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5 November 2012

Mr Ola Ajadi
HM Treasury
1 Horse Guards Road
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Dear Mr Ajadi

Issue 174: Consultation on the implementation of EMIR – Segregation and Porting

The remit of the Financial Markets Law Committee (the "FMLC" or the "Committee"), established by the Bank of England, is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.[1]

The FMLC is of the view that legal uncertainty may arise as to the legal efficacy of the segregation and porting requirements provided for in the Regulation on over-the-counter derivatives, central counterparties ("CCPs") and trade repositories (also known as the European Market Infrastructure Regulation or "EMIR").

Qualifying Collateral Arrangements: The FMLC welcomes the decision to remove from the definition of "qualifying collateral arrangements" in section 155(1A)(e) of Part VII of the Companies Act 1989 ("Part VII"), the possession or control test used in the Financial Collateral Arrangements (No 2) Regulations 2003 (the "FCARs").

The FMLC suggests that the definition of "qualifying collateral arrangements" should be widened to include collateral arrangements created over any property or rights whether by way of title transfer or security. Although it is important to avoid the uncertainties created by the possession or control requirement, the FCARs otherwise provide a useful model to follow in defining collateral arrangements.

There appears to be a potential gap between the new definitions of "qualifying collateral arrangements" and "qualifying property transfers" and the latter definition is unclear whether it is wide enough to cover a transfer made under a porting procedure contained in a CCP's default rules. Unless this potential uncertainty is removed, it could leave a resulting gap in the protection intended to be conferred by sections 158(1), 159(1) & (2), 164(1) & (3) and 165(4) & (5) of Part VII.

This potential gap could be easily avoided by first amending the definition of "qualifying property transfer" to make clear that this includes a transfer of margin and collateral assets (whether together with the original collateral arrangement or free of it); and second, amending the wording of section 155(3C)(b) of Part VII to make clear that it includes a transfer of assets (including margin and collateral assets) made by way of porting under a CCP's default rules.

Definition of "transfer": The FMLC welcomes the decision to expand the term "transfer" in section 190(3A) of Part VII to cover the alternative method of porting by closing out or terminating a client contract with the defaulting clearing member and re-establishing a replacement contract with the transferee. However, the opening words in sub-paragraph (c), namely "in the case of a clearing member client contract or client trade", might be misinterpreted as indicating that this was the only way of porting such contracts. The same

[1] The FMLC is grateful to Geoffrey Yeowart (Hogan Lovells International LLP) and Benedict James (Linklaters LLP) for their comments on this letter.

point arises in relation to section 156(3c)(b)(i) of Part VII. It would be helpful to clarify that the method of closing out, terminating a contract and establishing a replacement contract with a transferee is an alternative to novation and not the sole permitted method of porting.

Protection of "default rules": As recognised by the existing Part VII and the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 ("SFRs"), it is essential that the default arrangements of a CCP are fully protected so that a CCP can confidently operate them in an emergency without fear of challenge. It appears that the new definition of "default rules" may reduce the scope of the existing protection. It would be helpful if the opportunity were taken to conform the definition of "default rules" in Part VII with the wider definition of "default arrangements" in the SFRs.

Recoverability of net profit by the relevant office-holder: It would be useful to make clear that the protection provided by Section 164(4) of Part VII does not apply to any contract made or margin provided under a porting procedure. The exclusion in section 164(5) of Part VII does not go far enough. In particular it does not protect a CCP for margin accepted after the date of notice. Further rights of recovery apply under section 175(5) and (6) of Part VII. These sections are disapplied by regulation 21 of the SFRs and so in order to ensure the same protection for all, the FMLC thinks that provisions similar to regulation 21 of the SFRs should also be included in Part VII.

Priorities and floating charges: Where a market charge is taken (or is recharacterised) as a floating charge, there would generally be several disadvantages. To the extent that a market charge constitutes a "security financial collateral arrangement" for the purposes of the FCARs, then these disadvantages will be inapplicable in relation to the "financial collateral" thereby charged (regulations 8 and 10 of the FCARs). However, it may often be uncertain whether the FCARs apply because of the need to satisfy the control or possession test as discussed above.

If a charge qualifies as "collateral security" under the SFRs, it will benefit from the protections in Part III of the SFRs. However, not all recognised clearing houses and recognised investment exchanges benefit from the protections in Part III of the SFRs and so it would be useful if exclusions similar to those in regulations 14(5) and (6) and 16(3) of the SFRs were added to Part VII.

Part 6 of the Recognition Requirement Regulations ("RRR"):[2] The FMLC welcomes the new approach to state the objectives in high level and more flexible terms. The FMLC has the following comments on the new wording:

1. The requirement in paragraph 2(2)(c) of the RRR that the default rules must ensure that any method of transferring positions and assets is "fair" to clients and indirect clients, is too broadly expressed and would give rise to uncertainty and scope for argument. The requirement ought to be more specific and be confined to ensuring that the default rules comply with article 48 of EMIR.

2. The requirement in paragraph 2(2)(d) of the RRR that the default rules must ensure that any method of transferring position and assets minimises the effect of the transfer on any creditors of the defaulting clearing member who are not a party to the transfer, does not seem appropriate or necessary. It is important that a CCP, in performing its role, should not be exposed to possible claims from such creditors that they have been prejudiced by action taken by the CCP under its default rules. In addition, it is unclear why it is necessary to address the position of creditors. If client accounts and client collateral are treated as subject to a statutory trust in the hands of the defaulting clearing member, they would not form part of its insolvent estate. If no such trust applies, the porting of the client accounts and collateral would automatically remove them from the insolvent estate of the defaulting member. It is difficult to see what could be done in the CCP's default rules to minimise the consequences of this (which is driven by the requirements of EMIR).

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[2] New Part 6 to the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001

Definition of market contract: The definition of "market contract" is of central importance, since the purpose of Part VII is to safeguard not only the operation of financial markets but the transactions carried out on those markets. The definition of "market contract" must be clear and complete in order to achieve legal certainty. Any gap in the definition is likely to result in a gap in the safeguards sought to be provided by Part VII. The FMLC considers that the definition would benefit from further attention. For instance, it is unclear whether or not, for the purposes of the definition of "market contract" in section 155 of Part VII (at sub-section 155(1A)(d)), the provisions of sub-section 155(3)(b) are intended to encompass the totality of contracts entered into between the recognised clearing house and its members – i.e. both the underlying trades (the transaction contracts being cleared) and the agreement to abide by the clearing house rules. The scope of sub-section 155(3)(b) and its intended inter-relationship with some of the other more complex wording in sub-section 155(3) needs to be made clearer. Any gap, overlap or inconsistency should be avoided. A question also arises about the interpretation of the similar provisions in sub-section 155(2)(c). Further clarity in this regard would therefore be welcome.

The SFRs: The FMLC welcomes some of the most recent amendments in this regard, however, the FMLC considers that the following points merit attention in order to ensure maximum legal certainty:

1. Greater legal certainty would be achieved if the definition of "transfer order" in the SFRs was expressed to include a transfer made in accordance with article 48(7) of EMIR;
2. Regulation 14(1) of the SFRs requires amendment to ensure that it covers the same ground as section 159(1) of Part VII;
3. Regulations 16 and 17 of the SFRs require amendment to ensure that they are consistent with the new wording contained in sections 164 and 165 of Part VII;
4. References to "insolvency law" in regulation 2(2) of the SFRs should include references to the Banking Act 2009 and the Investment Bank Special Administration Regulations 2011;
5. As a transfer by way of porting may be carried out after the commencement of insolvency proceedings against the defaulting clearing member, regulation 20 of the SFRs should be amended so that the protections under Part III of the SFRs apply in such cases.

The insolvency of the CCP itself: In the situation of the clearing house itself becoming insolvent there is some uncertainty as to the manner in which sections 159 to 165 of Part VII would apply. The impact of Part VII not in fact applying to the insolvency of the clearing house is that there could potentially be two types of insolvency proceeding being run concurrently (one involving the protection of Part VII and the other using the normal insolvency regime). This could result in different commercial outcomes under the two processes. The FMLC suggests that Part VII is expanded to give identical protection on CCP insolvency as that given in relation to a clearing member.

Protection for default arrangements: Section 159(1) of Part VII provides that the default rules of a recognised clearing house will not be "regarded as to any extent invalid at law on the ground of inconsistency with the law relating to the distribution of assets of a person" in the event of bankruptcy, administration or winding up. It is unclear precisely how far this wording goes. This wording needs to be amended to ensure that it is not given a restrictive meaning. The words "on the ground of inconsistency with the law relating to the distribution of assets of a person" might be altered to read "on the ground of inconsistency with the general law of insolvency applicable".

I would be very happy to discuss the matters raised in this letter with you further. Please do not hesitate to contact me if you would like further information or if you would like to arrange a meeting.

Yours sincerely

Joanna Perkins
FMLC Director