



European Securities and
Markets Authority

Final Report

CCPs' Membership Criteria and Due Diligence





Table of Contents

1	Executive Summary	2
2	Introduction	3
3	Individuals as Clearing Members.....	4
4	Non-Financial Counterparties as Clearing Members	5
4.1	Enumeration and Categorisation	6
4.2	Risk.....	6
4.3	Classification as Participant under SFD.....	8
5	CCPs Due Diligence Practices	8
5.1	Main findings on current CCPs' Due Diligence Practices.....	8
5.2	Further considerations to enhance supervisory practices	11

1 Executive Summary

Reasons for publication

The default at Nasdaq Clearing AB in September 2018 of a physical person acting as a Direct Clearing Member on the Nasdaq Commodities clearing segment highlighted the importance of membership criteria as a first line of defence of CCPs to control counterparty credit risk.

As a follow-up to this incident, ESMA conducted a survey on CCPs' Membership Criteria and Due Diligence, in order to learn about CCPs' practices in this field and determine whether any supervisory convergence measure is needed to strengthen CCPs' compliance with Article 37 of EMIR¹ as well as Principle 18 of the CPMI-IOSCO Principles for financial market infrastructures.

This report presents the outcome of ESMA's analysis as well as the follow-up actions on the topic of CCPs' membership criteria and due diligence.

Content

Section III presents the results of the ESMA survey with respect to individuals acting as clearing members as well as the clarification to be published by ESMA on the level of stringency in admission criteria.

Section IV focuses on Non-Financial Counterparties acting as clearing members and presents the findings of a survey on their participation in EU CCPs.

Section V presents the practices that emerged from the survey as those used by EU CCPs on an ongoing basis to perform due diligence of their clearing members.

Next Steps

With respect to individuals acting as clearing members, along with this report, ESMA is also updating its Q&A document on the Implementation of EMIR with a new Q&A 23(c) on the level of stringency in admission criteria.

With regards to EU CCPs' due diligence practices, ESMA will consider enhancing supervisory practices, possibly by some form of guidance on detailed practices.

¹ OJ L 201, 27.7.2012, p. 1–59. Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

2 Introduction

1. The default at Nasdaq Clearing AB in September 2018 of a physical person acting as a Direct Clearing Member on the Nasdaq Commodities clearing segment highlighted the importance of membership criteria, as a first line of defence of CCPs to control counterparty credit risk.
2. In the aftermath of this incident, ESMA conducted a survey (covering all 16 authorised EU CCPs) on CCPs' Membership Criteria and Due Diligence in order to learn about CCPs' practices in this field and determine whether any supervisory convergence measure is needed to strengthen CCPs' compliance with Article 37 of EMIR as well as Principle 18 of the CPMI-IOSCO Principles for financial market infrastructures (PFMIs). ESMA's guideline and recommendation regarding the implementation of the PFMIs in respect of CCPs of 4 September 2014 reads:

“EMIR and the regulatory and implementing technical standards made under it establish requirements which are consistent with the Principles for Financial Market Infrastructures published by the Committee on Payment and Settlement Systems and the Board of the International Organization of Securities Commissions (PFMIs). When carrying out the duties resulting from EMIR for the authorisation and supervision of CCPs, competent authorities should ensure that CCPs established in their territory comply with these requirements in accordance with the PFMIs and operate in a manner that is consistent with them.”

3. More specifically, the survey investigated the following three topics:
 - whether individuals (i.e. a physical person, either as an individual trader or in a business capacity) are allowed to be clearing members at EU CCPs, and if so, how the CCP assesses the financial resources and operational capacities of such individuals;
 - what membership criteria EU CCPs apply and whether they apply specific criteria to non-financial counterparties as defined in EMIR²;
 - how EU CCPs conduct their on-going monitoring of compliance with membership requirements (due diligence of Clearing Members), especially with respect to entities different from banks or investment firms.
4. This Final Report presents the outcome of ESMA's analysis on the topic of CCPs' membership criteria and due diligence.

² 'Non-financial counterparties' refers to undertakings which are not authorised and supervised financial entities such as CCPs, credit institutions, insurances, investment firms, or managements companies of UCITS, pension funds or, AIFMs - see definition under point 9 of Article 2(1) of EMIR.

3 Individuals as Clearing Members

5. The survey highlighted that no EU CCP currently has an individual (i.e. a physical person) acting as a clearing member. Twelve CCPs stated that according to their rules, individuals are not allowed to participate as clearing members. However, four CCPs do not rule out that individuals could participate as clearing members should they satisfy all admission criteria, with the caveat that this is being reviewed at one CCP and might as well change at another.
6. With respect to follow-up actions on individuals as clearing members, two options were envisaged: 1) banning individuals altogether from becoming clearing members by amending the existing legal framework or 2) relying on the existing legal framework with regard to admission criteria. Preference was given to the latter.
7. Firstly, Article 2 of EMIR defines a Clearing Member as “an undertaking which participates in a CCP and which is responsible for discharging the financial obligations arising from that participation”. In addition, the European Commission’s EMIR Frequently Asked Questions³ clarify that individuals carrying out an economic activity can be considered as undertakings and as such are not excluded from being clearing members as per the EMIR definition.
8. Concurrently, with respect to settlement finality in payment and securities settlement systems, while a ‘participant’ was initially defined in the Settlement Finality Directive (the ‘SFD’)⁴ as “an institution⁵, a central counterparty, a settlement agent or a clearing house”, raising questions about the legal possibility for individuals to be qualified as participants, a recent amendment⁶ of the SFD extended this definition to the clearing members of a CCP.
9. As a direct result of this inclusion in the SFD definition of a participant, the assessment of the possibility for individuals acting as clearing members to be participants within the meaning of the SFD became irrelevant, as their status of clearing member would automatically qualify them as “participant”.
10. Given that the existing legal framework, with regards to both clearing and settlement, does not allow excluding individuals from being clearing members, the focus moved to the admission criteria applicable to clearing members, in order to clarify whether the participation requirements of EU CCPs are equally stringent in terms of outcome whilst being proportionate in terms of means so that they may be applied regardless of whether the admitted clearing member were a natural or legal person.

³ European Commission EMIR FAQ No 14

⁴ OJ L 166, 11.6.1998, p. 45–50

⁵ Following OJ L 166, 11.6.1998, p. 45-50 Article 2 a) last paragraph: “A Member State may decide that undertakings which participate in such a system and which have responsibility for discharging the financial obligations arising from transfer orders within this system can be considered institutions”.

⁶ OJ L 150, 7.6.2019, p. 296–344. Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU and Directive 98/26/EC

11. In terms of process, this clarification is provided through the publication at the same time as this report of an amended ESMA Q&A on the Implementation of EMIR with respect to the level of stringency in admission criteria. ESMA further developed the existing 'CCP Question 23 – Access Model' as it already deals with Article 2 and the notion of undertaking with the addition of a new question (c).

Box 1: **CCP Question 23 – Access model** [Last update 26 September 2018]

(c) Can a CCP accept an individual as a clearing member?

CCP Answer 23:

- (c) EMIR does not prevent in Article 2 and more specifically in the definition of a clearing member an individual from becoming a clearing member. However, should an individual apply to become a clearing member, it will need to prove to the CCP, among other requirements, that, like any other clearing member:
- it fulfils the capital requirements applicable to clearing members;
 - its financial accounts are audited;
 - it has the operational capacity, in terms of staff, systems and processes to meet its obligations towards the CCP, including with respect to risk management;
 - it is connected to the system managed by the CCP and, directly or indirectly, to the relevant payment and settlement systems; and
 - it has sufficient banking and contingency arrangements in place.

A CCP's participation requirements and risk-management controls should take into account any additional risks that may arise from having individuals as participants.

12. It must also be noted that in certain Member States legal persons partnerships composed of individuals exist, where the legal responsibility lies with each individual.

4 Non-Financial Counterparties as Clearing Members

13. This section presents the findings of the survey on non-financial counterparties acting as clearing members in authorised CCPs: how many they are, who they are, which risks they bring to CCPs.

4.1 Enumeration and Categorisation

14. Responses to ESMA's survey highlighted that while seven CCPs stated that their rules do not allow Non-Financial Counterparties to participate as clearing members, seven others reported that they accept and currently have Non-Financial Counterparties as clearing members. The remaining two do not categorize their clearing members between financial counterparties and non-financial counterparties⁷.
15. Further investigation took place with respect to the seven CCPs, which reported having existing Non-Financial Counterparties acting as clearing members, in order to provide a detailed breakdown of the categories of NFCs participating in their CCPs. Another purpose was to get confirmation that entities classified as NFCs under EMIR are classified as "participant" under the SFD as per the fifth category, which is defined under the national law applicable and designated by the system.
16. As of April 2019, 241 Non-Financial Counterparties were reported as acting as existing clearing members in seven EU CCPs, belonging to the following categories:
 - Energy and Power Market (market makers, agents, traders...): 174 NFCs (72%);
 - Industrials and Food producers: 40 NFCs (17%);
 - Commodities (traders, producers, intermediaries): 13 NFCs (5%); and
 - Financial institutions and insurance companies not falling under the EMIR definition of 'financial counterparty': 9 NFCs (4%).

4.2 Risk

17. The information gathered via the survey and follow-up requests highlighted a concentration of NFCs greater than 60% acting as clearing members in one EU CCP. The reason for this concentration is of a historic nature due to the natural resources in the relevant region for this CCP, which led to an important specialisation in the trading of energy and power, which then led to the clearing of instruments whose underlying is energy and power, and has attracted NFCs from all over Europe.
18. The data collected also confirmed that the categories of NFCs acting as clearing members are logically very correlated to the markets cleared by the CCP. For instance, CCPs clearing commodities count in their clearing members all the different players of the commodity markets, such as the producers, intermediaries, traders, market makers, which,

⁷ Two EU CCPs do not categorise their clearing members between financial counterparties and non-financial counterparties. This categorisation is determined solely by the clearing member and not provided to the Clearing House as it is not a part of their clearing membership criteria.



irrespective of their size, are by definition non-financials. This is the case for five out of the seven CCPs having NFCs acting as clearing members.

19. With regards to the access of NFCs to CCPs, the information gathered via the survey and the follow-up request highlights that for some CCPs a specific membership model or specific membership criteria seem to have been introduced in order to allow NFCs to become clearing members. However, non-financial counterparties bring their own counterparty risk to the CCP in the same way that financial counterparties do. For this reason, no lowering of the criteria should be granted to a non-financial counterparty to become a clearing member and NFCs should, as highlighted previously with respect to individuals, comply with obligations as stringent as those imposed on financial counterparties.
20. With respect to the risk brought by NFCs to CCPs, most CCPs allowing NFCs to act as clearing members highlighted that they do not allow them to clear on behalf of any other counterparty but themselves, i.e. only to conduct some proprietary clearing, no client clearing⁸. ESMA agrees that such restriction contributes to protecting clients from the default of an NFC acting as their clearing member. However, from a CCP perspective, this restriction does not limit per se the risk to which the CCP is exposed. Indeed, in the Nasdaq default event, no client clearing was involved, though the losses caused to the CCP proved significant.
21. In conclusion, it emerged from the survey that two approaches coexist across EU CCPs when it comes to managing the risk brought by NFCs into CCPs:
 - restricting NFCs' access to a specific membership model where the risk is contained, either by restricting their access or by increasing the cost of clearing;
 - allowing NFCs to use the same membership model as FCs, thus requiring them to comply with the same obligations as FCs.
22. Both approaches share the same goal of controlling the risk that might be imported when onboarding NFCs and the coexistence of these two practices does not constitute a heightened risk as long as membership models created purposely for NFCs are as conservative as the CCP's main membership model, i.e. the one applicable to Financial Counterparties.

⁸ One UK CCP reported that the NFCs currently acting as clearing members do not clear for clients, however the CCP does not rule out the possibility for NFCs to conduct some client clearing. If an NFC wanted to clear for clients as a general clearing member, the CCP would beforehand assess the appropriateness of that request, and whether the NFC can demonstrate in advance its capability to sufficiently risk manage clients (through technical expertise to model and manage client risk, risk systems, operational capacity etc). This is the standard process the CCP follows when assessing general clearing membership requests, whether from FCs or NFCs.

4.3 Classification as Participant under SFD

23. Responses to the survey clarified that having NFCs as clearing members is not only necessary due to the characteristics of the market the CCPs clear, but also, in some cases, is explained by the different classification of some financial entities under national laws falling outside the definition of an NFC under EMIR.
24. The definition used for NFCs in the survey came from EMIR (point 9 of Article 2(1)), where the term “Non-financial counterparties” referred to undertakings which are not authorised and supervised financial entities such as CCPs, credit institutions, insurers, investment firms, or managements companies of UCITS, pension funds or AIFMs. Yet, EMIR and the SFD differ. Indeed, the SFD provides for a fifth category of participants to be defined under national law. As a consequence, under national laws, the definition of NFCs might differ from the EMIR definition.
25. A follow-up with the CCPs accepting NFCs as clearing members clarified whether entities classified as NFCs under EMIR were classified, within the meaning of the SFD, either directly as “participant” or as “institution” as per the fifth category under the respective law designating the system. The situation in fact varied, one CCP was in the first category (“participants” as per the meaning of the SFD) while two other CCPs were in the second (“institutions” under the National Law designating the system).
26. While the situation was initially unclear and requesting an in-depth look with respect to the status of participant of NFCs at a few CCPs, an amendment to the SFD definition of “participant”, as detailed above in paragraph 8, extended the scope of participants as per the SFD to include clearing members of authorised CCPs and changed ESMA’s previous analysis which was challenging at the time the compliance of these CCPs with EMIR. However, the SFD amendment means that those cases are compliant.

5 CCPs Due Diligence Practices

5.1 Main findings on current CCPs’ Due Diligence Practices

27. ESMA via its survey sought to identify how EU CCPs conduct their on-going monitoring of compliance with membership requirements (due diligence of Clearing Members), generally with respect to all clearing members as well as more particularly with regards to entities different from banks or investment firms (NFCs). For instance, ESMA queried the CCPs’ good practices to ensure that any clearing member has sufficient financial resources and operational capacity not only at the time of admission but also on an ongoing basis, as well as the frequency of the comprehensive review by the CCPs of clearing members’ compliance.
28. The results of the survey emphasized six practices used by EU CCPs on an ongoing basis to perform the due diligence of their clearing members:



- a) internal credit classification;
- b) warning monitoring system of their economic and financial situation;
- c) availability of reporting packages or connection to CCP dedicated risk system;
- d) mandatory due diligence questionnaire;
- e) regular engagement with clearing members; and
- f) onsite visits.

Internal Credit Rating

29. The internal credit score or rating has a core importance in the counterparty risk management as described by many CCPs. The credit classification of clearing members is assessed based on the annual reports and other sources of information (e.g. external ratings) and includes the calculation of classical financial ratios.
30. In addition, a couple of CCPs reported that action would be taken if they had concerns over the financial resources and operational capability of a clearing member and if its credit score was either amongst the lowest ratings or subsequently deteriorated. For instance, actions available to the CCP would include calling increased margins via risk premiums, reducing credit tolerances or forcing the reduction of exposures and ultimately suspending or terminating the membership.
31. One CCP, taking into account that its local commodities market has a high ratio of NFCs, pointed out its non-financial internal credit score methodology to take into account characteristics particular to NFCs. In addition, as part of its enhancement programme, the CCP has planned the implementation of a new tiered clearing membership model where credit scoring will incorporate whether a member is a regulated financial counterparty or an NFC and will impact the maximum exposure limits and/or margin add-ons.

Constant Monitoring

32. Some alert service or tool has been reported as being in place by a few CCPs to be constantly on alert to any changes in the solvency of their clearing members.
33. One CCP indeed has an early warning monitoring system that allows the early identification of any situation of deterioration of the economic and financial condition of its counterparties, on a real time basis (or, at least, on a daily basis), using the following data: credit default swap prices, bond prices, equity / share prices, rating updates and company related major news, including those regarding its home country and/or industry.



34. These monitoring efforts are specially oriented to the detection of swift and volatile changes, so that the CCP can react to any altering scenario in a timely manner. All relevant company data is included in its individual file to be considered in the next regular or extraordinary update.

Reporting

35. Four CCPs reported the existence of a clear and comprehensive reporting package, through different communication tools, such as user interfaces allowing the CCP to make available to their clearing members end-of-day and intraday data files that can be uploaded into their own middleware for their position checks and risk management. Clearing members are then able to anticipate any intraday or end-of-day margin calls due to changes in margin, PnL movements or collateral changes by being provided with respective intraday and end-of-day reports.
36. Equally, another CCP proposes to its clearing members the possibility to connect to a risk system receiving continual and proactive information of risk figures in order to be aware of changes as they happen.
37. Lastly, with respect to the monthly resizing of the default fund contributions, one CCP reported sending each day a message with an estimated fund value and participant contribution.

Due diligence questionnaire

38. Additionally, four CCPs mentioned a mandatory due diligence questionnaire, required to be completed by all clearing members annually and including questions on each of the applicable membership requirements and requesting information on any changes to the members' arrangements during the previous year.

Onsite visits

39. A couple of CCPs added that due diligence visits may be organised when the CCP deems it necessary to evaluate the counterparty risk of a member. For instance, one CCP performs spot-checks in the form of onsite audits conducted at the premises of the clearing member. The annual selection of clearing members subject to these onsite audits is based on criteria such as clearing volumes, asset classes and observations in the operational day-to-day business activities.

Engagement with Clearing Members

40. Involving the Clearing Members actively via meetings held at the CCP seems to be a popular tool to keep them informed and up-to-date. Two types of meetings seem to emerge: the governance meetings and the information meetings.
41. With respect to the former category, one CCP for instance applies a governance model involving various recurring meetings with clearing members via the Advisory Board, where the CCP informs and engages with them on all matters relevant to its business, including risk management.
42. With regards the latter category, one CCP reported holding regular risk advisory group meetings, open to all members, which discuss areas of risk policy and the consequences of these in relation to member obligations. Similarly, another CCP holds clearing councils and risk councils on an ongoing basis, whereby members have the opportunity to a) gain more information and a better understanding of the processes and rules of the CCP, b) have the possibility to raise risk related questions.

5.2 Further considerations to enhance supervisory practices

43. As developed in this report, thanks to the review of CCPs' practices with respect to the ongoing due diligence of their clearing members, a number of good practices have been identified. And to build on that report, further considerations will now be given to these findings in order to enhance supervisory practices.
44. More specifically, ESMA will continue this work in order to provide further guidance (via Q&As, opinions or other supervisory convergence tools) on the areas for which CCPs would be expected to have detailed due diligence practices.