OCTOBER 2011

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 156 – OTC DERIVATIVES

The European Market Infrastructure Regulation

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London EC2R 8AH

www.fmlc.org

Services 9600755v9

FINANCIAL MARKETS LAW COMMITTEE

Issue 156 – The European Market Infrastructure Regulation

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CONTENTS

INDEX OF DEFINED TERMS

"CCP" means central counterparty

"Commission" means the European Commission

"ESMA" means the European Securities and Markets Authority

"FMLC" or "Committee" means the Financial Markets Law Committee

"FSA" means the Financial Services Authority

"OTC" means over the counter

1 INTRODUCTION

1.1. The role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets that might give rise to material risks and to consider how such issues should be addressed.

1.2. On 15 September 2010, the Commission published a draft of the Regulation on OTC derivatives, central counterparties and trade repositories, also known as the European Market Infrastructure Regulation (the "Regulation").[2] The stated purpose of the Regulation is to introduce more safety and transparency into the OTC derivatives market. To this end, the Regulation seeks to introduce clearing, reporting and risk mitigation obligations for "as many OTC contracts as possible"[3] that are entered into by financial counterparties and certain non-financial counterparties. The Regulation also introduces prudential, organisational and conduct of business standards for central counterparties ("CCPs"). Since its introduction in September 2010, there have been a number of draft texts[4] circulated within the Commission, the Council of the European Union (the "Council") and the European Parliament that have significantly broadened the Regulation's scope.[5]

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[2] Now renamed the Regulation of the European Parliament and of the Council on OTC derivative transactions, central counterparties and trade repositories.

[3] Commission's Explanatory Memorandum to the Regulation, paragraph 4.3.2.

[4] This Paper is based on the form of the Regulation set out in the Polish presidency compromise proposal dated 23 September 2011.

[5] Note also that on 24 May 2011, the Committee on Economic and Monetary Affairs of the European Parliament adopted a text of the Regulation. That text will ultimately be combined with the Polish presidency compromise proposal to create a final Regulation.

1.3. Much of the detail as to how the Regulation will be implemented will be given effect to through technical standards that, according to the latest draft of the Regulation, are not due to be submitted to the Commission until 30 June 2012.[6] The FMLC recognises that it will therefore not be possible to assess the legal uncertainty issues associated with the Regulation fully until these are published.

1.4. However, the FMLC considers that there are a number of key legal uncertainties arising from the Regulation at this stage, namely in connection with:

1.4.1. the scope of the Regulation as it relates to parties;

1.4.2. the scope of the Regulation as it relates to eligible contracts;

1.4.3. the civil law consequences of breach of the obligation to clear derivatives (the "Clearing Requirement");

1.4.4. frontloading;

1.4.5. segregation and different client clearing models;

1.4.6. default procedures and portability;

1.4.7. different methods of taking collateral and the need to amend the EU Collateral Directive;[7]

1.4.8. deficiencies arising from the Settlement Finality Directive[8] (the "SFD") and issues relating to the insolvency of a CCP;

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[6] Notably the clearing and information thresholds applicable to non-financial firms, the setting of capital and collateral charges for non-cleared OTC derivatives and the procedure for assessing eligibility for clearing of an OTC derivative contract.

[7] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

[8] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998.

1.4.9. interference with the automatic early termination election under an International Swaps and Derivatives Association ("ISDA") Master Agreement; and

1.4.10. regulatory capital.

1.5. The purpose of this Paper is to highlight these uncertainties for participants in the financial markets and to suggest ways in which the Regulation may be amended (or further EU legislation or technical standards adopted) to remedy these uncertainties. Legal uncertainty is a particular issue for market infrastructure. In particular, CCPs are required to manage positions and hold collateral for the entire marketplace and require a legally robust structure in order to be able to operate effectively and quickly upon a default. Many areas of law underpinning market infrastructure operated with little disruption in the European Union during the crisis precipitated by the Lehman Brothers bankruptcy. It is important to ensure that new legislation does not adversely affect the existing, arguably robust aspects of market infrastructure.

1.6. This Paper does not comment on policy issues other than as necessary to deal with issues of legal uncertainty or misunderstanding. Nevertheless, the FMLC notes a major consequence of the imposition of the Clearing Requirement is the concentration of risk in CCPs. This may give rise to an increased risk or more serious consequences of CCP failure.[9] The FMLC notes the various measures in

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[9] Notable examples of the failure of a clearing house are the failure of: (a) Caisse de Liquidation in Paris in 1974 owing to default on margin calls in connection with the sharp decline of prices (after a doubling thereof) in the Paris White Sugar Market; (b) the Kuala Lumpur Commodities Clearing House in 1983 owing to the default of six large brokers in connection with, *inter alia*, the sharp decline of palm-oil futures and an accumulation of uncovered selling positions; and (c) the Hong Kong Futures Exchange clearing house in connection with the 1987 global stock market crash. The failure of the Hong Kong Futures Exchange clearing house resulted in the closure of the stock market because, among other reasons, traders who faced margin calls could not, given the failure of the clearing house and the closure of the futures markets, access their margin moneys. In the case of (a) above, the situation leading to the clearing house failure was exacerbated by the failure of Caisse de Liquidation to adjust margin requirements. New

the Regulation which are designed to prevent CCP failure, such as the capital requirements in Article 12 and provisions governing margin in Article 39 and default fund contributions in Article 40. However, the FMLC also notes the absence of a proper regime for regulatory intervention in CCPs which are failing or in danger of failing. Aspects of the absence of adequate CCP resolution provisions are discussed below.[10]

1.7. Moreover, this Paper does not seek to address all ambiguities and uncertainties generated by the Regulation, nor identify exhaustively all concerns in connection with the issues raised.

2. SCOPE OF THE REGULATION: PARTIES

2.1. The Regulation will require all financial counterparties and non-financial counterparties with positions exceeding the clearing threshold to clear eligible derivatives transactions through an EU-based CCP.[11]

2.2. "Financial counterparties" extends to investment firms, credit institutions, insurance, assurance and reinsurance undertakings, undertakings for collective investment in transferable securities and their managers, institutions for occupational retirement provision and (alternative investment funds managed by) alternative investment managers that are authorised in accordance with their relevant sectoral directive. In effect, any financial counterparty established in an

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clearing rules were put in place before the sugar market reopened in 1976. See Tucker, Paul. "Clearing houses as system risk managers." DTCC-CSFI Post Trade Fellowship Launch. London. 1 June 2011 available at http://www.bankofengland.co.uk/publications/speeches/2011/speech501.pdf and Hills, Bob, David Rule, Sarah Parkinson and Chris Young. "Central counterparty clearing houses and financial stability." Financial Stability Review (June 1999): 122-134 available at http://www.jscc.co.jp/en/ccp12/materials/docs/11.pdf.

[10] See Section 9 (*Deficiencies of the Settlement Finality Directive and issues relating to the insolvency of a CCP*) below.

[11] Or a non-EU CCP that has been "recognised" under the Regulation. See Article 3(2) and Article 23.

EU Member State will be subject to the Regulation and will be required to clear all eligible derivative transactions with a CCP.

2.3. "Non-financial counterparty" refers to an undertaking established in the EU other than a central counterparty or financial counterparty. Unlike for financial counterparties, the Clearing Requirement for non-financial counterparties is subject to a clearing threshold calculated by reference to all the derivative contracts entered into by that counterparty.[12] Moreover, the Clearing Requirement for non-financial counterparties will extend to derivative contracts which "are not objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of the counterparty or of [the group to which the non-financial counterparty belongs]."[13] The Regulation enables the Commission to adopt implementing technical standards for the purpose of setting the threshold and establishing which contracts satisfy the criteria for reducing risk directly related to the items above. In effect, any non-financial counterparty established in an EU Member State will be subject to the Regulation with respect to any derivative contract entered into (other than for commercial hedging purposes) above an amount determined by reference to the total derivative contracts entered into by that counterparty.

2.4. Article 2a sets out the meaning of "intra-group transaction" as it relates to both non-financial and financial counterparties. It is clear that under the Regulation contracts that concern intragroup [sic] transactions are not subject to the Clearing Requirement,[14] but certain terms and phrases used in the description of intra-

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[12] See Article 5.

[13] See Article 5.

[14] Article 3(1)(a).

group transactions (such as "group" (to the extent that it is unclear whether the term contemplates groups with a non-EU parent) and "consolidation on a full basis") or of the exemption of intragroup [sic] transactions from the risk mitigation techniques set out in Article 6 (such as "no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties") are unclear and would benefit from expansion or revision. With respect to the phrase "consolidation on a full basis", the use thereof in relation to non-financial counterparties should be revised as most such counterparties, being unregulated firms, would not be subject to regulatory capital requirements (whether on a consolidated or unconsolidated basis).

2.5. For both financial and non-financial counterparties, the Regulation creates uncertainty with respect to its territorial scope. As many countries have subscribed to the G20 agenda to encourage the clearing of OTC derivatives, there is a danger of overlap and inconsistency with the mandatory clearing requirements in these countries and the requirement under the Regulation. In particular, the FMLC understands that some of the exemptions for non-financial counterparties in the US Dodd-Frank Wall Street Reform and Consumer Protection Act[15] (the "Dodd-Frank Act") are of different scope from those in the Regulation; however, the FMLC notes that in June 2011, a technical working group consisting of US regulators, the Commission and ESMA was established to examine the alignment of US and European derivatives regulations.

2.6. There is also uncertainty as to the application of the Regulation to non-EU establishments of entities established in the EU (whether financial counterparties

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[15] Pub.L. 111-230.

or non-financial counterparties). For instance, it is not clear whether the Regulation applies to activities carried out by a non-EU branch of an entity established in the EU, although it is proposed that the Clearing Requirement and risk mitigation procedures set out in Article 6 will apply to contracts concluded "between third country entities that would be subject to the [Clearing Requirement and risk mitigation procedures] if they were established in the EU, provided that the contract has a direct, substantial and foreseeable effect within the EU or where such obligation is necessary or appropriate to prevent the evasion of any provisions of [the] Regulation."[16] Without further clarification as to what would constitute a "direct, substantial and foreseeable effect within the EU", however, the proposal would give rise to uncertainty if adopted.

2.7. Another area of uncertainty relates to the fact that there will always be two parties to an OTC derivative contract. If one party is subject to a mandatory clearing, risk mitigation or reporting requirement under a third country's laws, it is unclear how the counterparty subject to the Regulation will be able to comply with the Regulation where the third country clearing, risk mitigation or (as the case may be) reporting requirement is inconsistent with the clearing, risk mitigation or (as the case may be) reporting requirement under the Regulation. In other words, the Regulation does not indicate how such inconsistency is to be resolved, although the Regulation provides that the "Commission shall be assisted by ESMA in

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16 See Article 3(1)(b)(v). Note also that the preamble to the Regulation provides at paragraph 32 that "ESMA should be directly responsible for recognising CCPs established in third countries and thus allowing them to provide clearing services within the Union, provided that the Commission has recognised the legal and supervisory framework of that third country as equivalent to the Union framework and that certain other conditions are met. Such recognition procedure should only apply to third country CCPs which could create direct risk to financial stability in the Union. Therefore, a CCP established in a third country, providing clearing services to clearing members or venues of execution established in the EU should be recognized [sic] by ESMA. However, in order not to hamper the further development of cross-border investment management business in the Union, a third country CCP providing services to clients established in the EU through a clearing member established outside the EU does not have to be recognised by ESMA."

monitoring and preparing reports to the Council and the European Parliament on the international application of principles laid down in [the Articles relating to, *inter alia*, the Clearing Requirement, risk mitigation and the reporting obligation,] including potential duplicative or conflicting requirements and recommend possible actions" and the "Commission may adopt an implementing act declaring that the legal, supervisory and enforcement arrangements of a third country are equivalent to the requirements [relating to, *inter alia*, the Clearing Requirement, risk mitigation and the reporting obligation under the Regulation]... and subject to effective supervision and enforcement in that third country."[17]

2.8. For non-financial counterparties, the Regulation creates uncertainty with respect to the types of derivative contracts that would be excluded. The press release issued by the Commission when the first draft of the Regulation was published stated that non-financial firms who use OTC derivatives to mitigate risk arising from their core business activities are exempt from the CCP clearing requirements.[18] Unfortunately, the exemption is not as clear-cut as this suggests.

2.9. In light of the centrality of the concept of "objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity" which will bind the Commission in its determination of technical standards, more clarity is required.

3. SCOPE OF THE REGULATION: ELIGIBLE CONTRACTS

3.1. The Regulation adopts a 'bottom up' approach for determining whether a class of contracts is eligible for clearing. A CCP that wishes to clear a class of OTC

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17 See Article 9a.

18 http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1125&format=HTML&aged=0&language=EN&guiLanguage=en

derivative contracts must apply to its home state regulator for authorisation to do so. If the home state regulator authorises the CCP to commence clearing those contracts, it notifies ESMA of its decision. ESMA then has six months to decide whether to treat the relevant class of contracts as eligible, based on criteria such as the reduction of risk in the financial system and liquidity of contracts.[19]

3.2. The Regulation also provides for a 'top down' approach whereby ESMA can, on its own initiative, identify and notify the Commission of the classes of OTC derivative contracts that it considers should be treated as eligible for the Clearing Requirement, even though no CCP has yet received the authorisation to clear those contracts. In that event, ESMA and the Commission might seek to use their general powers to mitigate any systemic risks identified.[20]

3.3. While the FMLC does not seek to comment on matters of policy, the FMLC considers that the 'bottom up' approach whereby the acts of a competent authority in one Home Member State can require ESMA to take steps that bind participants in the OTC derivatives market throughout the EEA could introduce legal uncertainty into the financial markets. The public consultation and European Systemic Risk Board consultation requirements will mitigate the risk of legal uncertainty by providing the opportunity for market participants to object to a particular Member State standard being forced on them throughout the EEA.

3.4. However, to the extent that there is an expectation that the acts of the competent authority in a Member State will ultimately have an EEA-wide binding effect rather than the acts of ESMA, in respect of which market participants have more visibility,

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[19] See Article 4.

[20] See Article 4a.

the legal uncertainty will remain. Moreover, the technical standards, which ESMA is required to implement, that specify the details to be included in the notification which a home state regulator makes to ESMA upon authorising a CCP to clear certain contracts,[21] may establish standards that guide a home state regulator's authorisation decision. However, the absence of a more active gatekeeper or other early intervention or decision-making role for ESMA or a college, akin to that in Article 14, in the authorisation process, may lead to further or prolonged legal uncertainty.

4. CIVIL LAW CONSEQUENCES OF BREACH OF THE CLEARING REQUIREMENT

4.1. The Regulation requires Member States to lay down rules for penalties applicable to infringements of the Clearing Requirement and reporting obligation (and other obligations set out under Title II of the Regulation, such as those relating to risk mitigation), which "shall include at least administrative fines".[22] The Regulation does not, however, address the civil law consequences for financial and non-financial counterparties of breach of the Clearing Requirement (or the other obligations under Title II). In particular, it does not specify whether a derivative contract which is not submitted for clearing in accordance with the Clearing Requirement will be void and/or unenforceable. Further, it does not specify whether any parties that had relied on the valid execution of that contract would have any remedy, such as the right to have the obligations and any collateral transferred

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[21] See Article 4(1).

[22] See Article 9.

under that derivative contract transferred to a party who could comply with the Clearing Requirement.

4.2. The FMLC considers that the lack of precision regarding remedies gives rise to legal uncertainty which is amplified in light of the systemic impact of many derivative contracts, particularly in the context of the hedging of other financial transactions, and the cross-border nature of many derivative contracts. Moreover, regulatory capital rules and good practice generally require the issuance of legal opinions as to the enforceability of agreements relating to derivatives. Such legal opinions are likely to be caveated as a result of the uncertain impact of the aforementioned provisions on the enforceability of derivatives contracts.

5. FRONTLOADING

5.1. Under the Regulation, derivative contracts entered into or novated on or after the date on which the Regulation comes into force but before the Clearing Requirement takes effect will be subject to the Clearing Requirement if the contracts have a remaining maturity to be determined by the Commission. Otherwise, only contracts entered into on or after the Clearing Requirement takes effect will be caught.[23]

5.2. The effect of this requirement is that a class of derivative, that is not subject to a clearing requirement at the time that a party enters into a trade in that derivative, may become subject to the Clearing Requirement contrary to the contractual expectations of the parties.[24] Those trades would have to be "frontloaded" into a CCP and the parties would be faced with the prospect of having to enforce a change in the terms of a contract switching it from an "uncleared" to a "cleared" contract.

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[23] See Article 3(1)(c).

[24] As a result of market developments, new classes of contracts may also become subject to mandatory clearing years after the Clearing Requirement has taken effect.

In addition, the parties would have to renegotiate certain terms (including those relating to pricing and the identity of the CCP) of their contract. This is in contrast to the position whereby only those contracts entered into after a requirement to clear derivatives came into force would have to be cleared.

5.3. The FMLC further queries the effect of "frontloading" on the capital treatment associated with contracts switched from "uncleared" to "cleared". This is particularly topical in light of the proposed capital incentives in the draft Capital Requirements Directive IV[25] (the "CRD IV").

6. SEGREGATION AND DIFFERENT CLIENT CLEARING MODELS

6.1. There are two basic models for client clearing, *i.e.* the situation where an entity that wishes to undertake a derivatives trade but is not a member of a CCP (the "Client" or "client") appoints a clearing member of a CCP (a "CM") to "clear the trade": (a) the "principal" or "back-to-back" model and (b) the "agency" model.

6.2. Under the "principal" model, the Client enters into a bilateral trade with the CM (the "Original Trade") and the CM enters into a cleared trade with the CCP on the same terms as the Original Trade (the "Mirror Trade"). For certain OTC derivatives, the Original Trade is typically entered into under a modified ISDA Master Agreement whilst the Mirror Trade is entered into under clearing house rules. The Client typically owes an obligation to the CM to deliver margin as cover for the Original Trade (the "Client Margin"). The CM owes a separate obligation to the CCP to deliver margin as cover for the Mirror Trade. However, the CM will, in practice, use the Client Margin to discharge its obligation to the CCP to deliver margin as cover for the Mirror Trade such that it can be said that

[25] Proposal for a Regulation of the European Union and of the Council on prudential requirements for credit institutions and investment firms.

the Client Margin flows through the CM to the CCP. In practice, the Client Margin will be placed in the CM's "client account" held with the CCP. (This account can be contrasted with the CM's "house account" which is used to hold the margin used as cover for trades entered into by the CM with the CCP which are referable to the CM's own obligations.[26]) In the event of a CM default, the Original Trade would be terminated and (a) the Mirror Trade terminated and under current law and regulation, the Client Margin returned by the CCP either to a segregated "client account" or client money pool of the CM (for distribution to the CM's clients outside the CM's insolvency estate), or if a mechanism has been put into place to achieve this, directly to the Client (or an agent acting on its behalf) or (b) the Mirror Trade transferred or ported to another CM (the "Back-up CM") and the Client Margin transferred to the Back-up CM's "client account".

6.3. Under the "agency" model, the Client and the CM enter into arrangements whereby the CM agrees to enter into derivatives trades with the CCP on the Client's behalf (the "Agency Arrangements"). Pursuant to the Agency Arrangements, the CM enters into a bilateral trade with the CCP as agent for the Client in terms pursuant to which, as between the CM and the Client, (a) the Client owes the principal obligations to the CCP, including the obligation to provide the Client Margin to the CCP and (b) the CM guarantees the principal obligations (the "Agency Trade"). As between the CCP and the CM, the CM is liable as principal for the Agency Trade and fully responsible for collecting and paying margin. The CCP will usually have no information about the identity of the Client, source of funds for the Client's "client account" or breakdown of a

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[26] This is not the case under the LCH.Clearnet model. Under the LCH.Clearnet model, the Client Margin is the CM's own but subject to a security interest in favour of the Client in connection with losses as between the CM and the Client.

portfolio of contracts or margin by client, so will look to the CM to meet all liabilities relating to its "client account" without reference to any Client. In practice, the CM will transfer the Client Margin to the CCP and the arrangements for holding Client Margin with the CCP usually will be the same as those under the "principal" model. A CM acting in a capacity as agent for its Client is not considered to be inconsistent with the CM also acting as principal in respect of those of its obligations owed to the CCP. In the event of a CM default, the Agency Arrangements would be terminated and (a) the Agency Trade terminated and the Client Margin returned to the Client or (b) a Back-up CM appointed under new agency arrangements and the Agency Trade transferred or ported to the Back-up CM and the Client Margin transferred to the Back-up CM's "client account". If such a transfer or porting were not achieved, then the Client Margin would be segregated and the trade closed out.

6.4. The "agency" model is used primarily in the US and is the model on which the Dodd-Frank Act is based. The "agency" model is driven by particular US tax and accountancy rules. The same economic effect (*i.e.* that the CM does not guarantee the CCP's performance) may be arrived at contractually under the principal model described above. The European financial markets have primarily adopted the "principal" model as the accepted model for derivatives trading.

6.5. The Regulation requires a CCP to keep records and accounts to enable it to distinguish the assets and positions of one CM from the assets and positions of another CM and from those of the CCP. It also requires the CCP to distinguish between the CM's own assets and positions held in its "house" account with the CCP from those which the CM holds on behalf of its clients in its "client" account

("CM/Client Segregation").[27] These requirements are consistent with both the "principal" and "agency" models of client clearing.[28]

6.6. However, the Regulation goes further and requires that CCPs offer to keep separate records and accounts to enable each CM to distinguish in accounts held by the CCP the assets and positions held for the account of one Client from the accounts of other Clients ("Individual Client Segregation").[29] It also requires CMs to offer Clients Individual Client Segregation in accounts held with CCPs.[30] Although a "principal" model could accommodate the Individual Client Segregation requirements, these requirements would be more closely aligned with the "agency" model and, in any event, would represent a departure from the current practice under the more universally accepted model, in accordance with which CCPs operate in the EU. Individual Client Segregation would also necessitate a charge structure and a third party deposit holder. It is unclear whether the Regulation would require CCPs and CMs to adopt an "agency" model. From a CCP's perspective, the agency model is based on well-established precedent in the US, but there is little case law or statutory authority as to how any such model would operate in the EU.

6.7. Even if Individual Client Segregation were to be offered as an operational matter, it may not result in actual segregation of client-related assets in the event of an insolvency of the CM without significant changes in current insolvency law and

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[27] Articles 37(1) and (2).

[28] This is subject to the comment at footnote 26 above.

[29] See Article 37(3). The FMLC notes that Article CCR30 (*Treatment of clearing members' and clients' transactions*) of the draft CRD IV effectively provides for capital incentives in connection with the offering of Individual Client Segregation.

[30] See Articles 37(3).

related laws and regulations. If the CM has received assets by title transfer from its Client, then the Client will arguably have no property interest in client account amounts returned by a CCP to the CM, only an unsecured claim. If the Client does have a property interest in the CM's claim or in assets held by the CCP, then under applicable insolvency laws in the UK and elsewhere in the EU, client moneys and client assets are in any event subject to a mandatory pooling upon the insolvency of a CM, resulting in assets in all of the individual segregated accounts being combined. It is, under current law, technically possible to establish trust or similar arrangements so as to by-pass the client money rules in the Markets in Financial Instruments Directive[31] and increase the level of protection, and some CCPs have sought to do this, but such structures can be seen as complex. Regulatory requirements for individual segregation offer little to no prospect of legally binding segregation upon an insolvency, which is the only situation in which such segregation would be of value, unless insolvency laws were also amended. Article 45(4d) of the Regulation requires Member States to "ensure that nothing in their respective national legal, regulatory and administrative framework prevents a full and swift compliance by the relevant parties with the requirements set out in paragraphs 4a, 4b and 4c." Given the range of account and collateral structures that may be used in clearing, the FMLC anticipates that achieving this level of certainty will be complex and, if not fully achieved at the time of implementation of the Regulation, will result in legal uncertainty.

6.8. The FMLC considers that the issues identified above create legal uncertainty with respect to (a) the practical difference in effect between CM/Client Segregation and Individual Client Segregation, (b) how the latter could be made more robust in

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[31] Directive 2004/39/EC of the European Parliament of the Council of 21 April 2004.

terms of insolvency law protection and (c) the extent to which the Regulation could be said to require CCPs and CMs to adopt a particular model of client clearing.

7. DEFAULT PROCEDURES AND PORTABILITY

7.1. The provisions on default procedures and portability[32] also give rise to uncertainty as to the distinction in practice between CM/Client Segregation and Individual Client Segregation. The language in Articles 45(4a) and 45(4b), which deal respectively with the CCP's obligation with respect to the transfer of Clients' or (as the case may be) a Client's assets and positions from a defaulting CM to a Back-up CM, is identical, *mutatis mutandis*. Moreover, Article 45(4c), which requires clients' collateral to be used exclusively to cover the positions held for Clients, does not distinguish between CM/Client Segregation and Individual Client Segregation, the requirement set out in Article 45(4c) applying in both cases.

7.2. A plain reading of Articles 45(4a), 45(4b) and 45(4c) suggests that, irrespective of whether a CCP and CM operate "client accounts" on a CM/Client Segregation or Individual Client Segregation basis, the CCP will have to take steps to avoid loss mutualisation between a CM's clients. Currently, loss mutualisation is a key feature of the "omnibus" structure accounts which CMs offer clients and loss mutualisation of equal-ranking property claims or creditors is a feature generally embedded into insolvency legislation regardless of account segregation (subject to the establishment of complex structures and to future changes in law that may reflect the intent of the Regulation).

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[32] See Article 45.

7.3. The blanket application of Article 45(4c) to “client accounts” on a between CM/Client Segregation and Individual Client Segregation basis is also difficult to reconcile with Article 37(3). Article 37(3) provides that where a Client opts for Individual Client Segregation, any excess margin over and above the Client’s requirements must be posted to the CCP and distinguished from other Clients’ or CMs’ margins and should not be exposed to losses recorded in another account. It, therefore, has much the same effect as Article 45(4c) in that it seeks to avoid loss mutualisation as between different Clients. However, the protections in Article 37(3) are limited to the case of Individual Client Segregation. They do not extend to CM/Client Segregation.

7.4. Furthermore, the requirements in Articles 45(4a) and 45(4b) that the CCP “contractually commit itself” to trigger the procedures for the transfer of assets and positions held by defaulting CMs may restrict the legal mechanisms whereby a CCP codifies its obligations. In this respect, a CCP should be given the option (if not required under the Regulation) elsewhere in its rules and regulations or in some other publicly accessible document to commit itself to trigger the procedures for the transfer of assets and positions in its default procedures. The requirement to do so by contract could give rise to uncertainty as the precise terms of a contract could be unknown to other participants in the CCP, the participation of all of whom may be required to ensure the effectiveness of default management. Moreover, where operational or other requirements necessitated a change in the CCP default management procedures, the need to amend each individual contract through negotiation, as opposed to a mere change to the default procedures themselves, could hamper the CCP’s ability to respond to new risks in the market. This requirement may also expose CCPs to risks at the time when they most need to apply flexibility—in dealing with a default. In particular, considerable risks would be created if a CCP were contractually required to port contracts or margin of a particular Client regardless of the consequences of doing so. The risk profile of a client account would change due to any porting event and could lead to remaining (non-porting) clients using the account being under-collateralised, exposing those Clients and, ultimately, the CCP and all its CMs, to additional risks. CCPs currently seek to have the option within their default rules to port an entire client account from a defaulting CM to a single solvent CM, but the Regulation would preclude this, mandating client choice at a time when this may be inappropriate. An entire account porting may expose the CCP to lower risks and would generally be an operationally less complex approach. The main commercial objective of Clients in the case of a default would be to move away from the insolvent CM and have their contracts and margin protected. A secondary consideration of the Clients would be which CM they would end up with, as they could thereafter move more simply.

7.5. The FMLC considers that the issues identified above create legal uncertainty with respect to the differences in effect between partial and full segregation in the context of portability and the duties to trigger default procedures.

8. DIFFERENT METHODS OF TAKING COLLATERAL AND AMENDMENTS TO THE EU COLLATERAL DIRECTIVE

8.1. Legal uncertainty may emerge from changes in the way collateral is taken by derivatives dealers and CCPs as a result of the implementation of the Regulation.

8.2. **Current methods of taking collateral**

8.2.1. At present there are two main agreements that are used to document the vast majority of collateral arrangements in connection with OTC derivatives transactions in the EU. The first is the English law title transfer based ISDA Credit Support Annex ("CSA") and the second is the New York law security interest based ISDA CSA. CCPs in the UK also generally take collateral by way of title transfer pursuant to their rules and membership agreements. Some CCPs have allowed a security interest to be used for some non-cash client collateral, but this has not been widely used.

8.2.2. Notwithstanding the EU Collateral Directive, the EU OTC collateral market remains largely based on title transfer, as many market participants were by the time of implementation of the EU Collateral Directive already used to title transfer collateral arrangements and there was no commercial pressure to use security interest based collateral arrangements more widely.

8.2.3. This has now begun to change as a result of experiences in the Lehman Brothers bankruptcy, which has brought attention to the point that excess collateral under a title transfer collateral arrangement is an unsecured debt of the collateral-taker, rather than a proprietary claim of the collateral-provider (as it would be if exactly the same non-cash assets were provided by way of security).

8.2.4. The apparent advantages of security interest based collateral arrangements have also received greater prominence as a result of, amongst other things, the ISDA Independent Amounts white paper published by ISDA, the Managed Funds Association and the Securities Industry and Financial Markets Association in March 2010.

8.2.5. Nevertheless, the vast majority of existing OTC derivatives collateral and clearing arrangements involving English law collateral agreements are currently based on title transfer collateral arrangements and therefore do not, as is further explained below, depend upon the English law concept of "control" for their efficacy. Title transfer is also used in the French Banking Federation master agreement and the German master agreement for financial derivatives transactions.

8.2.6. In contrast to the EU, the US has largely been a security interest based collateral market using documentation such as the ISDA New York law CSA. Primarily this is because it is possible under New York law to obtain all the advantages of title transfer (*i.e.* rights of use, simple perfection requirements and enforcement not being subject to any statutory stay in insolvency proceedings) through a pledge.

8.3. **Likely changes in methods of taking collateral**

8.3.1. Changes in both EU and US regulation of derivatives will result in a significant increase in the volume of OTC derivative contracts subject to a clearing requirement.

8.3.2. Given the wide-spread use of security interest collateral arrangements in the US, clearing structures currently used in the futures market and in the cleared derivatives markets are based around pledges, typically governed by New York law.

8.3.3. Currently, the proposed US regulatory structure for both cleared and non-cleared derivatives transactions envisages that collateral will be provided, in the case of cleared transactions, under some form of security interest collateral arrangement and, in the case of non-cleared transactions, with the collateral-provider having the option to require that its initial (but not variation) margin be held by a third-party custodian on its behalf, but subject to a security interest in favour of the collateral-taker.

8.3.4. Little consideration seems to have been given in the Regulation to the governing law of such security arrangements or indeed the cross-border implications for CMs in terms of the validity and enforceability of those collateral arrangements in light of applicable foreign laws, the locations where collateral may need to be held outside the US and the extent to which third party custodians are willing to implement non-automated control features on collateral held with them.

8.3.5. The Regulation requires CMs to distinguish the assets and positions of CMs and those of their clients. It also requires CCPs to distinguish such assets. Although this is a desirable result commercially, the Regulation appears not to recognise that most EU clearing houses take collateral by way of title transfer, such that all the collateral belongs to the clearing house, subject to an obligation on the clearing house to return excess collateral when required to do so under its rules. The returned excess collateral does not have to be the same collateral as originally posted as, unlike security based collateral arrangements, there is no obligation to return an asset in which the collateral-provider has retained a proprietary interest; there is merely an obligation to return an asset which is fungible with the original asset posted as collateral.

8.3.6. In addition, it is difficult for a CM or a CCP to take cash other than by way of title transfer without introducing a considerable administrative burden on the CM or the CCP or by exposing clients to the insolvency of another third party (*i.e.* the bank at which the cash is held).

8.3.7. Given that so much of the regulatory change is based around the idea of protecting a client's property, there is a risk that the Regulation will limit the ability of CMs to use title transfer collateral arrangements, which would have the effect of encouraging CMs to rely on security interest based collateral arrangements on a much greater scale than they do currently.[33]

8.3.8. The net result of the above is that there is likely to be a significant increase in the value of collateral provided under security interest based collateral arrangements involving cross-border legal issues (as to which the ISDA collateral opinions may provide some clarification). There may also be decreases in the effective recognised value of collateral (and increases in the amount of collateral taken by CCPs and CMs) as a result of the application of higher “haircuts”, if non-legally robust forms of collateral-taking are mandated or subject to client choice.

8.4. **Changes in methods of taking collateral and other developments in collateral management**

8.4.1. The existing standard forms of security interest based collateral arrangement (and the ways in which collateral is in practice managed as between market counterparties) are based around those counterparties selecting the most appropriate legal documentation for their market and the relevant counterparty, rather than taking a "one size fits all" approach regardless of the laws applicable to the counterparty and the specific collateral management structure being implemented.

8.4.2. For example, many of the collateral management techniques used by larger derivatives dealers and third party custodian banks have been developed in the context of use of the New York law ISDA CSA in New York, where

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[33] Note the comment at footnote 26 above.

issues of "control" in terms of the release of excess collateral or substitution of collateral do not cause problems under local law. Using exactly the same documentation and exactly the same collateral management techniques under an English (or, as the FMLC understands, other European) law security arrangement would give rise to a material risk of the collateral arrangement being construed as a floating, rather than a fixed, charge. Under current English law, there is some doubt as to whether such a floating charge benefits from the protections afforded by the English law implementation of the EU Collateral Directive (including exemption from registration, a right to enforce despite a moratorium, rights of use and rights of appropriation).[34] The FMLC understands that similar issues have been raised in various other European jurisdictions.

8.4.3. A possible outcome of clearing structures that force the CMs to take collateral from their customers by way of security interest (and force CCPs also to take collateral by way of security interest) could well be a significant increase in legal/operational risk for CMs and CCPs holding collateral in a form that may not be fully enforceable compared with the arrangements they would, by choice, put in place in the OTC derivatives market.

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[34] See *Gray & Ors v G-T-P Group Ltd Re F2G Realisations Limited (In Liquidation)*, [2010] EWHC 1772 (Ch), which concerns the meaning of "in the possession or under the control" of a collateral-taker in connection with a floating charge and the question of whether the floating charge qualifies as a security financial collateral arrangement for the purposes of the Financial Collateral Arrangements (No.2) Regulations 2003 (the "Financial Collateral Regulations"). "Possession" for the purposes of the Financial Collateral Regulations now includes the case where cash has been credited to an account held by or on behalf of a collateral-taker, provided that the rights of the collateral-provider in relation to the collateral are limited to the right to withdraw excess collateral or to substitute the collateral with new collateral of the same or greater value (and regardless of whether or not the collateral is subsequently credited to an account of the collateral-provider). See also the FMLC's letter to HM Treasury dated 7 April 2011 available at http://www.fmlc.org/papers/Issue1Ltr2HMTApr11.pdf in relation to the Financial Collateral Regulations.

8.4.4. The problem essentially arises as a result of the different legal backgrounds and concepts between English and New York law as to what form of "control" it is necessary for a collateral-taker to have in order to ensure a security interest based collateral arrangement is "perfected" under the relevant local law ("perfected" meaning that the security interest (a) is either registered or exempt from registration and (b) benefits from any safe harbours enabling the security to be enforced notwithstanding any stay on enforcement proceedings in an insolvency of the collateral-provider). Also, given the commercial importance of rights of use in the business model of derivatives dealers, the concept of "perfection" should also include a requirement that the security arrangement be taken in a form that entitles the collateral-taker to re-use the collateral with the collateral-provider's consent. Under English law (as in many other European jurisdictions), it is only possible to exercise such rights of use if the security arrangement is a security financial collateral arrangement within the English law (or other relevant jurisdiction's) implementation of the EU Collateral Directive.

8.4.5. Under New York law, "control" can be established relatively easily through having rights to direct the custodian holding the collateral as to how to deal with that collateral following enforcement of the security. In contrast, in very high level summary, under English law (and the laws of other European jurisdictions more generally) "control" may require the collateral-taker to have an absolute legal right to prevent the collateral-provider from dealing with the collateral at any time during the life of the collateral arrangement without the express consent of the collateral-provider.

8.4.6. OTC derivatives collateral arrangements are virtually always based around the collateral-provider being contractually entitled to the return of excess collateral and being entitled to substitute one type of collateral for another (subject in most cases to the collateral-taker's consent). Given the volume of these collateral arrangements, many collateral management systems are automated such that both rights to the release of excess collateral and rights of substitution do involve a degree of automation. If rights to return of excess collateral and/or automated substitution rights are included as a matter of English law, there is doubt as to whether or not the collateral-taker will have sufficient “control” so as to have a fixed charge and therefore sufficient “control” to have a security financial collateral arrangement protected by the English law implementation of the EU Collateral Directive.

8.4.7. This uncertainty would likely cause dealers and CCPs to prefer to structure their OTC collateral arrangement using the more effective title transfer structure, leaving them to manage their OTC and cleared collateral arrangements variously with consequent confusion and inefficiency for their customers.[35]

8.5. Possible solutions

8.5.1. The most obvious solutions would be to (a) make the Regulation more permissive in terms of the use of title transfer collateral by CMs and CCPs, making this a matter for those involved in a CCP’s risk management governance processes, such as its risk committee or (b) amend the EU Collateral Directive and its local law implementing legislation so as to

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35 Note that this is addressed in the LCH.Clearnet SwapClear client clearing model.

provide an express meaning of "control" that is consistent with the commercial structures of financial markets collateral arrangements.

8.5.2. Such an amendment to the EU Collateral Directive is in any event needed since the EU Collateral Directive has already been amended to include credit claims (such as loans) in the categories of financial collateral and expressly to allow the collateral-provider to collect the proceeds of credit claims (without disqualifying such arrangements from the security financial collateral arrangement category).

8.5.3. In order to ensure global consistency in collateral management techniques and to reflect current market practices in title transfer collateral arrangements, the EU and local implementing legislation should provide a definition of "control" that is consistent with that under New York law.

9. DEFICIENCIES OF THE SETTLEMENT FINALITY DIRECTIVE AND ISSUES RELATING TO THE INSOLVENCY OF A CCP

9.1. The Regulation does not appear to contain provisions which protect a CCP from insolvency law challenges (in the way that Part VII Companies Act 1989 ("Part VII"), for example, provides a shield for actions taken under the default rules of a CCP). CCPs typically wish to have insolvency law protections in connection with their mechanisms for close-out, transfer, netting and application of collateral. Specifically, Article 45 is limited in scope, focusing on default procedures and porting only.

9.2. There are alternative sources of such protections in part, for example through the EU Insolvency Regulation[36] (the "EUIR"), the Winding-up Directives[37] (the

[36] Council Regulation (EC) No. 1346/2000 of 29 May 2000.

"WUDs"), the EU Collateral Directive and the SFD. Each of these has loopholes which are further described below.

9.3. The EUIR and the WUDs do not apply to investment firms which receive client money and assets; furthermore, their protections depend on the effectiveness under national law of the default rules of the CCP. That is fine as regards UK CCPs, owing to Part VII (which, incidentally, is not a complete solution in itself), but for non-UK CCPs there may be a risk of challenge to the legality of the rules.

9.4. The EU Collateral Directive applies to close-out netting, but it does not protect other actions taken under the default rules of a CCP, such as hedging, the completion of in-flight transactions or porting.

9.5. The SFD was designed to protect payment and securities settlement systems, by giving finality to in-flight transfers of cash and securities. This generally covers the collection of margin payments by CCPs and, in relation to securities clearing houses, also covers cleared contracts (which involve the transfer of securities from one CM to another through the CCP); however, the SFD does not apply to the close-out, hedging or porting of open derivatives contracts. The definition of a "transfer order" in article 2(i) of the SFD is limited to instructions to transfer title to, or interest in, a security. It does not include an instruction to transfer title to a commodity or open derivatives contract. As a consequence, the rules of most designated systems that are derivatives clearing houses only provide for transfer orders to govern the making of payments under such derivatives and in-flight porting of contracts between solvent CMs.[38] The SFD is therefore only of limited protection to derivatives clearing houses, which must rely on national insolvency

[37] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001.
[38] For example, ICE Clear Europe Rules, Part 12.

legislation (such as the UK's Companies Act 1989) for other protections. If the SFD and the Regulation are to protect an effective EU-wide system for the protection of contracts in the event of the failure of a CCP, then the SFD will need to be extended in scope to protect a CCP's default rules more generally, not just those dealing with in-flight transfer orders. This is relevant not only to the failure of a CCP, but to providing an EU-wide basis for ensuring the protection of cleared contracts in the event of the default of a CM and would reinforce the provisions in Article 45 of the Regulation.

9.6. Furthermore, the eligibility criteria for "designation" under the SFD may not be satisfied by all CCPs, particularly as regards the requirements for membership of the CCP. Again, if the SFD is to protect an effective EU-wide system for the protection of contracts in the event of the failure of a CCP, then the SFD needs to be aligned with the Regulation. As above, this is also relevant in the context of the default of a CM and the reinforcement of Article 45 of the Regulation. The definitions of "participant" and "indirect participant" should also be amended so as automatically to include clients of CMs and all CMs, regardless of their regulatory status.

9.7. In addition, existing protections do not generally extend beyond the CCP to CM relationship and also apply down to the ultimate client level and would not be effective in protecting, for example, the rules on porting of clients' collateral from a defaulting CM to a Back-up CM. As noted above, Article 45(4d) obliges each Member State to "ensure that nothing in their respective national legal, regulatory and administrative framework prevents a full and swift compliance by the relevant parties" with the portability requirements in Articles 45(4a) to 45(4c). However, in the absence of an amendment to the SFD to provide a firm EU-wide legislative underpinning, the force of Article 45 in ensuring extended and consistent protection throughout the EEA is questionable. The FMLC notes that in an earlier draft of the Regulation (namely, the Hungarian presidency compromise proposal of 17 March 2011), Article 45(4d) provides that the requirements set out in Article 45 "shall prevail over any conflicting laws including insolvency legislation, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them."

9.8. The FMLC considers that the limitations identified above in the text of the SFD give rise to legal uncertainty as to its application in the context of the failure of a CCP. Amendments to the SFD to remedy such limitations would create a reinforced framework and add to the legal certainty around the application of Article 45; however, the FMLC is of the view that perhaps the most effective way of addressing the legal uncertainty issues relating to the insolvency of a CCP is through a comprehensive and robust cross-border European crisis management framework and insolvency regime (in respect of which the FMLC understands draft legislative proposals in connection therewith are not expected until November 2011, but in respect of which the consultations relating thereto have to date not dealt with CCPs).

10. INTERFERENCE WITH THE AUTOMATIC EARLY TERMINATION ELECTION

10.1. The FMLC notes that Article 45(3) of the Regulation provides that a "CCP shall promptly inform the competent authority where it considers that the CM will not be able to meet its future obligations and before the default procedure is declared or triggered."

10.2. The proposals contained in Article 45(3) create legal uncertainty as to the operation of the automatic early termination election under an ISDA Master Agreement. Where the automatic early termination election has been exercised it would not be possible to comply with Article 45(3) and notify the competent authority *before* the default procedure is triggered as the event of default and early termination procedure would have occurred automatically. The FMLC notes that automatic early termination is important to a CCP's business as it allows transactions to be terminated immediately before the relevant insolvency regime takes effect (which may create greater certainty of netting).

10.3. The FMLC considers that the provisions contained in Article 45(3) create legal uncertainty and undermine a key part of the legal infrastructure supporting a CCP. Article 45(3) should therefore be amended so as not to interfere with the proper operation of the automatic early termination election.

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