Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems. From this it follows that clearing members of CCPs should qualify as participants within the meaning of that directive. Further, clients providing indirect clearing services should be credit institutions, investment firms or equivalent third country credit institutions or investment firms to ensure an equivalent level of protection to indirect clients as is provided under EMIR.

account with the clearing member and the indirect client is a customer of that client. Examples of models where indirect clearing will commonly apply include the following:

(a) CCP, global bank US clearing member, global bank EU affiliate and indirect client; and

(b) CCP, large bank clearing member, regional bank or broker and indirect client.

2.3. Third country participants are common in indirect clearing arrangement chains involving EU CCPs. For example, a US Futures Commission Merchant ("FCM") (usually a major bank and broker-dealer) is often a clearing member or direct client.

2.4. The obligations of the clearing member and direct client are set out in Article 4 and Article 5 of the Draft RTS 38. Article 4(7) sets out the requirement for a clearing member to establish procedures for the default of a client which include steps to initiate the return of liquidation proceeds to an indirect client, i.e. to make leapfrog payments:

> A clearing member shall establish robust procedures to manage the default of a client that provides direct clearing services. The clearing member shall ensure that its procedures allow for the prompt liquidation of the assets and positions of indirect clients following the default of the client. It shall also include the details of…the steps required to initiate the return of the liquidation proceeds to the indirect client.

2.5. It is supported by Article 5(6) which requires the direct client to have contractual arrangements in place to facilitate the return of collateral to the indirect client from the clearing member.

2.6. As a preliminary matter, Article 4(7) is generally unclear as to whether the requirement to make leapfrog payments is mandatory in all circumstances.[13] It is possible to draw the inference from the reference to the "*return* of the liquidation proceeds to the indirect client" (emphasis added) that an indirect client has an *absolute* right to receive a leapfrog payment and the clearing member has an *absolute* obligation to ensure a leapfrog payment occurs, following the insolvency of a direct

[13] This contrasts to the position under EMIR in the case of a default by a clearing member. Article 48(7) of EMIR contemplates the CCP either making a leapfrog payment to the direct client or to the clearing member's liquidator if the identity of the direct client is unknown. See Section 5.2 of this paper, below.

client. The Consultation Paper appears to suggest that leapfrog payments are only required to the extent they are possible (see paragraph 17 on page 645):

> Contractual arrangements between the direct and indirect clients are required so the direct client would look to protect *to the extent possible* the return of the liquidation proceeds to the indirect client from its own insolvency. (Emphasis added.)

2.7. An unqualified obligation is problematic for several reasons, one example being where the insolvency law applicable to a direct client is incompatible with a leapfrog payment to the indirect client. This is considered in more detail in Section 3 below.

3. INSOLVENCY LAW CONFLICTS

3.1. Where indirect clearing services are provided, the purpose of the leapfrog payment is to bypass an insolvent direct client and return an indirect client's collateral from the CCP through the clearing member. The leapfrog payment is facilitated to some degree by Article 5(1) and Article 4(2) of the Draft RTS 38 which provide for the segregation of the indirect client's collateral.[14] The segregation rules do not, however, necessarily give rise to an insolvency proof legal ring fence surrounding the indirect client's collateral—this depends on how the indirect client has transferred the collateral to the direct client. If the indirect client has transferred the collateral to the direct client by way of a title transfer collateral arrangement (a "TTCA"),[15] its proprietary rights in the collateral pass to the direct client and the segregation rules become more akin to a "book-keeping exercise". Accordingly, in the event of the insolvency of the direct client, an insolvency practitioner could challenge a leapfrog payment by the clearing member to the indirect client on the basis that the collateral forms part of the insolvent direct client's estate and the payment conflicts with insolvency laws of the jurisdiction of the direct client.

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[14] Although this depends on the type of segregation instituted. Article 4(2)(b) of the Draft RTS 38 provides for two forms of segregation account: (a) a net omnibus segregation account; and (b) a gross omnibus segregation account. In the case of the former, the clearing member would not know the identity of indirect clients so would be unable to make leapfrog payments to them (see Section 5 below). Segregation rules at a Member State level may also apply, for example, in the case of the UK, the segregation rules set out in rules 7 and 7A of the Client Assets Sourcebook: https://www.handbook.fca.org.uk/handbook/CASS/.

[15] Title Transfer Collateral Arrangements ("TTCAs") are commonly used in clearing chains with margin flowing on an outright basis between direct clients and clearing members and indirect clients and direct clients. See for example pages 12 and 13 of the Policy Statement 12/23 of the then Financial Services Authority entitled "*Client assets regime: changes following EMIR*" (December 2012) available at: http://www.fca.org.uk/static/pubs/policy/ps12-23.pdf.

3.2. For example, as set out below, in the case of the UK, various principles and rules restrict the depletion of an insolvent company's estate and would *prima facie* conflict with the requirement to make a leapfrog payment. The purpose of these principles and rules is to uphold the *pari passu* principle which provides that the available assets of a company in administration or liquidation must be shared equally among its unsecured creditors—no creditor should be preferred to the detriment of the other creditors.

Anti-deprivation Principle

3.3. The anti-deprivation principle is a common law principle which operates to prevent property owned by a debtor from being removed from its estate as a result of its insolvency. It can be summarised as follows:

> [A] simple stipulation that, upon a man's becoming bankrupt, that which was his property up to the date of bankruptcy should go over to some one else and be taken away from his creditors, is void as being a violation of the policy of the bankrupt law.[16]

3.4. The principle is intended, therefore, to prevent a reduction in the value of an insolvent company's estate to the prejudice of its creditors and is most likely to apply to contractual provisions which have the effect of depriving an insolvent debtor of assets in its estate in the event of its insolvency. Accordingly, a contractual provision stipulating a leapfrog payment in accordance with Article 4(7) of the Draft RTS 38 may conflict with the principle because, triggered by a direct client's insolvency, it involves the removal of property from its estate.[17]

Preferences, Avoidance of Property Dispositions and Transactions at an Undervalue

3.5. The Insolvency Act 1986 sets out various avoidance rules which empower a liquidator to challenge transactions entered into by an insolvent company before or

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[16] James LJ, *Ex parte Jay: In Re Harrison* (1880) 14 Ch D 19, 25.

[17] The anti-deprivation is subject to several exceptions which are outlined in *Belmont Park Investments PTY Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc.* [2011] UKSC 38. In particular, a distinction is drawn between an asset determinable on liquidation (a "flawed asset") and an absolute interest which is made defeasible on liquidation by a condition subsequent. While this is ultimately a question of substance depending on the particular contractual provisions, a leapfrog payment could be said in general to have an effect more akin to the latter by depriving a direct client of its absolute property on its insolvency.

at the time of its insolvency, by making an order to the court to invalidate those transactions and return the property transferred to the insolvent company's estate.

3.6. Section 239 of the Insolvency Act permits "preferences", made in the six month period prior to insolvency, to be challenged. A company gives a preference to a person (*inter alia*) if: (a) that person is one of the company's creditors; and (b) the company does anything (or suffers anything to be done) which has the effect of putting that person into a position which, in the event of the company going into insolvency, will be better than the position he would have been in if that thing had not been done.[18]

3.7. Section 127(1) of the Insolvency Act 1986 provides that

> any disposition of the company's property…made after the commencement of the winding up is, unless the court orders otherwise, void.

3.8. Furthermore, Section 238 of the Insolvency Act 1986 permits "transactions at an undervalue", made in the two year period prior to insolvency, to be challenged. A transaction at an undervalue is described in section 238(4) as having occurred (*inter alia*) if the company enters into a transaction with a person

> for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company.

3.9. A leapfrog payment could potentially fall foul of these rules. It could be challenged as a preference, the indirect client being preferred at the expense of the other creditors of the direct client, or as a void disposition of the direct client's property after the commencement of a compulsory winding up. It may also be open to challenge as a transaction at an undervalue if there was, for example, disagreement

[18] Section 239(4) of the Insolvency Act 1986.

as to the value of the margin transferred to the indirect client by the clearing member.[19]

3.10. This issue is not confined to the UK—other Member States may have similar laws, as may third countries, one example being the US which is considered below.

US Example

3.11. As mentioned above, a direct client based in a third country (for example, a US FCM) may be a client of a clearing member of an EU CCP. If based in the United States, an insolvent FCM direct client will be subject to the liquidation rules in Subchapter IV of Chapter 7 of the United States Bankruptcy Code ("the Bankruptcy Code") and Part 190 of the Regulations of the United States Commodities Futures Trading Commission.[20]

3.12. The Bankruptcy Code contains various safe harbour provisions that are intended to mitigate disruption and reduce systemic risk to the financial markets by protecting various counterparties exercising rights under financial contracts. Pursuant to §556, a commodity broker, financial participant or forward contract merchant has the right to liquidate, terminate or accelerate a commodity contract in the event of the insolvency of the counterparty. An FCM falls within the definition of commodity

[19] Part VII of the Companies Act 1989 was enacted to protect the financial markets from the insolvency of a market participant. It dis-applies certain provisions of insolvency law where those provisions would conflict with contractual remedies agreed between market participants and their counterparties. The rationale behind Part VII is to mitigate the impact which the default of a market participant could have on a chain of transactions in the financial markets and ensure that UK insolvency law does not interfere with the rules governing the operation of the financial markets (which are a combination of statutory rules, the provisions of market contracts and the rules of exchanges). Section 159 dis-applies "the law relating to the distribution of the assets" of an insolvent company (i.e. the *pari passu* principle) to the extent that it would render invalid (*inter alia*) any market contracts, any rules of a recognised clearing house or any transfers or settlements of contracts by a recognised CCP. Section 165 exempts (*inter alia*) market contracts to which a recognised clearing house is party or which is entered into under its default rules and dispositions of property pursuant to such contracts from the purview of section 238 (transactions at an undervalue) and section 239 (preferences), as well as other provisions of the Insolvency Act 1986. Part VII was amended in light of EMIR (see footnote 26 below), one of the amendments being to protect the transfer of indirect client accounts in the event of a direct client default, provided that certain conditions are satisfied (see section 155(2D)). Part VII does not differentiate between exchange traded derivatives and over-the-counter derivatives so, at first sight, it may therefore appear that, provided the relevant conditions are satisfied, leapfrog payments could be protected from conflicting provisions of UK insolvency law pursuant to Part VII. It is not clear, however, whether Part VII applies (a) in relation to MiFIR and (b) in relation to defaults by direct clients where there is not also a default by the clearing member.

[20] If the Futures Commission Merchant is also a broker-dealer that is a member of the Securities Investor Protection Corporation, the provisions of the Securities Investor Protection Act of 1970 will apply.

broker and ETDs fall within the definition "commodity contract" for the purposes of the Bankruptcy Code.[21]

3.13. The proceeds of any liquidation though must be paid to the trustee to the liquidation. The Bankruptcy Code mandates the rateable distribution of customer property by the trustee to the liquidation appointed by the bankruptcy court to customers on the basis of, and to the extent of, such customers' allowed net equity claims, with public customers being afforded priority in such distribution to all other claims (other than certain administration expenses).[22]

3.14. Accordingly, a clearing member could not make a leapfrog payment to an indirect client without contravening the provisions of the Bankruptcy Code—under the Bankruptcy Code, the clearing member would have to make the payment to the trustee to the liquidation of the insolvent FCM direct client.

3.15. As set out in Section 4 below, the Draft RTS 38 anticipates conflicts with insolvency law and provides for an override, however, its provisions are necessarily restricted to the EU, extra-territorial effect being precluded. Accordingly, to address the situation where a leapfrog payment would conflict with the insolvency laws of a third country, the FMLC recommends in Section 5 below that this is made one of the exceptions to the requirement to make a leapfrog payment.

4. OVERRIDING INSOLVENCY LAW: RECITAL 5 OF DRAFT RTS 38

4.1. The Consultation Paper expressly acknowledges that issues could arise where the requirements of the Draft RTS 38 conflict with the national insolvency laws applicable to a direct client including:

> the risk that the insolvency practitioner of the insolvent direct client could seek to reclaim the value of its assets and positions from the clearing member.[23]

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21 "The term "commodity broker" means futures commission merchant…" as defined under Chapter 1, §101 of the Bankruptcy Code. "Commodity contract" in respect of a futures commission merchant, means a "contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade" as defined in Chapter 7, Subchapter IV, §61(4)(a) of the Bankruptcy Code.

22 § 766(h).

23 See Section 9.2, paragraph 6 on page 643 of the Consultation Paper.

Accordingly, it outlines two measures to deal with such issues, one of which is to:

> add a recital along the lines of Recital 64 of EMIR to remind that the requirements in a RTS, which is a Regulation directly applicable in all EU Member States, prevail over conflicting national insolvency laws.[24]

4.2. Recital 64 of EMIR provides that the requirements of EMIR on the segregation and portability of clients' assets and positions (which would include the requirement to make a leapfrog payment) should prevail over any conflicting national laws (which would include insolvency laws).[25] Accordingly, ESMA incorporated an equivalent recital (Recital 5) in the Draft RTS 38:

> … [i]n line with what is envisaged under Regulation (EU) No 648/2012 [EMIR], the requirements laid down in this Regulation on the segregation of indirect clients' positions and assets should prevail over any conflicting laws, regulations and administrative provisions of Member States that prevent parties from fulfilling them…

4.3. The insertion of Recital 5 is not, of itself, sufficient to ensure that the provisions of the Draft RTS 38 will unequivocally override Member States' national insolvency laws. This depends on whether Level 2 text is capable of overriding national laws of Member States, which is unclear. Although ESMA has modelled the recital on the wording provided in Recital 64 of EMIR, the key difference is that Recital 64 is Level 1 text, whereas Recital 5 is Level 2 text and there is no corresponding article or recital addressing the potential conflict of laws in the Level 1 text of MiFIR.

4.4. Further, the FMLC understands from discussions with market participants that uncertainty even existed in the case of Recital 64, regarding whether a *recital* was capable of overriding conflicting national laws, which would also be the case in respect of Recital 5.[26] The FMLC therefore requests, as outlined in Section 5 below, that the effect of Recital 5 in this regard is clarified.

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[24] See Section 9.2, paragraph 16 on page 645 of the Consultation Paper.

[25] Recital 64, states:

> The requirements laid down in this Regulation on the segregation and portability of clients' assets should therefore prevail over any conflicting laws, regulations and administrative provisions of the Member State that prevent parties from fulfilling them.

[26] For example, in the UK, legislation was enacted to implement EMIR and remove any conflicts with national law. Part VII of the Companies Act 1989 (which predated EMIR) was amended pursuant to The Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013 (SI 2013/504) to reflect various novel requirements under EMIR, including the ability of CCPs to transfer collateral directly to clients on the insolvency of a clearing member. See footnote 19 above for further details on Part VII.

5. PROPOSED SOLUTIONS

Article 4(7) and Article 5(6) of the Draft RTS 38

5.1. In the first instance, it would be helpful if it could be made explicit in Article 4(7) whether the requirement on clearing members to make a leapfrog payment is subject to exceptions, as discussed in paragraph 2.6. and 2.7.

5.2. Recognising that a leapfrog payment may not be feasible in all circumstances, such as where the identity of the indirect client is unknown, the FMLC suggests that it may be appropriate for exceptions to apply to the obligation to make a leapfrog payment. This also reflects the analogous position under EMIR. Article 48(7) of EMIR requires a CCP to make a leapfrog payment to a direct client in the event of a default by a clearing member, however, this obligation is not absolute—Article 48(7) expressly contemplates circumstances where such a payment would not be possible and permits payment to be made instead to the liquidator of the clearing member.[27]

5.3. As outlined above, a leapfrog payment may be incompatible with the insolvency laws of a third country applicable to a direct client. Cognisant that Recital 5 is incapable of having extra-territorial effect and overriding a third country's insolvency laws, the FMLC suggests that conflict with third country laws may constitute further grounds for an exception to the requirement to make a leapfrog payment.

5.4. If these changes are implemented consequential changes would be needed to Article 5(6) (for example, by way of the insertion of a proviso) to make it clear that a leapfrog payment would not need to be made in all circumstances.

Recital 5 of the Draft RTS 38

5.5. As outlined above in Section 4, it is unclear in Recital 5 whether third country firms are intended to be prohibited from providing indirect clearing services, where the requirements of the Draft RTS 38 conflict with the relevant third country insolvency laws. The FMLC observes that, if an exception were made to the requirement to make a leapfrog payment in such circumstances, third country firms would not be prevented from providing indirect clearing services and consequently Recital 5 would be unnecessary in this respect.

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[27] Any balance owed by the CCP after the completion of the clearing member's default management process by the CCP shall be readily returned to those clients when they are known to the CCP or, if they are not, to the clearing member for the account of the clients.

6. CONCLUSION

6.1. This paper has identified several issues of legal uncertainty in respect of Recital 5 and Articles 4(7) and 5(6) of the Draft RTS 38. Uncertainty arises in respect of the requirement in Article 4(7) (which is supported by Article 5(6)) to make a leapfrog payment, in terms of whether it is mandatory in all circumstances or subject to exceptions. The FMLC has provided examples of where this requirement would conflict with national insolvency laws, which may lend support for an exceptional basis. Recital 5 is also gives rise to uncertainty in respect of whether it is effective in overriding national law and its purported application to third countries.

6.2. This legal uncertainty could have a negative impact on the wholesale financial markets. Indirect clearing arrangements are common for ETDs transactions. Without a practical solution, parties to these transactions would not be able to rely on leapfrog payments being immune from challenge. The FMLC has therefore set out some suggestions to address the uncertainty, which include circumscribed carve-outs to the requirement to make a leapfrog payment, such as where there is a conflict with third country insolvency law, and clarification as to the effect and scope of Recital 5.

6.3. Accordingly, in view of the ongoing and future work by ESMA on its RTS for MiFID II and MiFIR, the FMLC would welcome consideration of the issues discussed in this paper.

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